



FINAL DECISION
Jemena 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 Jemena's 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 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 are provided for by the NER 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 their ability to invest in and operate their networks.¹

The NER includes 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, further pass through events may be 'nominated' by a service provider for a regulatory control period.⁴

This attachment sets out our final decision on the nominated pass through events to apply to Jemena's Victorian distribution network 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 Jemena 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) Jemena makes a claim or claims and receives the benefit of a payment or payments under a relevant insurance policy; (b) Jemena incurs costs beyond the policy limit; and (c) the costs beyond the policy limit increase the costs to Jemena in providing direct control services.

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 NER, Chapter 10: Glossary.

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>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 Jemena was regulated; and</p> <p>(e) Jemena will be deemed to have made a claim on a relevant insurance policy if the claim is made by a related party of Jemena in relation to any aspect of the Network or Jemena's business.</p> <p>Note in making a determination on an Insurance Cap Event, the AER will have regard to, amongst other things:</p> <p>(i) the insurance policy for the event</p> <p>(ii) the level of insurance that an efficient and prudent NSP would obtain in respect of the event, and</p> <p>(iii) any assessment by the AER of Jemena's insurance in making its distribution determination for the relevant period.</p>
Insurer credit risk event	<p>An insurer credit risk event occurs if:</p> <p>An insurer of Jemena 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, Jemena:</p> <p>(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</p> <p>(b) incurs additional costs associated with funding an insurance claim, which would otherwise have been covered by the insolvent insurer.</p> <p>Note: In assessing an insurer credit risk event pass through application, the AER will have regard to, amongst other things:</p> <p>(i) Jemena's attempts to mitigate and prevent the event from occurring by reviewing and considering the insurer's track record, size, credit rating and reputation</p> <p>(ii) in the event that a claim would have been made after the insurance provider became insolvent, whether Jemena had reasonable opportunity to insure the risk with a different provider.</p>
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 Jemena in providing direct control services, provided the fire, flood, earthquake or other event was not a consequence of Jemena's acts or omissions.</p> <p>Note: In determining the approved pass through amount for a natural disaster event, the AER will have regard to, amongst other things:</p> <p>(i) whether Jemena has insurance against the event, and</p> <p>(ii) the level of insurance that an efficient and prudent service provider would obtain in respect of the event.</p>
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> <p>(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</p> <p>(b) increases the costs to Jemena of providing direct control services to the</p>

Pass through event	Definition
Retailer insolvency event	<p>extent those costs are not recovered from a third party.</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 Jemena has insurance against the event (ii) the level of insurance an efficient and prudent NSP would obtain in respect of the event, and (iii) whether a relevant government authority has declared that an act of terrorism has occurred. <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>

15.2 Jemena's revised proposal

Our preliminary decision⁵ approved the following nominated pass through events, but did not accept Jemena's proposed definitions:

- insurance cap event
- insurer credit risk event
- natural disaster event
- terrorism event
- retailer insolvency event.

We also approved Jemena's proposal to apply the NER pass through provisions to alternative control services.

⁵ AER, *Preliminary Decision Jemena Distribution Determination 2016 to 2020, Attachment 15 - Pass Through Events*, October 2015.

We did not approve the following events:

- end of metering derogation event
- carbon cost event.

In its revised proposal, Jemena:⁶

- incorporated our alternative definitions of insurance cap event and retailer insolvency event
- did not accept our alternative definitions of insurer credit risk event, natural disaster event or terrorism event, proposing instead the definitions in its original proposal
- accepted our preliminary decision to reject the end of metering derogation event and carbon cost 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:⁷

- 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.⁸ Our final decision must include a decision on the additional (nominated) pass through events that are to apply for the regulatory control period.⁹

⁶ Jemena Electricity Networks, *2016–20 Electricity Distribution Price Review Regulatory Proposal - Revocation and substitution submission*, January 2016, p. 18.

⁷ NER, cl. 6.6.1(a1)(1)–(4). Each of these prescribed events is defined in Chapter 10: Glossary of the NER.

⁸ NER, cl. 6.6.1(a1)(5).

