



2016–2020 Price Reset

**Appendix L
Managing uncertainty**

April 2015

CitiPower
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1 Summary

CitiPower operates in an uncertain environment. Uncontrollable external events can alter the quantity and nature of services required to be provided to its customers.

In establishing the uncertainty regime, the Australian Energy Market Commission (**AEMC**) noted that in a normal competitive environment, production and pricing behaviour would adjust to respond to these changes where efficient producers can recover their costs and should generally earn at least a normal return on their investments. The regulatory arrangements, including the uncertainty regime, attempt to mimic the competitive market by allowing the Distribution Network Service Providers (**distributors**) to alter their production behaviour to meet market demand and undertake unexpected investment in new network capacity.¹

The 'uncertainty regime' under the National Electricity Rules (**Rules**) comprises:

- pass through events;
- capital expenditure (**capex**) reopeners; and
- contingent projects.

These mechanisms deal with expenditure that is required to be undertaken during a regulatory control period but which is not able to be predicted with reasonable certainty at the time of preparing or submitting a regulatory proposal to the Australian Energy Regulator (**AER**) for the start of the next regulatory control period.

Contingent projects are intended to apply to a matter which is more specific to a particular business and more likely to occur than a cost pass through.² CitiPower is not proposing any contingent projects in this Regulatory Proposal.

Capex reopeners are intended to perform a different function to cost pass throughs, being to afford protection for 'large, shipwreck-type events' that are more difficult to predict and to fully provide for as cost pass throughs, and 'to be subordinate to cost pass throughs'.³ That is, the introduction of capex reopeners to Chapter 6 of the Rules in 2012 has no bearing on the AER's decision whether to specify an event as a nominated pass through event in the distribution determination.

In making CitiPower's distribution determination, the AER is required to make constituent decisions in respect of the contingent projects for the purposes of the distribution determination and the additional pass through events that are to apply for the regulatory control period in accordance with clause 6.5.10 of the Rules (**nominated pass through events**).⁴ In addition, the AER is required to make a constituent decision on the form of the control mechanisms for alternative control services

¹ AEMC, *Rule Determination National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012*, 29 November 2012, p. 182, available from: <http://www.aemc.gov.au/Rule-Changes/Economic-Regulation-of-Network-Service-Providers>. See also AEMC, *Rule Determination National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006 No. 18*, 16 November 2006, pp. 54 and 104.

² AEMC, *Rule Determination National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012*, 29 November 2012, p. 186.

³ AEMC, *Rule Determination National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012*, 29 November 2012 p. 186, available from: <http://www.aemc.gov.au/Rule-Changes/Economic-Regulation-of-Network-Service-Providers>; AEMC, *Rule Determination National Electricity Amendment (Cost pass through arrangements for Network Service Providers) Rule 2012*, 2 August 2012, p. ii.

⁴ Clause 6.12.1(4A) and (14) of the Rules.

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and the formulae that give effect to those control mechanisms.⁵ In respect of CitiPower's distribution determination, that decision includes a decision on the formulae to enable cost pass throughs for alternative control services.

The AER is not required (or empowered) to make any decision in respect of capex reopeners in making a distribution determination. Accordingly, it is unnecessary for CitiPower to address this element of the uncertainty regime in this chapter.

In this chapter, CitiPower proposes the following pass through events be specified in its distribution determination as nominated pass through events, in addition to those events specified in the Rules (namely a regulatory change event; a service standard event; a tax change event and a retailer insolvency event).

Table 1.1 Proposed nominated pass through events

Pass through event	Description
An insurer credit risk event	The insolvency of an insurer of the distributor
An insurance event	Exposure to the risk of incurring liabilities above the insurance caps
Natural disaster event	Occurrence of natural disasters such as floods, earthquakes, major storms and bushfires
A terrorism event	Occurrence of an act of terrorism
Ending of the metering derogation event	The existing metering derogation that provides exclusivity for Victorian distributors providing metering services to residential and small customers ends, leading to metering contestability
Multiple trading relationships event	An event to capture the costs incurred should CitiPower be required to change the manner in which it interacts with meters and customers
Retailer failure event	To enable CitiPower to pass through costs (including unpaid charges for the provision of direct control services) it incurs as a result of the insolvency of a retailer

Source: CitiPower

CitiPower proposes that, in making its constituent decision on the formulae for the control mechanisms for alternative control services, the AER apply the pass through provisions in the Rules for specified and nominated pass through events to alternative control services, and that, in so doing, the materiality threshold be modified when applied to alternative control services.

⁵ Clause 6.12.1(12) of the Rules.

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2 Nominated pass through events

The regulatory framework recognises that a distributor cannot reasonably be expected to forecast costs (capital and/or operating expenditure) for all foreseen and unforeseen events over the regulatory control period. The regulatory framework addresses this issue by including a cost pass through mechanism, which allows distributors to seek the AER's approval to recover (or pass through) the costs (or savings) of defined, unpredictable, high cost event(s) for which the distribution determination does not provide a regulatory allowance.⁶

The inclusion of a pass through mechanism provides a means for distributors to recover the efficient costs of events that could not be forecast as part of their regulatory proposals. Without such a mechanism, the occurrence of such events would have a significant financial effect on the ability of distributors to invest in and operate their networks.⁷ The occurrence of a pass through event does not mean that a distributor can automatically pass through the costs of the event to distribution network users. Under the pass through mechanism in the Rules, a distributor must apply to the AER for approval to pass through a positive pass through amount.⁸ A distributor may only seek to pass through the costs of a pass through event, including a nominated pass through event, where the event results in a distributor incurring materially higher costs in providing direct control services, than it would have incurred but for that event.⁹

Further, in determining whether to approve a positive pass through amount the AER is required to take into account a number of factors, including the efficiency of the distributor's decisions and actions in relation to the risk of the pass through event (including actions taken to reduce the magnitude of the pass through amount).¹⁰ As such, in relation to each pass through event specified in clause 6.6.1(a1)(1) to (4) of the Rules and nominated in CitiPower's distribution determination, CitiPower retains its incentive to operate efficiently and mitigate its increased costs.

While the AEMC has recently observed that the incentive properties of cost pass throughs are nonetheless weak relative to those for operating expenditure captured in the building blocks,¹¹ it recognised, at the same time, that the specification of nominated pass through events is necessary to ensure that Network Service Providers (**NSPs**) are provided with the opportunity to recover their efficient costs where those costs result from unforeseen and uncontrollable events for which insurance is limited or not available on commercial terms and self-insurance is not appropriate.¹² In the absence of cost pass throughs in these circumstances, the AEMC recognised, efficient

⁶ The pass through mechanism is contained in clause 6.6.1 of the Rules.

⁷ AEMC, *Rule Determination National Electricity Amendment (Cost pass through arrangements for Network Service Providers) Rule 2012*, 2 August 2012, pp. 2 and 9.

⁸ Clause 6.6.1(a) of the Rules.

⁹ Under clause 6.6.1 of the Rules, a distributor may only seek to recover the costs of a 'positive change event' which is defined in Chapter 10 of the Rules to mean a pass through event that results in a distributor incurring materially higher costs in providing direct control services than it would have incurred but for the event. The term 'materially' is defined in Chapter 10 of the Rules for the purposes of the term 'positive change event' by reference to 1 per cent of the distributor's annual revenue requirement for any regulatory year in which the distributor incurs or is likely to incur costs as a result of the relevant event.

¹⁰ Clause 6.6.1(j) of the Rules.

¹¹ AEMC, *Rule Determination National Electricity Amendment (Cost pass through arrangements for Network Service Providers) Rule 2012*, 2 August 2012, p. 3.

¹² AEMC, *Rule Determination National Electricity Amendment (Cost pass through arrangements for Network Service Providers) Rule 2012*, 2 August 2012, pp. 18-19.

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investment in, and efficient operation of, a distributor's network would likely be adversely affected over the long term contrary to the National Electricity Objective (**NEO**).¹³ That is, the specification of a nominated pass through event is necessary and contributes to the achievement of the NEO where that event is consistent with the nominated pass through event considerations.

2.1 Rules requirements

Clause 6.5.10(a) of the Rules provides that a building block proposal may include a proposal as to the events that should be defined as pass through events under clause 6.6.1(a1)(5) having regard to the nominated pass through event considerations.

Clause 6.12.1(14) of the Rules in turn provides that one of the constituent decisions on which the distribution determination is predicated is a decision on the additional pass through events that are to apply for a regulatory control period in accordance with clause 6.5.10. Clause 6.5.10(b) of the Rules requires the AER, in making this constituent decision, to take into account the nominated pass through event considerations.

The 'nominated pass through event considerations' are relevantly defined in Chapter 10 of the Rules to be:

- 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);
- 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 NSPs is a nominated pass through event consideration.

As at the date of this proposal, the AER has not notified CitiPower of any other matter that is a nominated pass through event consideration.

For the purposes of paragraph (a) of the nominated pass through event considerations, clause 6.6.1(a1)(1)-(4) of the Rules specifies the following pass through events:

- a regulatory change event;
- a service standard event;
- a tax change event; and

¹³ AEMC, *Rule Determination National Electricity Amendment (Cost pass through arrangements for Network Service Providers) Rule 2012*, 2 August 2012, p. 18.

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- a retailer insolvency event.

The definition of each of these events is set out in Chapter 10 of the Rules, and summarised below.

- A *regulatory change event* is defined to be a change in regulatory obligation or requirement that:
 - falls within no other category of *pass through event*; and
 - occurs during the course of a *regulatory control period*; and
 - substantially affects the manner in which the distributor provides *direct control services* (as the case requires); and
 - *materially* increases or *materially* decreases the cost of providing those services.
- A *service standard event* is defined to be a legislative or administrative act that:
 - has the effect of substantially varying, during the course of a *regulatory control period*, the manner in which a distributor is required to provide a *direct control service*; or
 - has the effect of imposing, removing or varying, during the course of a regulatory control period, minimum service standards applicable to direct control services; or
 - has the effect of altering, during the course of a regulatory control period, the nature or scope of the direct control services, provided by the service provider; and
 - *materially* increases or *materially* decreases the cost to the service provider of providing direct control services.
- A *tax change event* is defined to occur:
 - if any of the following occurs during the course of a regulatory control period for a distributor:
 - a change in a *relevant tax*, in the application or official interpretation of a *relevant tax*, in the rate of a *relevant tax*, or in the way a *relevant tax* is calculated;
 - the removal of a *relevant tax*; or
 - the imposition of a *relevant tax*; and
 - in consequence, the costs to the service provider of providing *direct control services* are materially increased or decreased.
- A *retailer insolvency event* is defined as the failure of a *retailer* during a *regulatory control period* to pay a distributor an amount to which the service provider is entitled for the provision of *direct control services*, if:
 - an *insolvency official* has been appointed in respect of that *retailer*; and
 - the distributor is not entitled to payment of that amount in full under the terms of any *credit support provided* in respect of that *retailer*.

