



FINAL DECISION
Powerlink transmission
determination
2017–22

Attachment 13 – Pass through
events

April 2017

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Inquiries about this publication should be addressed to:

Australian Energy Regulator
GPO Box 520
Melbourne Vic 3001

Tel: 1300 585 165

Email: [AERInquiry@aer.gov.au](mailto:AERInquiry@ aer.gov.au)

Note

This attachment forms part of the AER's final decision on Powerlink's transmission determination for 2017–22. It should be read with all other parts of the final decision.

This final decision consists of an Overview and 11 attachments. As many issues were settled at the draft decision stage or required only minor updates we have not prepared final decision attachments for:

- Regulatory depreciation
- Operating expenditure; and
- Corporate income tax.

The AER's final decision on these matters is set out in the Overview. For ease of reference the remaining attachments have been numbered consistently with the attachment numbering in our draft decision.

The final decision includes the following documents:

Overview

Attachment 1 – Maximum allowed revenue

Attachment 2 – Regulatory asset base

Attachment 3 – Rate of return

Attachment 4 – Value of imputation credits

Attachment 6 – Capital expenditure

Attachment 9 – Efficiency benefit sharing scheme

Attachment 10 – Capital expenditure sharing scheme

Attachment 11 – Service target performance incentive scheme

Attachment 12 – Pricing methodology

Attachment 13 – Pass through events

Attachment 14 – Negotiated services

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Shortened forms

Shortened form	Extended form
AARR	aggregate annual revenue requirement
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
ASRR	annual service revenue requirement
augex	augmentation expenditure
capex	capital expenditure
CCP	Consumer Challenge Panel
CESS	capital expenditure sharing scheme
CPI	consumer price index
DMIA	demand management innovation allowance
DRP	debt risk premium
EBSS	efficiency benefit sharing scheme
ERP	equity risk premium
MAR	maximum allowed revenue
MRP	market risk premium
NEL	national electricity law
NEM	national electricity market
NEO	national electricity objective
NER	national electricity rules
NSP	network service provider
NTSC	negotiated transmission service criteria
opex	operating expenditure
PPI	partial performance indicators
PTRM	post-tax revenue model
RAB	regulatory asset base
RBA	Reserve Bank of Australia
repex	replacement expenditure
RFM	roll forward model
RIN	regulatory information notice

Shortened form	Extended form
RPP	revenue and pricing principles
SLCAPM	Sharpe-Lintner capital asset pricing model
STPIS	service target performance incentive scheme
TNSP	transmission network service provider
TUoS	transmission use of system
WACC	weighted average cost of capital

13 Pass through events

During the regulatory control period, a service provider can apply to us to pass material changes in its costs arising from pre-defined 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 transmission determinations:²

- a regulatory change event,
- a service standard event,
- a tax change event, and
- an insurance event.

In addition to these prescribed events, other (nominated) pass through events may be specified in a determination for a regulatory control period.³

Our final decision must include a decision on the nominated pass through events that are to apply for the regulatory control period.⁴

This attachment sets out our final decision on the nominated pass through events that will apply to Powerlink for the 2017-22 regulatory control period.

13.1 Final decision

Our final decision is that the nominated pass through events detailed in Table 13-1 will apply to Powerlink for the 2017–22 regulatory control period.

Table 13-1 Pass through events applying to Powerlink for the 2017-22 regulatory control period

Event	Definition
Insurance cap	An insurance cap event occurs if: <ol style="list-style-type: none">1. Powerlink makes a claim or claims and receives the benefit of a payment or payments under a relevant insurance policy;

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

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

³ NER, cl. 6A.7.3(a1)(5).

⁴ NER, cl. 6A.14.1(9).