⁹ NER, cl. 6.12.1(14).

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.¹⁰ They also provide incentives to promote economic efficiency.¹¹ Together, they promote a balance between the economic costs and risks of the potential for under and over investment by a service provider, to promote efficient investment.¹² In the context of pass through events, we have particular regard to the impact on price, quality, reliability and security of supply that 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.¹³

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

The *nominated pass through event considerations* are:

(a) whether the event proposed is an event covered by a category of *pass through event* specified in clause 6.6.1(a1)(1) to (4) (in the case of a distribution determination) or clause 6A.7.3(a1)(1) to (4) (in the case of a *transmission determination*);

(b) whether the nature or type of event can be clearly identified at the time the determination is made for the service provider;

(c) whether a prudent service provider could reasonably prevent an event of that nature or type from occurring or substantially mitigate the cost impact of such an event;

(d) whether the relevant service provider could insure against the event, having regard to:

(1) the availability (including the extent of availability in terms of liability limits) of insurance against the event on reasonable commercial terms; or

(2) whether the event can be self-insured on the basis that:

(i) it is possible to calculate the self-insurance premium; and

(ii) the potential cost to the relevant service provider would not have a significant impact on the service provider's ability to provide *network services*; and

¹⁰ NEL, s. 7A(2).

¹¹ NEL, s. 7A(3).

¹² NEL, s. 7A(6).

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

¹⁴ NER, cl. 6.5.10(b); NER Chapter 10: Glossary, definition of 'nominated pass through event considerations'.

(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.¹⁵
- that a pass through event should only be accepted when it is the least inefficient option and event avoidance, mitigation, commercial insurance and self-insurance are found to be inappropriate. That is, it is included after ascertaining the most efficient allocation of risks between a service provider and end customers.¹⁶

In turn, this protects the incentive regime under the NER by limiting the erosion of incentives on service providers to use market based mechanisms to mitigate the cost impacts that would arise.¹⁷ This promotes the efficient investment in, and efficient operation and use of, network services for the long term interests of consumers with respect to price.¹⁸

As a matter of good regulatory practice, one additional matter¹⁹ we take into account is consistency in our approach to assessing nominated pass through events across our electricity determinations and gas access arrangements.²⁰

Another additional matter we take into account²¹ 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.²² 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

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

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

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

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

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

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

²¹ NER, Chapter 10: Glossary, definition of 'nominated pass through event considerations', cl. (e).

²² NER, Chapter 10: Glossary, definitions of 'positive change event' and 'negative change event'.

incurred and is likely to incur over the regulatory control period to its users.²³ 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.²⁴

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:²⁵

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.

...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.²⁶

In making a determination on the amount to be passed through, we must then take into account:²⁷

- 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

²³ NER, cl. 6.6.1(c).

²⁴ NER, cl. 6.6.1(f).

²⁵ AEMC *Cost pass through arrangements for Network Service Providers, Rule Determination*, 2 August 2012, p. 3.

²⁶ NER, Chapter 10: Glossary, definition of 'materially'.

²⁷ NER, cl. 6.6.1(j) / 6A.7.3.

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 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.²⁸

For smaller projects, a service provider should generally utilise its existing expenditure allowance or reprioritise its work program rather than seeking approval of a pass through.²⁹ This is reflected in the materiality threshold that applies to applications for cost pass through determinations.³⁰

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.³¹

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.³²

15.4 Reasons for final decision

Our reasons for our final decisions on Jemena's proposed pass through events are set out below.

²⁸ AEMC, *Cost pass through arrangements for Network Service Providers, Rule Determination*, 2 August 2012, pp. 19–20.

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

³⁰ NER, Chapter 10: Glossary, definition of 'materially'.

³¹ 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.

³² NER, cl. S6.2.1(e)(1)(ii).

15.4.1 Natural disaster event

We accept the inclusion of a natural disaster event and have adopted some but not all of Jemena's modifications to our draft decision definition.

Jemena proposed the following definition in its original proposal and its revised regulatory proposal:³³

Any fire, flood, earthquake, or other natural disaster that occurs during the forthcoming regulatory control period and increases the costs to the DNSP of providing direct control services.