In addition, the AER must:

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- perform or exercise a function or power under the National Electricity Law (**NEL**) or the Rules that relates to the making of a distribution determination in a manner that will or is likely to contribute to the achievement of the NEO;¹⁴ and
- in making a distribution determination, if there are two or more decisions that will or are likely to contribute to the achievement of the NEO, the AER must make the decision that it is satisfied will or is likely to contribute to the achievement of the NEO to the greatest degree.¹⁵

Finally, the AER must take into account the revenue and pricing principles when exercising a discretion in making those parts of a distribution determination relating to direct control network services.¹⁶ The revenue and pricing principles are set out in section 7A of the NEL and relevantly include:

(2) A regulated network service provider should be provided with a reasonable opportunity to recover at least the efficient costs the operator incurs in-

(a) providing direct control network services; and

(b) complying with a regulatory obligation or requirement or making a regulatory payment.

(3) A regulated network service provider should be provided with effective incentives in order to promote economic efficiency with respect to direct control network services the operator provides. The economic efficiency that should be promoted includes-

(a) efficient investment in a distribution system ... with which the operator provides direct control network services; and

(b) the efficient provision of electricity network services; and

(c) the efficient use of the distribution system ... with which the operator provides direct control network services.

...

(5) A price or charge for the provision of a direct control network service should allow for a return commensurate with the regulatory and commercial risks involved in providing the direct control network service to which that price or charge relates.

The revenue and pricing principles in section 7A can be taken to be consistent with and to promote the objectives in section 7.

2.2 CitiPower's proposal

As set out above, CitiPower nominates the following pass through events for inclusion in its distribution determination:

- an insurer credit risk event;
- an insurance event;
- a natural disaster event;
- a terrorism event;

¹⁴ NEL, section 16(1)(a) and section 2(1) definition of 'AER economic regulatory function or power'.

¹⁵ NEL, section 16(1)(d) and sections 2(1) and 71A definitions of 'reviewable regulatory decision'.

¹⁶ NEL, section 16(2)(a).

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- an ending of the metering derogation event;
- a multiple trading relationships event; and
- a retailer failure event.

CitiPower explains each of these events and how they satisfy the nominated pass through event considerations below.

2.2.1 Insurer credit risk event

This event is contained within CitiPower's distribution determination for the 2011-2015 regulatory control period.

CitiPower has in place a number of mitigation strategies to avoid being in a situation where one of its insurers becomes insolvent. In particular, CitiPower seeks to mitigate the risk of any insurers becoming non-viable by regular monitoring and reporting by AON of each insurer's Standard & Poor (**S&P**) or equivalent credit rating movements. CitiPower's minimum acceptable insurer S&P rating is A minus. If an insurer rating changes below the S&P or equivalent A minus rating, CitiPower's Risk Management & Compliance Committee has the discretion to:¹⁷

- approve continued use of an insurer that does not have an A minus rating. The decision to do this is only taken after consideration of financial analysis, which includes but is not limited to, size of paid up capital and shareholder funds, amount of gross reinsurance and the quality of the reinsurance; or
- move away from an insurer that falls below the A minus rating. In doing so a remedial strategy is prepared and reviewed/approved by CitiPower's Chief Executive Officer (**CEO**) and this strategy outlines timing associated with moving away from the insurer in question. It is safe to say that the objective is to move away from the insurer as quickly as possible.

In addition, for selected key policies such as General Liability insurance, CitiPower takes out insurance with multiple insurers, therefore spreading the risk amongst several insurers and minimising the reliance on any one insurer.

The risk of one of CitiPower's insurers becoming insolvent is, thus, very low but nonetheless not improbable. Despite acting prudently in selecting an insurance provider, an insurer may still fail. For example, HIH Insurance was placed into liquidation in 2001; similarly AIG faced a liquidity crisis during the global financial crisis but was bailed out by the US Government. While such events are infrequent, they can occur and the risk of an insurer failing is beyond the control of CitiPower. Consequently, to ensure that CitiPower has the opportunity to recover at least its efficient costs, it proposes that its distribution determination continues to include an 'insurer credit risk event'.

CitiPower proposes that an 'insurer credit risk event' is defined as:

An insurance credit risk event occurs if, as a result of the insolvency of an insurer, the distributor:

- (a) incurs higher or lower costs for insurance premiums;*
- (b) in respect of a claim for a risk that would have been insured by the distributor's insurers, is subject to a higher or lower claim limit or a higher or lower deductible than would have otherwise applied under the relevant policy; and/or*

¹⁷ Refer: VPN, *Insurance Management Policy Appendix C: Insurance Credit Management Policy*.

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

Insurer credit risk event satisfies nominated pass through event considerations

Such an event is consistent with the nominated pass through event considerations, as CitiPower notes the following:

- the event is not covered by a category of pass through event specified in clause 6.6.1(a1)(1) to (4) of the Rules;
- the nature or type of event can be clearly identified at the time of the determination for the distributor, as evidenced by the fact that the AER has previously included this event in CitiPower’s 2011-2015 distribution determination;
- while CitiPower takes all prudent steps to assess the viability of actual and potential insurers and to use only those providers that are expected to have the capacity to satisfy any claims under a policy (as discussed in greater detail above), it remains the case that it could not reasonably prevent the occurrence of an insurer credit risk event (as defined above) or substantially mitigate the cost impact of such an event. The AER has itself expressly recognised that this is so, in accepting the insurer credit risk event as a nominated pass through event for all Victorian distributors in the 2011–2015 regulatory control period.¹⁸ There has been no change in circumstances that would justify the making of a different factual finding in respect of the present distribution determination; and
- CitiPower has not identified insurance for insurer credit risk failure available on reasonable commercial terms. Due to the low probability of the event occurring, it is not possible to calculate a self-insurance premium.

While the AER noted, in accepting an insurer credit risk event as a nominated pass through event for Aurora Energy for the 2012/13–2016/17 regulatory control period, that it may be possible for a distributor to affect the occurrence of such an event, by selecting a cheap but unstable insurance company, it correctly noted that, as part of the criteria for approving actual pass through costs, it could permissibly take into account whether the distributor could have done anything to mitigate the costs.¹⁹

CitiPower considers that the proposed nominated pass through event is consistent with the NEO and the revenue and pricing principles in the NEL, as it ensures that CitiPower is not placed in a position where it is unable to mitigate or avoid the event without creating unacceptable risks, and provides a reasonable opportunity to recover its efficient costs. Further, the inclusion of an insurer credit risk event means that consumers only bear the risk should such an event occur and satisfy the provisions for the approval of pass through amounts in clause 6.6.1 of the Rules, rather than, for example, funding excessive and potentially unnecessary insurance premiums.

Significantly, the AER has previously recognised that the specification of an insurer credit risk event in a distribution determination is consistent with the regulatory regime and its object, reasoning as

¹⁸ AER, *Draft decision Victorian electricity distribution network service providers Distribution determination 2011-2015*, June 2010, p. 725.

¹⁹ AER, *Draft Distribution Determination – Aurora Energy Pty Ltd 2012-13 to 2016-17*, November 2011, p. 287. The AER confirmed its decision to nominate the insurer credit risk event in its final determination - AER, *Final Distribution Determination - Aurora Energy Pty Ltd 2012-13 to 2016-17*, April 2012, p. 183.

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follows in allowing that event for all Victorian distributors in the 2011–2015 regulatory control period.²⁰

The AER accepts that the occurrence of increased insurance premiums (or deductibles) from external insurers (where the original insurer becomes insolvent) is largely beyond the control of the DNSP (subject to any choice that the DNSP has with regards to insurance companies), and that the costs associated with higher insurance premiums are also beyond the control of the DNSP (in that they cannot be mitigated). The AER acknowledges that such costs should be allowed in the regulatory regime.

Following an insurer credit risk event, insurance premiums and/or deductibles may increase because of a negative shock to industry capital. As Cagle and Harrington note:²¹

It may be very costly for insurers to issue new equity immediately following a negative shock to capital because of agency costs, such as those that arise from asymmetrical information in capital markets. The decline in capital may thus constrain the capacity to write coverage; i.e., it may cause the supply curve for existing firms to shift backward. If immediate and substantial supply by new entrants is infeasible, the resulting increase in price will provide at least partial shifting of the cost of the shock to policyholders.

Accordingly, a negative shock to insurance industry capital could cause premiums and/or deductibles to increase, at least temporarily. If any change in premium and/or deductibles does not give rise to a material change in CitiPower's costs, for example because that change in premium and/or deductibles is only temporary, then CitiPower will not be able to pass through the cost consequences of that change in premium and/or deductibles as the insurer credit risk event will not, in those circumstances, constitute a 'positive change event' for the purposes of clause 6.6.1 of the Rules.

2.2.2 Insurance event

CitiPower considers that the most efficient and appropriate means of managing its exposure to the risk of incurring liabilities above its insurance limits/caps is via the pass through mechanism.

CitiPower has an incentive to choose the most efficient mix of risk mitigation mechanisms, and has recently reviewed its level of insurance cover for all insurance categories. CitiPower considers that its level of insurance cover is appropriate, taking into account the probability of an insurance event occurring, the financial consequence of any such event occurring, and the cost and availability of insurance in the market.

The probability of an insurance event occurring that results in liability above the insurance cap is very low, however to continue to manage the risk, CitiPower proposes to continue to include an 'insurance event' in its distribution determination.

The 'insurance event' would allow CitiPower to recover material costs incurred in excess of its insurance claim limit. It would protect CitiPower from high cost impact events which would be

²⁰ AER, *Draft decision Victorian electricity distribution network service providers Distribution determination 2011-2015*, June 2010, p. 725. In its final decision, the AER accepted the 'insurer credit risk event' as a nominated pass through event, modifying the definition of that event to also cover distributors in the event that the insolvency of one of its insurers results in that insurer not being able to pay out under an insurance policy: AER, *Final decision Victorian electricity distribution network service providers Distribution determination 2011-2015*, October 2010, pp. 783-784.

²¹ Cagle J. and Harrington S., *Insurance supply with capacity constraints and endogenous insolvency risk*, *Journal of Risk and Uncertainty*, Vol. 11 Issue 3, December 1995, pp. 219-220.

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uneconomical to insure, while at the same time benefiting consumers because they are not required to fund excessive premiums where insurance, if available, would be uneconomic. Consumers then only bear the risk should an ‘insurance event’ occur.