Event	Definition
	<p>2. Powerlink incurs costs beyond the relevant policy limit of the relevant insurance policy at the time of the event that gives rise to the relevant claim; and</p> <p>3. The costs beyond the relevant policy limit materially increase the costs to Powerlink of providing prescribed transmission services.</p> <p>For this Insurance Cap Event:</p> <p>4. The relevant policy limit is the greater of:</p> <p>(a) Powerlink’s actual policy limit at the time of the event that gives, or would have given rise to a claim; and</p> <p>(b) the policy limit that is explicitly or implicitly commensurate with the allowance for insurance premiums that is included in the forecast operating expenditure allowance approved in the AER’s final decision for the regulatory period in which the insurance policy is issued.</p> <p>5. A relevant insurance policy is an insurance policy held during the 2017/18 to 2021/22 regulatory control period or a previous regulatory control period in which Powerlink was regulated, and</p> <p>6. Powerlink will be deemed to have made a claim on a relevant insurance policy if the claim made by a related body corporate of Powerlink in relation to any aspects of Powerlink’s prescribed transmission services.</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 Powerlink’s insurance documented in respect of its transmission determination for the relevant period.</p>
Terrorism event	<p>A terrorism event is:</p> <p>An act (including, but not limited to, the use of force or violence or the threat of force or violence) of any person or group of persons (whether acting alone or on behalf of or in connection with any organisation or government), which from its nature or context is done for, or in connection with, political, religious, ideological, ethnic or similar purposes or reasons (including the intention to influence or intimidate any government and/or put the public, or any section of the public, in fear) and which increases the costs to Powerlink in providing prescribed transmission services.</p> <p>Note: In assessing a terrorism event pass through application, the AER will have regard to, amongst other things:</p> <p>(i) whether Powerlink has insurance against 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) Whether a declaration has been made by a relevant government authority that an act of terrorism event has occurred.</p>
Insurer credit risk event	<p>An insurer credit risk event occurs if:</p> <p>A nominated insurer of Powerlink becomes insolvent, and as a result, in respect of an existing, or potential, claim for a risk that was insured by the insolvent insurer, Powerlink:</p>

Event	Definition
	<ul style="list-style-type: none"> i. is subject to a materially higher or lower claim limit or a materially higher or lower deductible than would have otherwise applied under the insolvent insurer's policy; or ii. Incurs additional costs associated with self-funding an insurance claim, which would otherwise have been covered by the insolvent insurer.
	<p>Note: In assessing an insurer's credit risk event pass through application, the AER will have regard to, amongst other things:</p>
	<ul style="list-style-type: none"> (a) Powerlink's attempts to mitigate and prevent the event from occurring by reviewing and considering the insurer's track record, size, credit rating and reputation, and (b) In the event that a claim would have been made after the insurance provider became insolvent, whether Powerlink had reasonable opportunity to insure the risk with a different provider.

13.2 Powerlink's revised proposal

Our draft decision approved Powerlink's proposed insurer's credit risk event. We also approved Powerlink's proposed insurance cap and terrorism event with minor amendments.

In its revised proposal, submitted on 1 December 2016, Powerlink accepted our draft decision on pass throughs. In its revised proposal Powerlink highlighted the need to correct the regulatory period in the definition of the insurance cap event for the final decision.

13.3 Our assessment approach

The NER set out how we must assess an application from a service provider to pass through changes in costs where an event occurs.⁵

Our approach to assessing nominated pass through events proposed by service providers is guided by the National Electricity Objective (NEO) and the Revenue and Pricing Principles. These provide the service provider with a reasonable opportunity to recover at least the efficient costs incurred in providing services and complying with its obligations.⁶ They also provide incentives to promote economic efficiency.⁷ 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.⁸ 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

⁵ NER, cl. 6A.7.3.

⁶ NEL, s. 7A(2).

⁷ NEL, s. 7A(3).

⁸ NEL, s. 7A(6).

efficient operation of, and ability and incentive of, a service provider to invest in its network.⁹

In determining whether we accept a nominated pass through event, we must take into account the nominated pass through event considerations:¹⁰

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

⁹ NEL, s. 7; AEMC 2012, *Cost pass through arrangements for Network Service Providers, Rule Determination*, 2 August 2012, Sydney, p. 6.