Our preliminary decision accepted the natural disaster event but modified the definition so as to:

- identify certain factors we would consider in assessing a natural disaster pass through claim
- explicitly required that the fire, flood et cetera would have to be 'major' to fall within the definition, and
- exclude disasters caused by the service provider.

Our preliminary decision definition was as follows:³⁴

A natural disaster event occurs if:

Any major fire, flood, earthquake or other natural disaster occurs during the 2016–20 regulatory control period and materially increases the costs to Jemena in providing standard control services,³⁵ 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 DNSP'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 Jemena has insurance against the event,
- ii. the level of insurance that an efficient and prudent NSP would obtain in respect of the event,

³³ Jemena Electricity Networks, *2016-20 Electricity Distribution Price Review, Regulatory Proposal, Revocation and Substitution Submission, Attachment 4-1 Risk Management Framework*, January 2016, p. 14.

³⁴ AER, *Preliminary Decision Jemena Distribution Determination 2016 to 2020 - Attachment 15 - Pass Through Events*, October 2015, p. 15-16.

³⁵ This reference to 'standard control service' instead of 'direct control services' was a drafting error which we have corrected in this final decision.

iii. whether a relevant government authority has made a declaration that a natural disaster has occurred.

In response, Jemena submitted that the adjective 'major' is unclear, inconsistent with the NER and may lead to unjustified inconsistencies in results between DNSPs. As set out in our preliminary decision, the term 'major' was intended to make it clear that the fire, flood et cetera must be of a scale or impact beyond what might be regarded as the service provider's ordinary operating environment. We consider this is entailed by the very concept of a 'natural disaster.' Accordingly, while we do not agree with Jemena's submissions on this issue, we accept that the word 'major' (and the associated definition) need not be included in the approved definition.

Jemena's definition also excludes the word 'materially'. While Jemena did not discuss its reasons, we accept this change as we are satisfied it will not impede the intended operation of this event or its compatibility with the nominated pass through event considerations. It is adequately captured by the materiality threshold that applies to all pass through events under the NER.³⁶

Jemena's proposed definition does not include the proviso in our preliminary decision, that the natural disaster event not be caused by the service provider. Jemena did not make submissions specifically on this. However, we consider it should be included to maintain the incentives on service providers to appropriately manage risks.

Jemena also submitted that consideration of whether a relevant government authority has made a declaration that a natural disaster has occurred was inappropriate. It argued that this may lead to inconsistent application of the event from jurisdiction to jurisdiction (as relevant legislation is not uniform). It also argued that the purpose of such a declaration was unlikely to have bearing on the cost impact of the event on the DNSP and other criteria under the NER. While we do not accept Jemena's arguments on this issue, we are satisfied it is unnecessary to refer explicitly to this factor and have removed it from the definition.

Jemena submitted that the words 'amongst other things' should be removed from the note to the definition. Rule 6.6.1(j) lists a number of 'relevant factors' that, having decided that a positive change event has occurred, we must take into account in making a determination on the approved pass through amount. Sub-rules 6.6.1(j)(1) to (7) list specific matters. Sub-rule 6.6.1(j)(8) requires us to take into account any other matters we consider relevant.³⁷ Jemena submitted that providing a non-exhaustive list of factors is unclear and lacks transparency as it does not identify what those other things might be. However, the list of relevant matters under rule 6.6.1(j) is itself not exhaustive. Nor do we consider it appropriate for us, in providing guidance on what factors may be relevant under sub-rule 6.6.1(j)(8), to purport to make it exhaustive.

³⁶ NER, Chapter 10: Glossary, definitions of 'positive change event', 'negative change event' and 'materially'.

³⁷ The section above on our assessment approach explains the basis on which we consider, in the course of deciding whether to accept a pass through event, factors that may be relevant to our subsequent consideration of an application to pass through cost changes under that event.