CitiPower would continue to have an incentive to mitigate the risks associated with the ‘insurance event’ including through acquiring appropriate levels of insurance and implementing other risk minimisation strategies because, if such an event were to occur, the AER could consider the efficiency of CitiPower's decisions and actions in assessing its application for pass through in accordance with clause 6.6.1(j)(3) of the Rules.

While an ‘insurance event’ is contained in CitiPower’s 2011-2015 distribution determination, CitiPower's proposed definition of an ‘insurance event’ for the purposes of the 2016–2020 distribution determination takes into account the outcome of the AER’s amendment to the definition of the event for SP AusNet (now AusNet Services) following its successful appeal to the Australian Competition Tribunal.²²

CitiPower proposes that an ‘insurance event’ is defined as:

An ‘insurance event’ occurs if:

- (a) the distributor makes a claim on a relevant insurance policy; and*
- (b) the distributor incurs costs beyond the relevant policy limit.*

For the purposes of this insurance event:

- (a) the relevant policy limit is the distributor’s actual policy limit at the time of the event that gives rise to the claim; and*
- (b) a relevant insurance policy is an insurance policy held during the 2016-2020 regulatory control period or a previous regulatory control period in which CitiPower was regulated.*

Insurance event satisfies nominated pass through event considerations

Such an event is consistent with the nominated pass through event considerations, as:

- the event is not covered by a category of pass through event specified in clause 6.6.1(a1)(1) to (4) of the Rules;
- the nature or type of event can be clearly identified at the time of the determination for the distributor. The AER has recognised this in including this event in CitiPower’s 2011-2015 distribution determination;
- the extent to which CitiPower can reasonably prevent a claim occurring which exceeds its insurance cap, or can take steps to mitigate incurring costs above the cap, is limited;
- CitiPower has obtained efficient levels of insurance cover which are commensurate with an assessment of its business risk. However, the coverage of such insurance is typically capped, with levels of cover above the cap typically requiring higher, uneconomic premiums; and
- including an insurance cap event as a pass through event represents a more appropriate means for managing CitiPower’s risk exposure to such an event than self-insurance given:

²² AER, *SPI Electricity Pty Ltd, Distribution Determination 2011–15*, August 2013; AER, *Final Decision SPI Electricity Pty Ltd 2011-15 Distribution Determination Insurance Pass Through Event*, April 2013 (pursuant to Orders of the Australian Competition Tribunal in Application by United Energy Distribution Pty Limited [2012] ACompT 8, April 2013).

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- the complexity associated with developing credible self insured risk quantifications for very low probability events, such as those that are above existing liability limits/caps; and
- that such an event is likely to be catastrophic in nature and have a significant financial impact on CitiPower.

CitiPower considers that the proposed nominated pass through event is consistent with the NEO and the revenue and pricing principles in the NEL. Having the insurance event as a nominated pass through event in its distribution determination would protect CitiPower from high cost impact events that are uneconomical and not prudent or efficient to insure against. It ensures that CitiPower is not placed in a position where it is unable to mitigate or avoid the event without creating unacceptable risks, and provides a reasonable opportunity to recover its efficient costs. Consumers also benefit from the inclusion of such a pass through event because they are not required to fund excessive insurance premiums where insurance, if available, would be uneconomic. Further, consumers only bear the risk should an insurance event occur and satisfy the provisions for the approval of pass through amounts in clause 6.6.1 of the Rules.

2.2.3 Natural disaster event

A natural disaster event is contained within CitiPower's distribution determination for the 2011-2015 regulatory control period, after it was nominated by the AER in its draft determination in respect of that period.

In that draft determination, the AER noted that:²³

the occurrence of natural disasters such as floods, earthquakes, and major storms is entirely beyond the control of the DNSPs. The timing of such an event cannot be determined in advance. Costs incurred as a result of a natural disaster depend on several variables, such [as] the type of event, the magnitude of the event, and the areas of the DNSP's network which are affected (and the extent to which they are affected). Natural disasters are likely to be of a high magnitude or potentially even catastrophic under certain circumstances. For these reasons, such events should not be subject to self insurance, but rather, compensation for them should be deferred until the event actually occurs.

CitiPower proposes that it should continue to have a 'natural disaster event' in its distribution determination for the 2016–2020 regulatory control period. CitiPower proposes that the 'natural disaster event' be defined as:

A natural disaster event occurs if:

Any major fire, storm, flood, earthquake or other natural disaster beyond the reasonable control of the DNSP that occurs during the 2016-20 regulatory control period.

The term 'major' in the above paragraph means an event that is serious and significant. It does not mean 'materially' as that term is defined in the Rules (that is 1 per cent of the distributor's annual revenue requirement for that regulatory year).

CitiPower has added major storm to the definition of 'natural disaster event' in its current distribution determination to ensure that such events are captured in the definition. This is consistent with the AER's comment in its draft decision on CitiPower's distribution determination for the 2011-2015 regulatory control period (set out above) that major storms are beyond the control of

²³ AER, *Draft decision Victorian electricity distribution network service providers Distribution determination 2011-2015*, June 2010, pp. 725-726.

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distributors. CitiPower has also removed the requirement that such an event materially increase the costs to the distributor in providing direct control services because the event will only constitute a 'positive change event' (as defined in the Rules) in respect of which a distributor may seek cost pass through under clause 6.6.1 of the Rules if this is the case, rendering the inclusion of such a requirement in the definition of the 'natural disaster event' unnecessary.

While the AEMC recently determined against amending the Rules such that the Rules prescribe a 'natural disaster event', its reasons for so deciding do not establish a general proposition that such an event should not be specified as a nominated pass through event.²⁴ To the contrary, the AEMC decided not to prescribe such an event in the Rules because the proposal of events of this kind as nominated pass through events provides the most efficient means of assessing them and, in so doing, expressed the view that these events should be accepted by the AER as nominated pass through events where they are the most efficient method to manage the risks of the event (relative to insurance or self-insurance).

Natural disaster event satisfies nominated pass through event considerations

The specification of such an event in CitiPower's distribution determination is consistent with the nominated pass through event considerations, as:

- the event is not covered by a category of pass through event specified in clause 6.6.1(a1)(1) to (4) of the Rules. Whilst there may be some overlap between this event and an 'insurance event', the AER has previously commented that it 'recognises that there is some potential overlap with other allowances or events such as liability above the insurance cap. However, it will consider any specific cost claim under the most appropriate event and ensure it is not double counted.'²⁵ Further, CitiPower submits that both the 'natural disaster event' and the 'insurance event' are needed because a distributor may incur costs as a result of a natural disaster which an insurance policy would not ordinarily cover;
- the nature or type of the event can be clearly identified at the time of the determination for the distributor, as evidenced by the fact that the AER has previously included this event in CitiPower's 2011-2015 distribution determination;
- while CitiPower has in place a number of preventative measures of the kind detailed below, it cannot reasonably prevent an event of the requisite nature or type from occurring (as the AER has previously recognised, including in accepting such a nominated pass through event in CitiPower's 2011–2015 distribution determination);
 - an 'Enterprise Risk Management' approach is utilised to provide a comprehensive and consistent means to manage and report on business risk exposures through identification of strategic and operational risks, determining accountability for those risks, assessment of controls and the control environment and ensuring that there are adequate resources to manage the risks;
 - an annual risk profiling exercise is conducted by CitiPower which results in a detailed risk register and risk profile. The risk assessment process is the foundation that enables CitiPower to maintain a dynamic risk management system tailored to its requirements. Risks in the risk register are clearly defined as to the event, causes and consequences. Controls

²⁴ AEMC, *Rule Determination National Electricity Amendment (Cost pass through arrangements for Network Service Providers) Rule 2012*, 2 August 2012, pp. 23-25.

²⁵ AER, *Draft Distribution Determination, Aurora Energy Pty Ltd 2012-13 to 2016-17*, November 2011, p. 39.

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- applying to a particular risk are then rated on their effectiveness and reliance on the control to manage the risk. Each risk is then assessed for its inherent (without controls) and residential (with controls applied) risk rating. The risk rating is then assessed for acceptability and additional actions determined in accordance with the residential risk rating;
- CitiPower has a duty under the *Electricity Safety Act 1998 (Vic)* to design, construct, operate, maintain and decommission its supply network to minimise as far as practicable the hazards and risks to the safety of any person or of damage to the property of any person arising from the supply network, and the bushfire danger arising from the supply network;
 - an electricity safety management scheme (**ESMS**) must be submitted to Energy Safe Victoria (**ESV**) for each of CitiPower's supply networks under the *Electricity Safety Act 1998 (Vic)*. CitiPower must comply with the accepted ESMS, which also must include a plan for the mitigation of bushfire danger in relation to its supply network. The bushfire mitigation strategy plan is published on CitiPower's website;²⁶
 - in the event of a natural disaster, CitiPower has in place a Crisis and Emergency Management System which provides an effective state of readiness to prepare for, respond to and recover from, a range of credible and potential events with the aim of mitigating the effects of the event as far as practicable;²⁷ and
- efficient levels of commercial insurance cover have been obtained through CitiPower's Industrial Special Risks insurance policy, which is commensurate with an assessment of its business risk arising from natural disasters. However, this insurance would likely not cover all costs associated with a natural disaster event and taking out further insurance would likely be inefficient and result in unnecessary cost increases to customers.

CitiPower considers that including natural disasters as a pass through event represents a more efficient means for managing CitiPower's risk exposure to such an event than self-insurance given the complexity associated with developing credible self-insured risk quantifications for very low probability events and CitiPower's likely inability to pool enough risk to cover the cost impacts of a major natural disaster.

Having regard to the above, consumers are the most appropriate party to bear the costs associated with a 'natural disaster event'. Further, the inclusion of a natural disaster pass through event means that consumers only bear the risk should such an event occur and satisfy the provisions for the approval of pass through amounts in clause 6.6.1 of the Rules, rather than, for example, funding excessive and potentially unnecessary insurance premiums.

CitiPower considers that the proposed nominated pass through event is consistent with the NEO and the revenue and pricing principles in the NEL, as it ensures that CitiPower is not placed in a position where it is unable to mitigate or avoid the event without creating unacceptable risks, and provides a reasonable opportunity to recover its efficient costs.

2.2.4 Terrorism event

A terrorism event applied during the 2011-2015 regulatory control period pursuant to CitiPower's distribution determination for that period, as it was previously a defined pass through event in the Rules.

²⁶ See CitiPower, *Bushfire Mitigation Strategy Plan 2014-2019*, 2014, available from https://www.citipower.com.au/media/2201/citipower-bfm-strategy-plan-2014_2019-issue-2.pdf.

²⁷ CitiPower and CitiPower, *Crisis and Emergency Management System Manual*, 21 January 2014.