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

unavailable. That is, a cost pass through event is the least efficient option for managing the risk of unforeseen events.¹¹

- 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.¹²

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.¹³ 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,¹⁴ in accordance with the NEO and Revenue and Pricing Principles.

As a matter of good regulatory practice, one additional matter¹⁵ we take into account is consistency in our approach to assessing nominated pass through events across our electricity determinations and gas access arrangements.¹⁶

13.3.1 Interrelationships

The pass through mechanism is not the only way in which service providers can manage their risks under a transmission determination. It is interrelated with other parts of this decision, in particular with the forecast opex and capex and rate of return included in our revenue determination. These interrelationships require us to balance the incentives in the various parts of our decision.

For systemic risks, service providers are compensated through the allowed rate of return. Service providers also face business-specific, or residual, risks. Service providers are compensated for the prudent and efficient management of these risks through the forecast opex and capex we include in our revenue determination for strategies such as:

- prevention (avoiding the risk)
- mitigation (reducing the probability and impact of the risk)
- insurance (transferring the risk to another party)

¹¹ AEMC 2012, *Cost pass through arrangements for Network Service Providers, Rule Determination*, 2 August 2012, Sydney, p. 19.

¹² AEMC 2012, *Cost pass through arrangements for Network Service Providers, Rule Determination*, 2 August 2012, Sydney, p. 20.

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

¹⁴ AEMC 2012, *Cost pass through arrangements for Network Service Providers, Rule Determination*, 2 August 2012, Sydney, p.8.

¹⁵ NER, Chapter 10: Glossary, definition of 'nominated pass through event considerations', cl. (e).

¹⁶ AEMC 2012, *Cost pass through arrangements for Network Service Providers, Rule Determination*, 2 August 2012, Sydney, p. 18.

- 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.¹⁷

In general, in respect of smaller projects a service provider should be using up its existing expenditure allowance, or reprioritising or substituting its projects, to avoid seeking cost recovery through the pass through mechanisms.¹⁸ This is reflected in the materiality threshold that applies to applications for cost pass through determinations.¹⁹

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.²⁰

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.²¹

13.4 Reasons for final decision

In this section we set out the reasons for our final decisions on each of Powerlink's proposed pass through events.

Our final decision accepts Powerlink's proposed insurance cap event (including its correction to the regulatory control period), terrorism event and insurer credit risk event, as set out in its revised proposal.

We are satisfied that these three nominated pass through events satisfy the matters set out in the nominated pass through event considerations because:

- these events are not covered by the prescribed pass through events under the NER.²²

¹⁷ AEMC 2012, *Cost pass through arrangements for Network Service Providers, Rule Determination*, 2 August 2012, Sydney, pp. 19–20.

¹⁸ AEMC 2012, *Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services, Final Position Paper*, 29 November 2012, Sydney, p. 186.

¹⁹ NER, Chapter 10: Glossary, definition of 'materially'.

²⁰ 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.

²¹ NER, cl. S6A.2.1(f)(1)(ii).

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

- the nature and type of events can be clearly identified at the time of our decision, and where there is room for doubt appropriate parameters can be applied through our assessment of a pass through application.²³
- while a prudent service provider could take steps to reduce the likelihood of these events and the cost impact of the events should they occur,²⁴ and could insure or self-insure against the event,²⁵ expenditure beyond a certain point (e.g. to eliminate, rather than manage, risk) is likely to be imprudent or inefficient. In such circumstances we consider a sharing of risk between Powerlink and its customers is appropriate and more likely to be in the long term interest of consumers with respect to price.

²³ NER, Chapter 10: Glossary, definition of 'nominated pass through event considerations', cl. (b).

²⁴ NER, Chapter 10: Glossary, definition of 'nominated pass through event considerations', cl. (c).

²⁵ NER, Chapter 10: Glossary, definition of 'nominated pass through event considerations', cl. (d).