Jemena also submitted that including a non-exhaustive list of matters is inconsistent with the nominated pass through considerations, on the basis that we have not notified DNSPs that these factors are nominated pass through considerations. However, we do not consider clause 6.6.1(j)(8) requires the AER to notify the network service provider in the same way that paragraph (e) of the definition of 'nominated pass through event consideration' does. Jemena also objected to those matters we had specifically identified as relevant factors. It submitted that it was redundant and unnecessary to include consideration of whether Jemena had insurance, and the level of that insurance, because:

- we accepted in our preliminary decision that a DNSP may incur costs under this event that an insurance policy would not ordinarily cover
- to the extent relevant, insurance cover is already dealt with under paragraph (d) of the nominated pass through considerations and the matters relevant to assessment of an approved pass through amount in rule 6.6.1(j)(3)
- the setting of an approved total opex allowance includes (explicitly or implicitly) setting a level of insurance a DNSP can purchase given the revenue available and prevailing conditions in the insurance market, so that a later assertion that a different level of cover should be obtained is not appropriate.³⁸

As set out in our preliminary decision, we recognise—both in this context and in our consideration of the insurance cap event—that it may not be prudent or efficient for a DNSP to fully insure against all possibilities. However, we also consider a DNSP should take reasonable steps to insure to the extent that it *is* prudent and efficient to do so. This is clearly reflected in paragraph (d) of the nominated pass through event considerations, which go to whether a nominated pass through event should be approved.

Our revenue determination for Jemena includes a decision on total forecast opex. While expenditure on insurance is opex for the purposes of that decision, we do not set the level of insurance Jemena can purchase. It can make its own decision in that respect. What we will take into account in considering an approved pass through amount is whether that decision—be it more or less insurance than assumed in the total opex forecast—is efficient. For example, a natural disaster pass through event may create a perverse incentive for a service provider 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.

When assessing the amount recoverable under the NER when an approved nominated pass through event has actually occurred, rule 6.6.1(j)(3) requires us to take into account the efficiency of the DNSP's decisions and actions in relation to the risk of the event. We accept that this rule already allows us to consider the efficiency of the

³⁸ Jemena Electricity Networks, *2016-20 Electricity Distribution Price Review, Regulatory Proposal, Revocation and Substitution Submission, Attachment 4-1 Risk Management Framework*, January 2016, p. 14.

DNSP's actions (or failure to act) in respect of insurance. However, given the particular import of paragraph (d) of the nominated pass through event considerations to our approval of the natural disaster event, we do not accept that it is in any way contrary to the NER to provide further clarity and transparency as to how we will do so.

15.4.2 Terrorism event

We accept the inclusion of a terrorism event and we have adopted some but not all of Jemena's modifications to the definition.

Jemena proposed the following definition in both its original and its revised regulatory proposal:³⁹

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 Jemena in providing direct control services, to the extent those costs are not recovered from a third party.

Our preliminary decision allowed a terrorism event but amended the definition to delete the final phrase (about cost recovery from a third party) and identify certain factors we would consider in assessing a terrorism pass through claim. Our alternative definition was:⁴⁰

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 Jemena in providing standard control services.⁴¹

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

(i) whether Jemena has insurance against the event,

³⁹ Jemena Electricity Networks, 2016-20 *Electricity Distribution Price Review, Regulatory Proposal, Revocation and Substitution Submission, Attachment 4-1 Risk Management Framework*, January 2016, p. 18.

⁴⁰ AER, *Preliminary Decision Jemena Distribution Determination 2016 to 2020 - Attachment 15 - Pass Through Events*, October 2015, p. 15–17.

⁴¹ This reference to 'standard control service' instead of 'direct control services' was a drafting error which we have corrected in this final decision. Jemena indicated it supports this correction: Jemena Energy Networks response to information request 50 [email to AER], 29 March 2016, p.3.

(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.

Jemena's revised proposal omits the adjective 'materially' in specifying that the event must increase its costs of providing direct control services. For the same reasons that we have accepted the omission of 'materially' from the definition of the natural disaster event (above), our final decision accepts this element of Jemena's proposed definition.