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A rule change in 2012 removed the terrorism event from the prescribed pass through events in the Rules.²⁸ In determining to remove the terrorism event from the Rules, the AEMC noted that its conclusion did not imply that these types of events should not be treated as cost pass through events, but that the decision should be made as part of the AER's distribution determination process, having regard to the circumstances of the distributor, rather than prescribed in the Rules.²⁹ The terrorism event remains a pass through event for CitiPower during the current regulatory control period as a result of the transitional arrangements in clause 11.49.2 of the Rules.

CitiPower proposes that a 'terrorism event' be included as a pass through event, as part of its distribution determination for the 2016-2020 regulatory control period, as this represents the most prudent and efficient means for managing a risk of this nature in its forthcoming regulatory control period. CitiPower proposes that the event be defined as:

An act (including, but not limited to, the use of force or violence, the threat of force or violence, attacks or other disruptive activities against, or the deliberate introduction of harmful code or viruses to, computer systems, computer networks, data and/or communication systems, or the threat of such attacks or disruptive activities, or of the deliberate introduction of such harmful code or viruses) 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).

This definition is similar to the definition of 'terrorism event' previously contained in the Rules and which is a pass through event for CitiPower during the current regulatory control period, except that:

- it has been amended to specifically refer to attacks against, and the deliberate introduction of harmful code or viruses to, computer systems, computer networks, data and/or communication systems and the threat of same; and
- CitiPower has removed the requirement that such an event materially increase the costs to the distributor in providing direct control services because the event will only constitute a 'positive change event' (as defined in the Rules) in respect of which a distributor may seek cost pass through under clause 6.6.1 of the Rules if this is the case, rendering the inclusion of such a requirement in the definition of the 'terrorism event' unnecessary.

Terrorism event satisfies nominated pass through event considerations

Such an event is consistent with the nominated pass through event considerations, as:

- the event is not covered by another category of pass through event specified in clause 6.6.1(a1)(1) to (4) of the Rules. Whilst there may be some overlap between this event and an 'insurance event', CitiPower submits that both the 'terrorism event' and the 'insurance event' are needed because a distributor may incur costs as a result of terrorism which an insurance policy would not ordinarily cover;

²⁸ AEMC, *Rule Determination National Electricity Amendment (Cost pass through arrangements for Network Service Providers) Rule 2012*, 2 August 2012 pp. 24-25. Available from: <http://www.aemc.gov.au/Rule-Changes/Cost-pass-through-arrangements-for-network-service>.

²⁹ AEMC, *Rule Determination National Electricity Amendment (Cost pass through arrangements for Network Service Providers) Rule 2012*, 2 August 2012 p. 25.

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- the nature or type of event can be clearly identified at the time of the determination for the distributor, as evidenced by the fact that this type of event was previously prescribed in the Rules and included in CitiPower’s 2011-2015 distribution determination;
- CitiPower’s ability to reasonably prevent a terrorism event from occurring or substantially mitigate the cost impact of such an event is limited. Whilst the occurrence of a terrorism event is largely beyond its control, CitiPower undertakes a range of measures to reduce the likelihood of a terrorism event. CitiPower continues to review and assess the level of security at its sites in addition to undertaking security surveys. CitiPower also interacts with a range of organisations and participates in various groups, including:
 - the Australian Security Intelligence Organisation (**ASIO**) Business Liaison Unit;
 - the Trusted Information Sharing Network (**TISN**) through the Attorney-General’s Department;
 - the Critical Infrastructure Program for Modelling and Analysis (**CIPMA**), also through the Attorney-General’s Department;
 - Victorian Energy Security and Continuity Network (**SCN**);
 - AEMO’s Victorian Electricity Emergency Committee (**VEEC**); and
 - the Victorian distributors’ security group;
- generally, the commercial market for insurance in Australia is insufficient to cover demand. While the Australian Government found in its 2012 *Terrorism Insurance Act Review* that the availability of insurance for terrorism is increasing, it nonetheless concludes that insurance for terrorism events remains insufficiently available at affordable rates:³⁰

...some commercial market capacity for terrorism insurance is re-emerging both internationally and domestically, although it remains insufficient to cover the available demand and is concentrated in supporting national pooled arrangements. Furthermore, there is insufficient capacity at reasonable prices for individual risks in Australia with the quantum of commercial market capacity being significantly below the current \$13.4 billion scheme operated by the ARPC [Australian Reinsurance Pool Corporation].

- CitiPower’s Industrial Special Risks insurance policy covers property damage and business interruption for terrorism, however it may not cover all of the impacts of a terrorism event on its network and business. Taking out further insurance would likely be inefficient given prevailing market conditions; and
- self-insurance would not be a credible option because the relative infrequency and potentially high costs associated with terrorism events create significant challenges for self-insurance for this type of risk, and there is limited data on which to calculate a credible self-insurance premium.

CitiPower considers that the proposed nominated pass through event is consistent with the NEO and the revenue and pricing principles in the NEL, as it ensures that CitiPower is not placed in a position where it is unable to mitigate or avoid the event without creating unacceptable risks, and provides a reasonable opportunity to recover its efficient costs. Further, the inclusion of a terrorism pass through event means that consumers only bear the risk should such an event occur and satisfy the

³⁰ Australian Government, *Terrorism Insurance Act Review: 2012*, p. 2. Available from: http://www.treasury.gov.au/~media/Treasury/Publications%20and%20Media/Publications/2012/Terrorism%20Insurance%20Act%20Review%202012/downloads/Terrorism_Insurance_Act_Review_2012.ashx.

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provisions for the approval of pass through amounts in clause 6.6.1 of the Rules, rather than, for example, funding excessive and potentially unnecessary insurance premiums.

2.2.5 Ending of the metering derogation event

CitiPower is proposing that an ending of the metering derogation event be included as a nominated pass through event in its distribution determination for 2016-2020.

Under the Advanced Metering Infrastructure (**AMI**) program for the Victorian Government's mandated rollout of smart meters in 2006, Victorian distributors were required to install and maintain smart meters at all residential and small business premises in Victoria. To facilitate this rollout, a jurisdictional derogation to Chapter 7 of the Rules was put in place in Victoria under which the Victorian distributors are exclusively responsible for providing metering services to residential and small business customers (**Victorian Metering Derogation**).

The Victorian Metering Derogation is established by clause 9.9C of the Rules. It was initially made by the AEMC in 2009³¹ and was extended by the AEMC in November 2013 to preserve that exclusivity until the earlier of:³²

- the commencement in Victoria of:
 - a framework for competition in metering and related services for residential and small business customers under the Rules;
 - regulatory arrangements that provide for an orderly transfer of regulation of relevant metering installations under clause 9.9C of the Rules to Chapter 7 of the Rules; and
- 31 December 2016.

In relation to the first point, following the AEMC's Power of Choice Review in November 2012, the Standing Council on Energy and Resources (**SCER**, now **COAG Energy Council**) submitted a rule change request in October 2013 to the AEMC which seeks to establish arrangements that would promote competition in the provision of metering and related services in the National Electricity Market (**NEM**).

The rule change request proposes changes to the Rules and relevant provisions of the National Energy Retail Rules to implement arrangements to support a competitive environment for the provision of metering and related services.³³ The most significant of the changes is to change who can be responsible for the provision of metering and related services, including:

- separating the responsibility for metering services from the roles of the retailer and the local distributor so that no party has the exclusive right to provide those services;
- enabling any party accredited with the AEMO to be able to provide metering services; and
- enabling consumers to engage with a metering co-ordinator directly.

An overview of SCER's proposed model and responsibilities is provided in figure 2.1.

³¹ AEMC, *National Electricity Amendment (Victorian Jurisdictional Derogation – Advanced Metering Infrastructure) Rule 2009*, 29 January 2009.

³² AEMC, *National Electricity Amendment (Victorian Jurisdictional Derogation – Advanced Metering Infrastructure) Rule 2013*, 28 November 2013; clause 9.9C.2 of the Rules.

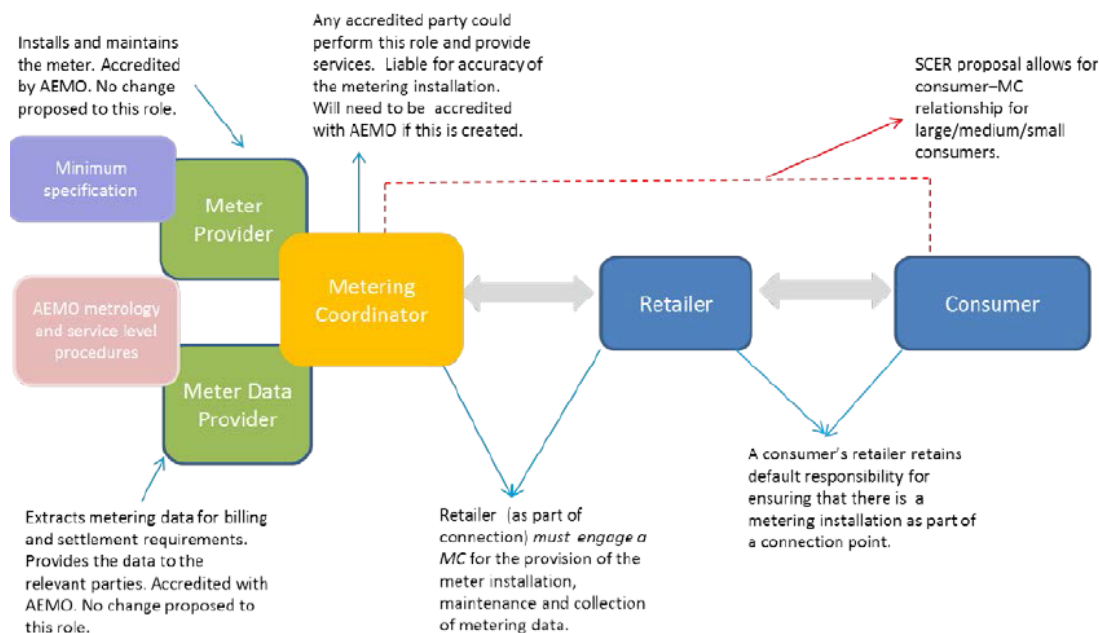
³³ SCER, *Rule Change Request, Introducing a new framework in the National Electricity Rules that provides for increased competition in metering and related services*, October 2013.