In its revised proposal Jemena raises similar concerns with our inclusion of matters relevant to our consideration of the approved pass through amount in the definition of this event as it did for the natural disaster event. The reasons we have provided above for rejecting Jemena's arguments regarding the non-exhaustive nature of the matters listed, and the inclusion of considerations regarding insurance, apply equally here.

Jemena further submitted that we should not have regard to whether a relevant government body has declared an act to be a terrorist event. Jemena argued this may lead to inconsistent application of the event across jurisdictions and introduce irrelevant considerations into our decision making. However, a declaration or otherwise is not determinative of whether an occurrence is within the scope of the terrorism event. It may not be straightforward to distinguish between an act of terrorism and a bare crime, particularly since motivation and intent of the perpetrators are key elements. As such, we consider that we are justified in having regard to the deliberations of government authorities with responsibilities and expertise in this field in relation to the occurrence of an act of terrorism.

We invited Jemena to indicate whether it would like us to include the words "to the extent those costs are not recovered from a third party". We noted we were unsure of the practical utility of these words, and that we were disinclined to include it as part of the definition for other Victorian electricity distributors. Jemena advised it would like to keep these words in substitution for other of our identified considerations on the basis that they provide an adequate and appropriate mechanism for taking into account any actual amounts which may be recovered directly by a DNSP from a third party and that this would be a more appropriate criterion to apply than a re-examination of insurance levels or government declarations which are uncertain and potentially inappropriate or irrelevant criteria.⁴² Given Jemena's preference to include the words (i.e. 'to the extent those costs are not recovered from a third party'), we have incorporated them into the definition. However, we maintain that the considerations relating to insurance and government declaration are appropriate for the reasons discussed in the foregoing paragraphs, and we have included them in the note to the definition of terrorism event.

⁴² Jemena Electricity Networks response to information request 50 [email to AER], 29 March 2016, p. 3.

15.4.3 Insurer credit risk event

We accept the inclusion of an insurer credit risk event but have modified Jemena's proposed definition.

Jemena proposed the following definition in both its original and its revised regulatory proposal:⁴³

Insurer credit risk event means the insolvency of the DNSP's insurer, as a result of which the DNSP:

(a) incurs higher or lower costs for insurance premiums than those allowed for in the distribution determination;

(b) in respect of a claim for a risk that would have been insured by the DNSP's insurers, is subject to [a] materially higher or lower claim limit, or a materially higher or lower deductible than would have applied under that policy; or

(c) incurs additional costs associated with self-funding an insurance claim, which would have otherwise been covered by the insolvent insurer.⁴⁴

Our preliminary determination rejected Jemena's definition because it allowed pass through of insurance premium increases. We consider the risk of premium increases is best managed by, and therefore should be borne by, the regulated entity. We also noted the possibility that Jemena's definition could create an incentive to delay the purchase of alternative insurance, thereby transferring the risk of insurable events to customers. We adopted the definition we have approved in recent decisions to address these issues, with a minor amendment to remove a redundant word.⁴⁵ Our definition also identified factors relevant to a determination on an application under the insurer credit risk event.⁴⁶ Our preliminary determination definition was as follows:

An insurer's credit risk event occurs if:

A nominated insurer of Jemena 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, Jemena:

- 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
- incurs additional costs associated with funding an insurance claim, which would otherwise have been covered by the insolvent insurer.

⁴³ Jemena Electricity Networks, *2016-20 Electricity Distribution Price Review, Regulatory Proposal, Revocation and Substitution Submission, Attachment 4-1 Risk Management Framework*, January 2016, p. 9.

⁴⁴ Jemena Electricity Networks, *2016-20 Electricity Distribution Price Review, Regulatory Proposal, Revocation and Substitution Submission, Attachment 4-1 Risk Management Framework*, January 2016, p. 9.

⁴⁵ 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.

⁴⁶ *AER Preliminary Decision Jemena Distribution Determination 2016 to 2020 - Attachment 15 - Pass Through Events*, October 2015, pp. 15-13 to 15-15.

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

- Jemena's 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 Jemena had reasonable opportunity to insure the risk with a different provider.

In response, Jemena submitted that premium increases following the failure of an insurer may be extraordinary and atypical, as demonstrated following the collapse of HIH. Jemena says not allowing pass through of this element is likely to result in it not being able to recover its efficient costs.⁴⁷ We accept that the failure of a large insurer such as what occurred with HIH can have significant implications for the availability and cost of insurance. However, we do not believe this provides a foundation to shift the risk from the regulated firm to its customers. The firm remains best placed to manage risks in the new environment, and therefore should bear the costs of an increase in premiums following the failure of an insurer.

Jemena further submitted that the words 'amongst other things' should be removed from the note to the definition. The reasons we have provided above for rejecting Jemena's arguments regarding the non-exhaustive nature of the matters listed under the natural disaster and terrorism events apply equally here.

Jemena further submitted that the definition should not identify as considerations⁴⁸ its attempts to mitigate and prevent the event or its opportunity to insure the risk elsewhere. However, in making a determination under NER clause 6.6.1(d) we must take into account the efficiency of the DNSP's decisions and actions in relation to the risk of the event, including whether the DNSP has failed to take any action that could reasonably be taken to reduce the magnitude of the pass through amount.⁴⁹ The considerations in our definition are well within the scope of the matters we are required to have regard to, and including them in the definition improves transparency and predictability and provides greater clarity as to what will be covered by the event.

15.4.4 Insurance cap event

We accept the inclusion of an insurance cap event, but have modified the definition in Jemena's revised regulatory proposal.

Our preliminary decision and Jemena's revised proposal define the insurance cap as the greater of:

- (a) the regulated entity's actual policy level, and

⁴⁷ Jemena Electricity Networks, *2016-20 Electricity Distribution Price Review, Regulatory Proposal, Revocation and Substitution Submission, Attachment 4-1 Risk Management Framework*, January 2016, pp. 6–7.

⁴⁸ i.e. considerations relevant to a determination of a pass through amount under NER cl. 6.6.1(d).

⁴⁹ NER cl. 6.6.1(j)(3).

(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.⁵⁰

The second limb is intended 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.

In response to our preliminary decision Jemena conditionally accepted this definition on the basis that:

Having already approved [Jemena's] opex allowance and considered what is the appropriate level of insurance cover (via the definition of "relevant policy limit" [...]) the additional words included in the preliminary decision would not result in a pass through being denied on the basis of hindsight.⁵¹

Comments on the 'operating expenditure' limb of the definition have been made in a number of other regulatory processes. CitiPower objected to defining the relevant policy limit by reference to its approved operating expenditure on the basis that:

- this limb is very uncertain in meaning and effect, as it is impossible to ascertain the allowance for insurance premiums in its approved operating expenditure
- no conclusions were reached as to the efficient and prudent level of insurance when determining CitiPower's forecast operating expenditure for the Preliminary Determination
- the amendments are unnecessary, since the policy objectives are met through clauses 6.6.1(j)(3) and (7) of the NER.⁵²

ActewAGL opposed this limb, arguing that:

the policy limit assumed or provided for in forecasting operating expenditure at the time the access arrangement is approved (putting aside the ambiguity in determining what is implicitly commensurate with the allowance) may be substantially different from a new actual policy limit.⁵³

We accept that a firm's approved operating expenditure may not imply a particular level of insurance cover, and consulted with service providers on two changes to address this issue:

⁵⁰ AER, *Preliminary Decision Jemena Distribution Determination 2016 to 2020 - Attachment 15 - Pass Through Events*, October 2015, pp. 15-11 to 15-13.

⁵¹ Jemena Electricity Networks, *2016-20 Electricity Distribution Price Review, Regulatory Proposal, Revocation and Substitution Submission, Attachment 4-1 Risk Management Framework*, p. 2.

⁵² CitiPower, *Revised Regulatory Proposal 2016-2020*, January 2016, pp. 420–421; also Powercor, *Revised Regulatory Proposal 2016-2020*, January 2016, pp. 412–413.

⁵³ ActewAGL Distribution, *Response to AER's draft determination, 2016-21 ACT, Queanbeyan and Palerang Gas Network Access Arrangement*, January 2016, p. 125.