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Figure 2.1 SCER’s proposed model and responsibilities



Source: AEMC, *Expanding competition in metering and related services in the National Electricity Market, Consultation Paper*, 17 April 2014, p. 21

The AEMC published a consultation paper relating to the rule change request on 17 April 2014.³⁴ The paper notes that if the competitive model proposed by SCER in the rule change request is put into place, it will be necessary to determine what arrangements should be established for meters provided to consumers under the AMI program. Transitional arrangements for Victoria are discussed in the paper.³⁵

On 26 March 2015 the AEMC published a draft rule determination on the rule change request (**Draft Metering Determination**).³⁶ The Draft Metering Determination sets out significant changes to the Rules and the National Energy Retail Rules in respect of the provision of metering services. Consistent with SCER's rule change request, the draft rule contemplated by the Draft Metering Determination broadens who can have responsibility for metering services under the Rules. The AEMC proposes that this be achieved by:³⁷

- providing for the existing roles and responsibilities of the responsible person (being distributors in the case of Victoria) to be undertaken by a new type of registered participant - a Metering Coordinator;

³⁴ AEMC, *Expanding competition in metering and related services in the National Electricity Market, Consultation Paper*, 17 April 2014.

³⁵ AEMC, *Expanding competition in metering and related services in the National Electricity Market, Consultation Paper*, 17 April 2014, p. 64.

³⁶ AEMC, *Draft Rule Determination, National Electricity Amendment (Expanding competition in metering and related services) Rule 2015*, 26 March 2015.

³⁷ AEMC, *Draft Rule Determination, National Electricity Amendment (Expanding competition in metering and related services) Rule 2015*, 26 March 2015, p. iii.

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- allowing any person to become a Metering Coordinator, subject to meeting the registration requirements;
- permitting a large customer to appoint its own Metering Coordinator; and
- requiring a retailer to appoint the Metering Coordinator, except where a large customer has appointed its own Metering Coordinator.

The draft rule proposes that the contemplated amendments to the Rules and the National Retail Rules will commence on 1 July 2017. The Draft Metering Determination notes that as the National Energy Retail Rules do not currently apply in Victoria, the amendments to National Energy Retail Rules contained in the draft rule will not apply in Victoria.³⁸ However, the amendments to the Rules enabling any party to provide metering services (in particular the introduction of a new Chapter 7 to the Rules) will apply in Victoria.

The draft rule proposes that:³⁹

- at the commencement of the new Chapter 7 of the Rules, Victorian distributors will become the initial Metering Coordinator for the advanced meters they deployed under the AMI program and will continue in this role until another Metering Coordinator is appointed to the site by the retailer or a large customer, or those services cease to be classified by the AER as direct control services; and
- the current Victorian Metering Derogation will be extended by six months so that it ends on the date the new Chapter 7 of the Rules commences (1 July 2017). After that date, the Victorian distributors will no longer be exclusively responsible for metering services for AMI meters, and other parties will be able to take on the Metering Coordinator role.

The draft rule also specifies the minimum services that a new or replacement meter installed at a small customer's premises must be capable of providing. The Draft Metering Determination notes that the national minimum services specification will take effect in Victoria when the new Chapter 7 of the Rules commences.⁴⁰

In advance of the expiration of the Victorian Metering Derogation, CitiPower will be required to implement new, or amend existing, systems and processes to facilitate the contestable metering framework, such as:

- implementation of a new customer information system to maintain necessary data (e.g. location, life support for planned or unplanned outages);
- reconfiguration and other changes to systems such as the billing system, market transaction system (**MTS**), meter management system (**IEE**) and integration platform (**USB**), including to enable CitiPower to receive meter outage notifications from meter data agents and allow changes in classification of AMI meters from type 5 to type 4 etc;

³⁸ AEMC, *Draft Rule Determination, National Electricity Amendment (Expanding competition in metering and related services) Rule 2015*, 26 March 2015, pp. 277 and 292.

³⁹ AEMC, *Draft Rule Determination, National Electricity Amendment (Expanding competition in metering and related services) Rule 2015*, 26 March 2015, pp. xi, 277 and 291.

⁴⁰ AEMC, *Draft Rule Determination, National Electricity Amendment (Expanding competition in metering and related services) Rule 2015*, 26 March 2015, pp. xi and 292.

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- reconfiguration of the IEE to validate and process incoming meter data from meter data agents and reconfiguration of the meter reading system (**UIQ**) to remotely read meters that have transferred away; and
- development and implementation of new automated processes into the billing system and market transaction and integration platform to allow exchange of meters to another meter data agent.

The costs for the new IT systems and processes would need to be incurred before the Victorian Metering Derogation expires, to enable CitiPower to be ready for metering contestability on the first day that the new framework is effective.

Notwithstanding the Draft Metering Determination, CitiPower considers that there is still uncertainty as to the detail of the framework for metering contestability, including regarding:

- CitiPower's roles and responsibilities for metering services;
- the IT investment CitiPower would need to undertake to facilitate and operate in a contestable metering market;
- business to business (B2B) procedures ; and
- the shared market protocol.⁴¹

Having regard to that uncertainty, the cost implications of the expiration of the Victorian Metering Derogation and the introduction of metering contestability are not sufficiently certain such that they could be included in CitiPower's forecast expenditure in its regulatory proposal.

Accordingly, CitiPower proposes as a nominated pass through event the expiry of the derogation in Victoria relating to the provision of AMI services.

CitiPower proposes that the 'ending of the metering derogation event' be defined as:

An ending of the metering derogation event occurs if the impending or actual expiry of the Victorian Metering Derogation:

- (1) *results in the distributor incurring 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;*
 - (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; and*

⁴¹ A shared market protocol is an electronic platform that allows parties to communicate with each other regarding the services that will be offered by advanced meters. The AEMC notes in its *Draft Rule Determination, National Electricity Amendment (Expanding competition in metering and related services) Rule 2015*, 26 March 2015, pp. 12, 80 and 310 that AEMO is currently preparing advice to the COAG Energy Council on the content of the shared market protocol, and the AEMC will provide advice to the COAG Energy Council on the implementation and governance of the shared market protocol, including a draft rule change, around the time the final determination is made on the metering rule change. The AEMC notes that it is expected that the rule change and subsequent development of the shared market protocol will be undertaken in parallel with the implementation of the metering rule change. In addition, the AEMC notes (in footnote 220 on p. 112) that its advice on the shared market protocol will consider governance arrangements for that protocol which may partly or wholly replace the business to business (B2B) procedures.

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- (2) *does not constitute any category of pass through event specified in clause 6.6.1(a1)(1) to (4) of the Rules.*

For the purposes of this ending 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 AEMC, National Electricity Amendment (Victorian Jurisdictional Derogation – Advanced Metering Infrastructure) Rule 2013, 28 November 2013 and any subsequent derogation which may be made with similar effect to that in clause 9.9C of the Rules, albeit with a different expiry date.

Ending of the metering derogation event satisfies nominated pass through event considerations

Such an event is consistent with the nominated pass through event considerations, as:

- the event is not covered by a category of pass through event specified in clause 6.6.1(a1)(1) to (4) of the Rules. The event is not a tax change event or a retailer insolvency event. Further, CitiPower considers that the event may not be classified as either a service standard event or a regulatory change event, as it is possible that it will be necessary to incur at least some of the costs referable to the event prior to the change in the regulatory obligation or requirement, or occurrence of the legislative or administrative act or decision if metering contestability is to be technically feasible and practicable on and from the expiration of the Victorian Metering Derogation. In any event, paragraph (2) of the proposed definition of the ‘ending of the metering derogation event’ ensures that this event is, by definition, not covered by a category of pass through event specified in clause 6.6.1(a1)(1) to (4) of the Rules. That is, the impending or actual expiration of the Victorian Metering Derogation could only constitute an ‘ending of the metering derogation event’ if it is not covered by the Rules’ prescribed service standard event or regulatory change event;
- the nature or type of event can be clearly identified at the time of the determination for the distributor. While CitiPower considers that there is still uncertainty regarding aspects of the framework for metering contestability, it can be seen from the AEMC’s Draft Metering Determination described above that the event (being the expiration of the Victorian Derogation and consequent introduction of metering contestability) can be clearly identified at the time of the distribution determination and is highly likely to occur during the 2016–2020 regulatory control period. As set out above, it is also clear that in advance of the expiration of the Victorian Metering Derogation, CitiPower will be required to implement new systems and processes to facilitate the contestable metering framework;
- a prudent service provider could not reasonably prevent an ending of the metering derogation event from occurring or substantially mitigate the cost impact of such an event, as the decision on the expiry of the Victorian Metering Derogation will be made by the AEMC, and, while the AEMC is consulting with distributors, including CitiPower, on the framework for metering contestability, the decision on that framework will ultimately be made by the AEMC. That said, CitiPower will be preparing more generally for the introduction of metering contestability, such as through the planned implementation of a new customer relationship management system to minimise the cost impacts when a decision is ultimately made; and
- it is not economically viable for CitiPower to insure (either externally or self-insure) against this event as the uncertainty is as to the contestable metering framework that will be in place after the expiry of the Victorian Metering Derogation and the system and process changes that will be needed to facilitate that competitive environment, rather than the occurrence of the event itself.

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CitiPower considers that the proposed nominated pass through event is consistent with the NEO and the revenue and pricing principles in the NEL, as it provides a reasonable opportunity for CitiPower to recover its efficient costs for complying with the changed operating environment.

2.2.6 Multiple trading relationships event

CitiPower is proposing an event relating to the proposed introduction of multiple trading relationships at a single connection point. Currently, only a single financially responsible market participant at a connection point can provide energy and non-energy services.⁴²

In its final reports regarding the Power of Choice Review⁴³ and the Energy Market Arrangements for Electric and Natural Gas Vehicles Review,⁴⁴ the AEMC foreshadowed changes to the NEM that would allow multiple commercial relationships with a customer at a single connection point, including more than one financially responsible market participant, responsible person, metering provider, metering data provider or small generator aggregator.⁴⁵

By letter dated 24 July 2013, SCER (now the COAG Energy Council) requested AEMO to lead the implementation of work to better allow for multiple trading relationships at a single site in the NEM and attached terms of reference to guide AEMO in undertaking that work.⁴⁶ While the details remain unresolved, the terms of reference note that examples of outcomes which might be supported under the new arrangements could include:⁴⁷

- consumers buying electric vehicle charging services separately from the general household electricity supply;
- consumers having different retailers for different loads - for example a specialist retailer might provide a wholesale pass-through contract for a controllable load in a factory, while the factory bought electricity for the rest of its plant through a traditional retail contract; and
- consumers selling the output from a small generator to one company while buying electricity for the same site from a different company.

AEMO was therefore asked by SCER, in that letter, to undertake the work necessary to:⁴⁸

- develop and submit rule change requests to the AEMC which would give effect to SCER's policy intent and the AEMC's recommendations;

⁴² AEMC, *Final Report Power of Choice review - giving consumers options in the way they use electricity*, 30 November 2012, p. 144.

⁴³ AEMC, *Final Report Power of Choice review - giving consumers options in the way they use electricity*, 30 November 2012, pp. 18-19.

⁴⁴ AEMC, *Energy market arrangements for electric and natural gas vehicles*, 11 December 2012, Chapter 3.