- (a) deleting the definitional limb referring to approved operating expenditure forecasts, and
- (b) adding to the note a statement that in assessing an application under this event we will have regard to '(iii) any assessment by the AER of Jemena's insurance in approving the distribution determination for the relevant period.'

While other service providers generally supported these modifications, Jemena expressed concerns that the phrase 'any assessment of insurance' is imprecise and uncertain, and stated the wording in the preliminary decision may provide greater certainty and transparency.⁵⁴ However, we consider the additional note on assessment considerations (i.e. the statement that we will have regard to assessments made in the course of approving the distribution determination) will add to transparency rather than detract from it. Accordingly we have incorporated the changes in subparagraphs (a) and (b) above in the definition of insurance cap event for Jemena's distribution determination.

15.4.5 Retailer insolvency event

Retailer insolvency is a category of prescribed pass through event under the NER,⁵⁵ 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.⁵⁶

The prescribed event is not available to Victorian NSPs. Our preliminary decision accepted the inclusion of a nominated pass through event for retailer insolvency, but modified the definition Jemena had proposed because of uncertainty around the NER definition due to a rule change proposal being considered by the AEMC. Our preliminary decision definition was:

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.

⁵⁴ Jemena Electricity Networks, response to information request 50 [email to AER], 29 March 2016, p. 3.

⁵⁵ NER cl. 6.6.1(a1).

⁵⁶ NER, chapter 10: Glossary.

Jemena's revised proposal incorporated that definition, on the basis that:⁵⁷

- the definition only applies until such time as the National Energy Retail Law set out in the Schedule to the *National Energy Retail Law (South Australia) Act 2010* (as amended from time to time) is applied in Victoria
- the term 'retailer' means a holder of a licence to sell electricity under the *Electricity Industry Act 2000* (Vic)
- any amendments to the materiality threshold applicable to this event that arise as a result of a change to the NER (including via a rule change by the AEMC) will apply to the nominated pass through event.

Jemena submitted that if we did not accept this interpretation, it retained the definition set out in its original proposal.

We accept Jemena's interpretation of the retailer insolvency event approved in our preliminary decision. However, in our final decisions for other Victorian DNSPs, we have approved the following alternative definition that more clearly reflects this intention and refers explicitly to the three points Jemena has raised:⁵⁸

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); 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 Retail Law in Victoria.

⁵⁷ Jemena Electricity Networks, *2016-20 Electricity Distribution Price Review, Regulatory Proposal, Revocation and Substitution Submission, Attachment 4-1 Risk Management Framework*, January 2016, p. 20.

⁵⁸ This definition was proposed by CitiPower and Powercor: CitiPower, *Revised Regulatory Proposal 2016–2020*, January 2016, pp. 430-431; Powercor, *Revised Regulatory Proposal 2016–2020*, January 2016, pp. 422–433.

We invited Jemena's comment on this definition. While Jemena supported adjusting the definition to reflect the Victorian legislation, it indicated it would prefer clearer wording, and stated the definition should be expanded to include customers who are exempt from holding a retail licence.⁵⁹

However, we are satisfied the above definition is sufficiently clear, and we consider including exempt retailers in paragraph (a) would be inconsistent with the objective of aligning the nominated retailer insolvency event with the corresponding event prescribed in the NER. A 'retailer', for the purposes of the NER event "means a person who is the holder of a retailer authorisation issued under the National Energy Retail Law in respect of the sale of electricity". It does not include a person who is exempt from that requirement. This narrower definition is consistent with the definition of 'retailer' in Victoria's Electricity Industry Act,⁶⁰ and with the definition of 'licensee' on which the Electricity Industry Act's supplier of last resort provision applies.⁶¹

We have therefore adopted this definition for Jemena's distribution determination.