⁴⁵ AEMO, *National Electricity Rule Change Request - Embedded Networks*, September 2014, p. 5.

⁴⁶ Letter from SCER to AEMO dated 24 July 2013 regarding metering arrangements to provide for multiple trading relationships at a single site and attached terms of reference.

⁴⁷ Terms of reference for arrangements to support multiple trading relationships at a single site and for metering in embedded networks attached to the letter from SCER to AEMO dated 24 July 2013, p. 2. See also AEMO, *Rule Change Request – Multiple Trading Relationships*, 17 December 2014, p. 4.

⁴⁸ Terms of reference for arrangements to support multiple trading relationships at a single site and for metering in embedded networks attached to the letter from SCER to AEMO dated 24 July 2013, p. 3.

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- at an appropriate point, develop the procedure changes necessary to support the operation of these rule changes, for example coordination between parties where there is more than one trading relationship at a single connection point; and
- at an appropriate point, implement the system changes necessary to support the Rule and procedure changes.

AEMO, in consultation with a stakeholder reference group, developed a high level market design for implementation of multiple trading relationships at a single site. As part of that process, AEMO engaged Jacobs SKM to undertake a cost benefit analysis based on the high level design. Jacobs SKM provided its final report in May 2014.⁴⁹ On 29 August 2014, AEMO provided CitiPower with a document entitled 'Multiple Trading Relationships - Market Design for High Level Impact Assessment' (dated 28 August 2014) and CitiPower subsequently provided comments on the document.⁵⁰

On 17 December 2014, AEMO submitted a rule change request to the AEMC relating to multiple trading relationships. AEMO noted that it identified three fundamental metering arrangements that support multiple trading relationships:⁵¹

- Model 1: parallel metering. This arrangement contemplates a separate meter for each load type at a site, where a load type may be a form of consumption (e.g. peak, off-peak, controlled) or local generation (e.g. PV or battery). The parallel metering arrangement mirrors the arrangement where a separate service line connects the distribution network to separate sites, however, in this case there is only one service line to a single site, which eliminates the need to establish a second physical connection/service line.
- Model 2: subtractive metering. AEMO notes that this is the most complex of the metering arrangements that support multiple trading relationships for market participants to implement.⁵² It requires multiple parties to develop processes and IT systems that can track relationships between multiple National Metering Identifiers (**NMIs**) at a site and their electricity flows in order to determine the quantity of electricity flows to be settled. The metering arrangement features a settlements point with meters that measure electricity flows across the boundary of the site, from and to the national grid (i.e. consumption/local generation). However, unlike the other metering arrangements, these flows can include electricity consumed or generated within the site that are separately metered and assigned to other settlement points within the site.
- Model 3: net-metering. This arrangement is intended to allow consumers with a site that has a local generation system to maximise the value of their local generation. Net-metering is a specific form of parallel metering. It is achieved by having two NMIs that share a single service line and metering installation. One NMI would be associated with a retailer that sells electricity and the other NMI would be associated with a retailer that buys electricity.

⁴⁹ Jacobs SKM, *Benefits and Costs of Multiple Trading Arrangements and Embedded Networks*, May 2014 (Appendix D to AEMO, *Rule Change Request – Multiple Trading Relationships*, 17 December 2014).

⁵⁰ AEMO, *Multiple Trading Relationships - Market Design for High Level Impact Assessment*, 28 August 2014; CitiPower, *Response to Consultation (template) on AEMO's 'Multiple Trading Relationships - Market Design for High Level Impact Assessment'*, provided on 16 September 2014.

⁵¹ AEMO, *Rule Change Request – Multiple Trading Relationships*, 17 December 2014, p. 10 and Appendix A.

⁵² AEMO, *Rule Change Request – Multiple Trading Relationships*, 17 December 2014, Appendix A, p. 4.

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According to AEMO, the parallel model is an efficient short term solution requiring the least amount of change to participant systems, while the subtractive model provides a long term solution to deliver the maximum consumer benefit. The net metering model allows a customer to purchase supply from one retailer while supplying their net generation to a different retailer.⁵³

Accordingly, AEMO's high level design requires participants to support all possible metering arrangements, as the market design does not mandate which arrangements are allowed: rather the development of the arrangements will be left for market forces to determine. AEMO considers that this should allow early uptake through parallel and net metering arrangements, while delaying the costs of supporting subtractive metering arrangements to such time as the demand justifies participants' expenditure.⁵⁴

AEMO's rule change proposal provides a high level framework in which multiple trading relationships can operate and evolve – it does not contain detailed prescriptive requirements. However, following the rule change determination, AEMO will develop retail market procedures in consultation with stakeholders. These will contain the details of the multiple trading relationships day-to-day operation.⁵⁵

In order to allow for each of the models identified by AEMO, CitiPower will need to undertake significant changes to its systems. This is because at the core of the CitiPower information technology system architecture and reporting capability is the NMI. That is, CitiPower systems have a NMI-centric view of operations.

The rule change request will result in multiple identities at a single property, rather than a single identity. It is the inter-dependencies and relationships between these multiple identities and retailers at that single property that will result in complexity in the working market model.

CitiPower is unable to fully assess the impact of multiple trading relationships until after the rule change determination and/or retail market procedures have concluded. However, CitiPower will need to make significant changes to the business logic and rules that underpin its information systems, particularly the Market Transaction System and the billing and customer relationship management systems. The introduction of multiple trading relationships will result in the need to establish new data relationships within the system and reporting landscapes so that CitiPower can ensure that its customer safety is maintained, particularly for life support customers.

CitiPower therefore proposes that a 'multiple trading relationships event' be included as a nominated pass through event, as part of its distribution determination for the 2016-2020 regulatory control period, as this represents the most prudent and efficient means for managing a risk of this nature in its forthcoming regulatory control period. CitiPower proposes that the event be defined as:

A multiple trading relationships event occurs if a change (including without limitation any NEM procedure or system change) occurs that:

- (1) results in the distributor incurring costs to facilitate two or more entities being able to provide services at a single connection point; and*
- (2) does not constitute any category of pass through event specified in clause 6.6.1(a1)(1) to (4) of the Rules.*

⁵³ AEMO, *Rule Change Request – Multiple Trading Relationships*, 17 December 2014, p. 10.

⁵⁴ AEMO, *Rule Change Request – Multiple Trading Relationships*, 17 December 2014, p. 11.

⁵⁵ AEMO, *Rule Change Request – Multiple Trading Relationships*, 17 December 2014, p. 8.

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While AEMO is proposing to allow for multiple trading relationships by amendments to the Rules and the National Energy Retail Rules and the development of retail market procedures, as the rule change proposal is still pending consideration by the AEMC and the details of the arrangements for multiple trading relations are currently expected to be determined by AEMO only after the AEMC's final determination through a discrete, further consultation process, CitiPower considers that there is still considerable uncertainty as to the model for multiple trading relationships and the manner of its implementation such that it remains uncertain whether the implementation of SCER's policy intent in respect of multiple trading relationships will fall within the Rules' definition of a service standard event or regulatory change event. So, for example, it is presently unclear whether the establishment of retail market procedures by AEMO would constitute an exercise of legislative power or administrative act or decision, with the consequence that it is uncertain whether the establishment of those procedures would constitute such a Rules defined event. Accordingly, CitiPower proposes that the 'multiple trading relationships event' should be accepted as a nominated pass through event in order to provide it with certainty that it will recover the significant anticipated costs it will incur as a consequence of the implementation of SCER's policy intent.

Multiple trading relationships satisfies nominated pass through event considerations

The acceptance of the proposed 'multiple trading relationships event' as a nominated pass through event in CitiPower's distribution determination is consistent with the nominated pass through event considerations, as:

- it is uncertain whether such an event is covered by another category of pass through event specified in clause 6.6.1(a1)(1) to (4) of the Rules. Specifically:
 - the event is not a tax change event or a retailer insolvency event; and
 - since the AEMC is yet to consider AEMO's rule change request and the extent of the impact on CitiPower and the manner of implementation of multiple trading relationships is currently unknown, it is uncertain whether the event will fall within the definitions of a 'service standard event' or a 'regulatory change event' in the Rules and/or the extent to which any cost impact on CitiPower of the implementation of multiple trading relationships will be causally related to those aspects of the manner of implementation that constitute a 'service standard event' or 'regulatory change event'. In particular, it is unclear whether the cost impact on CitiPower will result from any rule change or administrative act or decision (such as may constitute a 'service standard event' or 'regulatory change event') or will, instead, result from other aspects of the implementation of SCER's policy intent such as through retail market procedures established by AEMO;
- in any event, paragraph (2) of the proposed definition of the 'multiple trading relationships event' ensures that this event is, by definition, not covered by a category of pass through event specified in clause 6.6.1(a1)(1) to (4) of the Rules. That is, any change that facilitates multiple trading relationships at a single connection point would only constitute a 'multiple trading relationships event' if it is not covered by the Rules' prescribed service standard event or regulatory change event;
- the nature or type of event can be clearly identified at the time of the determination for the distributor and is foreseeable, as the AEMC has described the types of changes that will be made during the 2016-2020 regulatory control period to facilitate multiple trading relationships and AEMO has submitted a rule change request to the AEMC to facilitate those changes;⁵⁶

⁵⁶ AEMO, *Rule Change Request – Multiple Trading Relationships*, 17 December 2014.

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- CitiPower's ability to reasonably prevent an event of that nature or type from occurring or substantially mitigate the cost impact of such an event is limited. Specifically, AEMO has developed a rule change request to allow multiple trading relationships and to progress procedure and system changes to facilitate multiple trading relationships.⁵⁷ As such, the decisions as to whether multiple trading relationships at a single connection point will be facilitated and the manner in which this will occur, are out of CitiPower's control;
- the provision for multiple trading relationships at a single connection point would be a market development or an example of industry reform or progress. CitiPower is not able to obtain insurance against the occurrence of an event of that nature or type from an insurance provider because insurance providers do not provide insurance against events of that nature or type; and
- in any event, it is not economically viable for CitiPower to insure (either externally or self-insure) against this event as the uncertainty is as to the model for, and manner of implementation of, multiple trading relationships and the changes CitiPower will need to make as a consequence, rather than the occurrence of this market development or industry reform.

CitiPower submits that, in circumstances such as the present, where AEMO's rule change request is pending before the AEMC, and it is currently expected that only after the AEMC determination will the detail be determined, regarding a specific change in respect of a fundamental element of market design that would necessitate that CitiPower incur significant costs in respect of (amongst other things) complex IT changes, the most efficient means of managing this risk is to specify a nominated pass through event in CitiPower's distribution determination. This will have the consequence that all costs can be avoided by the consumer if the event does not occur but CitiPower is still able to recover its reasonable costs if the event does occur. In these circumstances, having a nominated pass through event for the 'multiple trading relationships event' means that the party who is in the best position to manage the risk is bearing the risk.