15.4.6 End of metering derogation event

The metering derogation⁶² varies the application of the NER in Victoria, making distribution business exclusively responsible for metering services for small electricity customers and preventing retailers from providing these services. The derogation will continue until 1 July 2017⁶³ when amendments to the NER take effect providing for a national framework for competition in metering and related services for small customers.⁶⁴

Jemena's regulatory proposal foreshadowed it would have to implement new, or change existing, systems and processes to be ready for the end of the derogation and the new metering contestability framework.⁶⁵ Jemena proposed a pass through event for these costs in the following terms:

An end of the metering derogation event occurs if, as a result of the impending or actual expiry of the Victorian Metering Derogation, the DNSP incurs, or will incur, costs to facilitate the introduction of metering contestability (whether prior to, or subsequent to the expiry of that Derogation) including, but not limited to:

(a) system costs for establishing metering contestability;

⁵⁹ Jemena Electricity Networks response to information request 50 [email to AER], 29 March 2016, p. 3.

⁶⁰ *Electricity Industry Act 2000* (Vic), s. 3: 'Retailer means the holder of a licence to sell electricity otherwise than through the wholesale electricity market'.

⁶¹ *Electricity Industry Act 2000* (Vic), s. 3: Licensee means the holder of a licence issued under Part 2.

⁶² *National Electricity Amendment (Victorian jurisdictional derogation, advanced metering infrastructure) Rule 2013* No. 7.

⁶³ The derogation was originally to expire on 31 December 2016 but was extended by *National Electricity Amendment (Expanding competition in metering and related services) Rule 2015* No. 12.

⁶⁴ *National Electricity Amendment (Expanding competition in metering and related services) Rule 2015* No. 12.

⁶⁵ Jemena, *2016-20 Electricity Distribution Price Review Regulatory Proposal Attachment 5-4 Risk Management Framework*, 30 April 2015, p. 15.

(b) meter provider of last resort costs; and

(c) costs incurred to obtain non-metrology data from meters to enable the distributor to operate its network.

For this end of the metering derogation event, the Victorian Metering Derogation is the derogation currently provided for in clause 9.9C of the Rules pursuant to the National Electricity Amendment (Victorian Jurisdictional Derogation – Advanced Metering infrastructure) Rule 2013 and any subsequent derogation which may be made with similar effect to that in clause 9.9C of the Rules but with a different expiry date.⁶⁶

Our preliminary decision did not approve the end of metering derogation pass through as we considered it likely these would already be within the scope of the regulatory change event or the service standard event.⁶⁷ We also expressed the view that costs incurred prior to the derogation expiring in preparation for metering contestability should be borne by the NSP and not passed on to its monopoly customers.⁶⁸

Jemena's revised regulatory proposal does not include an end of metering derogation event, based on our view that such costs are within the scope of the regulatory change event or the service standard event.⁶⁹ Jemena also stated that the finalisation in November 2015 of new arrangements for metering services⁷⁰ means it can now estimate the magnitude of costs for providing distribution services in a contestable environment, enabling it to seek recovery through its operating expenditure and capital expenditure forecasts. Jemena states that "if this submission is not accepted" it should be allowed to recover the costs it incurs preparing for the new metering contestability framework.⁷¹ In this regard we maintain our draft decision position that it would be open to the DNSP to make a pass through application under the regulatory change event or the service standard event in such circumstances.

⁶⁶ Jemena, *2016-20 Electricity Distribution Price Review Regulatory Proposal Attachment 5-4 Risk Management Framework*, 30 April 2015, p. 2.

⁶⁷ NER cl. 6.6.1(a1)(1) and (2)

⁶⁸ AER, *Preliminary Decision Jemena Distribution Determination 2016 to 2020 - Attachment 15 - Pass Through Events*, October 2015, p. 15-18.

⁶⁹ Jemena Electricity Networks, *2016-20 Electricity Distribution Price Review, Regulatory Proposal, Revocation and Substitution Submission, Attachment 4-1 Risk Management Framework*, January 2016, p. 22.

⁷⁰ *National Electricity Amendment (Expanding competition in metering and related services) Rule 2015* No. 12.

⁷¹ Jemena Electricity Networks, *2016-20 Electricity Distribution Price Review, Regulatory Proposal, Revocation and Substitution Submission, Attachment 4-1 Risk Management Framework*, January 2016, p. 22