CitiPower considers that the proposed nominated pass through event is consistent with the NEO and the revenue and pricing principles in the NEL, as it provides CitiPower with a reasonable opportunity to recover its efficient costs and avoids placing CitiPower in a position where it incurs costs that it is unable to avoid, recover or mitigate.

2.2.7 Retailer failure event

CitiPower considers that there may be some uncertainty regarding whether the retailer insolvency event specified in clause 6.6.1(a1)(4) of the Rules applies to Victorian distributors. This is because:

- that pass through event was initially introduced into the Rules through the *National Electricity (National Energy Retail Law) Amendment Rule 2012 (NERL Amendment Rule)*;
- the NERL Amendment Rule purports to only apply to jurisdictions that have implemented the National Energy Retail Law;⁵⁸ and
- CitiPower understands that the Victorian Government's current position is that it does not intend to adopt the National Energy Customer Framework (**NECF**) (which encompasses the National Energy Retail Law), with the exception of the amendment to the Rules to insert Chapter

⁵⁷ AEMO, *Rule Change Request – Multiple Trading Relationships*, 17 December 2014.

⁵⁸ Section 2 of the *National Electricity (National Energy Retail Law) Amendment Rule 2012* provides that the Rule comes into operation on the day on which Schedule 1 of the *National Energy Retail Law (South Australia) Act 2011* (No 6 of 2011) comes into operation. There is a note to section 2 which states '[t]his Rule does not apply in a participating jurisdiction until the *National Energy Retail Law* is applied in that jurisdiction as a law of that jurisdiction.'

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5A ‘Electricity connection for retail customers’, which the Government proposes to adopt from 1 January 2016.

Accordingly, CitiPower proposes that a ‘retailer failure event’ be included as a pass through event as part of its distribution determination for the 2016–20 regulatory control period.

CitiPower proposes that the event be defined as:

A retailer failure event occurs if a distributor incurs costs as a result of the failure of a retailer during a regulatory control period to pay a distributor an amount to which the distributor 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 distributor is not entitled to payment of that amount in full under the terms of any credit support provided in respect of that retailer.*

For the purposes of this definition:

- (a) The term 'costs' includes amounts which the distributor was entitled to be paid (but which are or will be unpaid as a result of a retailer failure event) for the provision of direct control services, including, but not limited to:*

- (i) charges for direct control services provided by the distributor;*
- (ii) charges to recover the designated pricing proposal charges incurred by that distributor, and*

these amounts must be taken to be a cost that can be passed through and not a revenue impact of the event.

- (b) The term 'insolvency official' means a receiver, receiver and manager, administrator, provisional liquidator, liquidator, trustee in bankruptcy or person having a similar or analogous function.*
- (c) The term 'credit support' takes its ordinary and natural meaning.*
- (d) Other terms used in this definition that are defined in the Rules take their definition in the Rules.*

In formulating this definition CitiPower has had regard to the recent rule change request proposed by the COAG Energy Council that seeks to ensure that distributors are able to pass through foregone revenue, in the form of distribution network charges, for the provision of direct control services following the insolvency of a retailer (**COAG Energy Council Rule Change Request**).⁵⁹ In the COAG Energy Council Rule Change Request, the COAG Energy Council observed that the policy intent of the inclusion of the retailer insolvency pass through event in the Rules was to enable distributors to recover foregone revenue as a result of a retailer defaulting on its network payment obligations and as such the Ministerial Council of Energy considered it would be appropriate to treat the revenue impact of a retailer insolvency as if it were an increase in costs for the purpose of these provisions.⁶⁰ The AEMC has released a consultation paper in respect of that Rule Change Request, in which the AEMC notes that since the Rule Change Request seeks to make amendments to the Rules relating to

⁵⁹ SCER, *Definition of Retailer Insolvency Costs Rule Change Request*, March 2014.

⁶⁰ SCER, *Definition of Retailer Insolvency Costs Rule Change Request*, March 2014, p. 4.

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matters that were implemented under the NECF, if made, the rule will only affect jurisdictions that have implemented that framework.⁶¹

CitiPower considers that the rationale for the inclusion of the retailer insolvency pass through in the Rules for distributors in jurisdictions which have adopted the NECF also applies to CitiPower. The Retail Policy Working Group policy paper for the retailer insolvency pass through event states that:⁶²

The policy rationale for the retailer insolvency pass-through is an economic one. Distributors are unable to manage the risk of retailers defaulting on payment of their network charges (due to the regulated credit support regime, and the obligation to supply distribution services to all retailers). Therefore, any amount they cannot otherwise recover (by drawing on credit support or by recourse to other commercial law recovery options) should be passed through to customers.

The credit support arrangements in Chapter 6B referred to in the above extract from the Retail Policy Working Group policy paper, which apply under the NECF are described in the COAG Energy Council Rule Change Request as follows:⁶³

The Chapter 6B arrangements therefore require retailers to provide guarantees against the required credit support amount, which is calculated as the retailer's network charges liability less a retailer's credit allowance which is set to reflect a judgment of an acceptable level of network charges at risk taking into account the total distributor revenues at risk and the risk of retailer default reflected in its credit rating.

The implication of this regime is that in the event of a retailer becoming insolvent, there may be outstanding network charges which are not fully recovered by credit support guarantees provided by that retailer. This would most likely be the case if a retailer unexpectedly became insolvent despite a good credit rating.

CitiPower is similarly unable to manage the risk of retailers defaulting on payment of its network charges. Retailers are required to pay CitiPower the distribution network charges associated with their customers. These charges are substantial and paid in arrears.

CitiPower is constrained by its Distribution Licence to implement in its Default Use of System Agreement (**Default UoSA**) provisions which reflect the credit support arrangements in the Essential Services Commission of Victoria (**ESCV**), Credit Support Arrangements, Final Decision, October 2006 (**ESCV Credit Decision**).⁶⁴ These credit support arrangements do not fully compensate CitiPower for retailer failure and were put in place on the basis that Victorian distributors had a pass through event for a financial failure of a retailer.

In the ESCV Credit Decision, the ESCV determined that a retailer will be required to provide credit support to a distributor when the amount of the retailer's average billed and unbilled distribution service charges liability exceeds its credit allowance. The amount of credit support provided by the

⁶¹ AEMC, *National Electricity Amendment (Retailer insolvency events – costs pass through provisions) Rule 2015*, Consultation, 30 October 2014, p. 1.

⁶² Joint Implementation Group (Retail Policy Working Group), *National Energy Customer Framework Implementation issue No. 0001 Retailer insolvency event and pass through*, 8 February 2012.

⁶³ SCER, *Definition of Retailer Insolvency Costs Rule Change Request*, March 2014, p. 2; AEMC, *National Electricity Amendment (Retailer insolvency events – costs pass through provisions) Rule 2015*, Consultation, 30 October 2014, p. 4.

⁶⁴ CitiPower, *Electricity Distribution Licence*, as varied on 31 August 2005; CitiPower, *Default Use of System Agreement Victorian Electricity Industry*, June 2011; ESCV, *Credit Support Arrangements, Final Decision*, October 2006.

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retailer equals the amount by which the retailer's average billed and unbilled distribution service charges over a three month period exceeds the retailer's credit allowance. The retailer's credit allowance is calculated as the percentage of the relevant distributor's maximum credit allowance corresponding to its credit rating.⁶⁵ The distributor's maximum credit allowance is equal to 33.33 per cent of the distributor's annual distribution service charges revenue for the most recent year reported to the ESCV.⁶⁶

In the ESCV Credit Decision, the ESCV adopted the model developed by The Allen Consulting Group (ACG) who conducted a review of credit support arrangements on the ESCV's behalf. In determining what model to recommend, ACG placed emphasis on the fact that the ESCV's 2006-2010 Electricity Distribution Price Review had established a mechanism for distributors to pass through to customers the 'net financial consequences associated with retailer default'.⁶⁷

As a result of the ESCV Credit Decision, in practice CitiPower holds almost no credit support. Further, it is likely that CitiPower would not receive credit support from a retailer that demonstrates financial stress, such as through late payment of network charges. The ESCV Credit Decision extends a credit allowance to retailers with very low credit ratings. Retailers with credit ratings below BBB- are given a credit allowance. This means that retailers can develop such a sizeable debt before a distributor can ask for credit support, that it is probable those retailers would be under financial distress by the time CitiPower asks for support and, as a consequence, would be unable to provide that requested support. Further, retailers with a low credit rating are effectively not required to seek insurance cover or even provide a bank guarantee.

In the event of a retailer default CitiPower is not able to simply cease supply. The distribution use of service debt will continue to accumulate until the retailer rectifies the default or customers are transferred to another retailer under commercial arrangements or by use of the retailer of last resort mechanism.

Retailer failure event satisfies nominated pass through event considerations

The retailer failure event is consistent with the nominated pass through event considerations, as:

- the event may not be covered by a category of pass through event specified in clause 6.6.1(a1)(1) to (4) of the Rules. This because there is some uncertainty over whether the retailer insolvency event specified in clause 6.6.1(a1)(4) of the Rules applies to Victorian distributors. Further, having regard to the policy behind the COAG Rule Change Request, in its proposed definition CitiPower has clarified the definition of the retailer insolvency event in the Rules to ensure that it can seek to pass through unpaid charges for the provision of direct control services;
- the nature or type of event can be clearly identified at the time of the determination for the distributor as it is based on the retailer insolvency event in Chapter 6 of the Rules;
- as set out above, similar to distributors in jurisdictions which have adopted the NECF, CitiPower is unable to manage the risk of retailers defaulting on payment of its network charges and as

⁶⁵ See definition of 'Credit Allowance' in the Appendix to CitiPower, *Default Use of System Agreement Victorian Electricity Industry*, June 2011.

⁶⁶ See definition of 'Maximum Credit Allowance' in the Appendix to CitiPower, *Default Use of System Agreement Victorian Electricity Industry*, June 2011.

⁶⁷ The Allen Consulting Group, *Retailer DUoS Credit Support Arrangements Implementation Issues in Victoria, Report to Essential Services Commission*, June 2006, p. 10.

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such is unable to reasonably prevent a retailer failure event (as defined above) from occurring or substantially mitigate the cost impact of such an event; and

- due to the low probability, but potentially high cost, of a retailer failure event occurring, it is inefficient for CitiPower to insure (either externally or self-insure) against this event.

CitiPower considers that the proposed nominated pass through event is consistent with the NEO and the revenue and pricing principles in the NEL, as it provides CitiPower with a reasonable opportunity to recover its efficient costs and avoids placing CitiPower in a position where it incurs costs that it is unable to avoid, recover or mitigate. The existing credit support arrangements for CitiPower for failure of a retailer do not recover the full amount of the outstanding debt to CitiPower and this shortfall in cost recovery can be significant. The costs to CitiPower of a retailer failure which fall within the proposed definition of the retailer insolvency event and satisfy the provisions for the approval of pass through amounts in clause 6.6.1 of the Rules should be borne by consumers because:

- the costs of retail contestability should be borne by the beneficiaries of that contestability, that is, by consumers; and
- consumers are the most appropriate party to bear the costs of the financial failure of a retailer because CitiPower is unable to manage the risk of a retailer failure, and they are also better placed to bear these costs as they can be spread across a diversified consumer base.

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3 Application to Alternative Control Services

CitiPower proposes that, in making its constituent decision on the formulae for the control mechanisms for alternative control services, the AER apply the pass through provisions in the Rules for specified and nominated pass through events to alternative control services, and that, in so doing, the materiality threshold be modified when applied to alternative control services.

CitiPower agrees with the AER's conclusion in previous distribution determinations for other States that it is appropriate to apply the pass through provisions of the Rules to alternative control services as all direct control services are subject to the distribution determination.⁶⁸

3.1 Rules requirements

The Rules allow for the cost pass through arrangements in clause 6.6.1 to apply to alternate control services. While clause 6.6.1 is contained in Part C of Chapter 6 of the Rules which relates to building block determinations for standard control services, clause 6.2.6(c) of the Rules provides that the control mechanism for alternative control services may utilise elements of Part C of Chapter 6 (with or without modification). Below that clause in the Rules, an example is given that the 'distribution determination might provide for the application of clause 6.6.1 to pass through events with necessary adaptations and specified modifications'.⁶⁹

Pass through events specified in clauses 6.6.1(a1)(1) to (4) of the Rules and nominated pass through events can relate to both standard control services and alternative control services. The definitions of the pass through events specified in clauses 6.6.1(a1)(1) to (4) of the Rules allow the pass through provisions to apply to both standard control and alternative control services as they relate to direct control services which encompass both standard control services and alternative control services.⁷⁰

In respect of nominated pass through events, clause 6.6.1(a1)(5) of the Rules provides that a pass through event includes any other event specified in a distribution determination as a pass through event for the determination. Clause 6.5.10 of the Rules provides that a building block proposal may include a proposal as to the events that should be defined as pass through events under clause 6.6.1(a1)(5), having regard to the nominated pass through event considerations. While clause 6.5.10 refers to 'building block proposal', which is defined as the part of the distributor's regulatory proposal relevant to standard control services, as noted above clause 6.2.6(c) enables the control

⁶⁸ AER, *Draft Decision South Australian distribution determination 2010-11 to 2014-15*, 25 November 2009, p. 407, AER, *Draft Decision Queensland distribution determination 2010-11 to 2014-15*, 25 November 2009, p. 347. See also the AER's draft decisions on the Australian Capital Territory and New South Wales 2009/10 to 2013/14 distribution determinations where the AER observed that the Rules do not preclude the pass through provisions applying to alternative control services for defined events and nominated events accepted by the AER: AER, *Draft Decision New South Wales distribution determination 2009-10 to 2013-14*, 21 November 2008, p. 286; AER, *Draft Decision Australian Capital Territory distribution determination 2009-10 to 2013-14*, 7 November 2008, p. 171.

⁶⁹ Consistently with that example, the AER notes at p. 79 of its *Final Framework and approach for the Victorian Electricity Distributors, Regulatory control period commencing 1 January 2016*, 24 October 2014 (**Framework and Approach Paper**) that the control mechanism for alternative control services in a distribution determination may incorporate a pass through mechanism.

⁷⁰ See the definitions of regulatory change event, service standard event, tax change event and retailer insolvency event set out at the beginning of this Attachment and contained in Chapter 10 of the Rules. The definition of 'alternative control service' in Chapter 10 of the Rules provides that an alternative control service is a 'direct control service' but not a 'standard control service'. The definition of 'standard control service' provides that a standard control service is a 'direct control service' that is subject to a control mechanism based on a distributor's total revenue requirement. Further, clause 6.2.2(a) of the Rules provides that direct control services are to be divided into two subclasses being (1) standard control services and (2) alternative control services.

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mechanism for alternative control services to utilise elements of Part C (with or without modification).

The AER is required to make a constituent decision on the form of the control mechanisms for alternative control services and the formulae that give effect to those control mechanisms.⁷¹ In respect of CitiPower's distribution determination, that decision includes a decision on the formulae to enable cost pass throughs for alternative control services. The formulae that give effect to the control mechanisms for alternative control services must be as set out in the relevant framework and approach paper, unless the AER considers that unforeseen circumstances justify departing from the formulae set out in that paper.⁷²

The AER sets out the following price cap formula for the control mechanism for alternative control services (excluding the type 5, 6 and smart metering - regulated service) in the Framework and Approach Paper:⁷³

$$\bar{p}_i^t \geq p_i^t \quad i=1,\dots,n \text{ and } t=1,2,3,4$$

$$\bar{p}_i^t = \bar{p}_i^{t-1}(1 + CPI_t)(1 - X_i^t)$$

Where:

\bar{p}_i^t is the cap on the price of service i in year t

p_i^t is the price of service i in year t. The initial value is to be decided in the final decision.

CPI_t is the percentage increase in the consumer price index. To be decided in the final decision.

X_i^t is the X-factor for service i in year t, incorporating annual adjustments to the PTRM for the trailing cost of debt where necessary. To be decided in the final decision.

The AER sets out the following revenue cap formula for the control mechanism for the type 5, 6 and smart metering - regulated service (which the AER classifies as an alternative control service) in the Framework and Approach Paper:⁷⁴

$$(1) \quad MAR_t \geq \sum_{i=1}^n \sum_{j=1}^m p_i^{ij} q_t^{ij} \quad i=1,\dots,n \text{ and } j=1,\dots,m \text{ and } t=1,\dots,5$$

$$(2) \quad MAR_t = AR_t + T_t + B_t$$

$$(3) \quad AR_t = AR_{t-1}(1 + CPI_t)(1 - X_t)$$

⁷¹ Clause 6.12.1(12) of the Rules.

⁷² Clause 6.12.3(c1) of the Rules.

⁷³ AER, *Final Framework and approach for the Victorian Electricity Distributors Regulatory control period commencing 1 January 2016*, 24 October 2014, p. 92.

⁷⁴ AER, *Final Framework and approach for the Victorian Electricity Distributors Regulatory control period commencing 1 January 2016*, 24 October 2014, pp. 92-93.

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Where:

MAR_t is the maximum allowable revenue in year t.

P_t^{ij} is the price of component i of tariff j in year t.

q_t^{ij} is the forecast quantity of component i of tariff j in year t.

AR_t is the annual revenue requirement for year t.

AR_{t-1} in 2016 is the annual smoothed revenue requirement in the PTRM for the 2016 year in 2015 dollar value. After 2016 this is the AR_t from the previous year.

T_t is the adjustments in year t for true-ups relating to the AMI-OIC.

B_t is the sum of annual adjustment factors in year t for the overs and unders account.

CPI_t is the percentage increase in the consumer price index. To be decided in the final decision.

X_t is the X-factor in real terms in year t, incorporating annual adjustments to the PTRM for the trailing cost of debt where necessary. To be decided in the final decision.

3.2 CitiPower's proposal

CitiPower proposes that a pass through mechanism be applied to alternative control services through the formulae for alternative control services in the Framework and Approach Paper. CitiPower proposes, however, that in so applying the pass through mechanism to alternative control services a modification be made to the application of the materiality threshold for cost pass throughs in respect of alternative control services.

For alternative control services other than the type 5, 6 and smart metering - regulated service, CitiPower considers that the AER could give effect to CitiPower's proposal in its distribution determination by defining the X_t^i term in the control mechanism set out in the Framework and Approach Paper for those services to incorporate the pass through mechanism in clause 6.6.1 of the Rules, including all defined pass through events (including any event specified in the distribution determination as a pass through event for the distribution determination), but to provide that, as discussed below, for the purposes of the application of clause 6.6.1 to alternative control services 'materially' takes its ordinary and natural meaning.

For the type 5, 6 and smart metering - regulated service, CitiPower considers that the AER could give effect to CitiPower's proposal in its distribution determination in a similar way to the way it provides for the pass through mechanism in specifying the formula for standard control services, given that the formula for the control mechanism for standard control services set out in the Framework and Approach Paper is substantively similar to that set out in the Framework and Approach Paper for the type 5, 6 and smart metering - regulated service.⁷⁵ For standard control services, CitiPower

⁷⁵ AER, *Final Framework and approach for the Victorian Electricity Distributors Regulatory control period commencing 1 January 2016*, 24 October 2014, pp. 87-88 and 92-93.

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presumes that this will occur by defining the B_t term so as to encompass any pass through amounts arising in respect of those services. If that is the case, then the AER could give effect to CitiPower's proposal by defining the B_t term in the control mechanism for the type 5, 6 and smart metering - regulated service to incorporate the pass through mechanism in clause 6.6.1 of the Rules, including all defined pass through events (including any event specified in the distribution determination as a pass through event for the distribution determination), but to provide that for the purposes of the application of clause 6.6.1 to alternative control services 'materially' takes its ordinary and natural meaning.

CitiPower observes that under the Rules the materiality threshold applies to cost pass throughs through the definitions of 'positive change event' and 'negative change event' and also in some instances through the definitions of the pass through events (for example, the definitions of 'regulatory change event' and 'service standard event'). 'Materially' for the purposes of those definitions and the application of clause 6.6.1 is defined in Chapter 10 of the Rules as:

For the purposes of the application of clause 6.6.1, an event results in a Distribution Network Service Provider incurring materially higher or materially lower costs if the change in costs (as opposed to the revenue impact) that the Distribution Network Service Provider has incurred and is likely to incur in any regulatory year of a regulatory control period, as a result of that event, exceeds 1% of the annual revenue requirement for the Distribution Network Service Provider for that regulatory year.

The definition is not appropriate for alternative control services as the reference to annual revenue requirement in that definition relates to the revenue amount in respect of standard control services. It would therefore be perverse to apply such a definition of 'materially' to pass throughs in respect of alternative control services as the one per cent threshold defined by reference to the annual revenue requirement for standard control services has no reference to the materiality or otherwise of the impact of an event or the costs of providing alternative control services. CitiPower therefore proposes that the definition of 'materially' to apply in respect of alternative control services for the purposes of the definitions of 'positive change event' and 'negative change event' in Chapter 10 of the Rules, the pass through events specified in clauses 6.6.1(a1)(1) to (4) of the Rules and nominated pass through events be modified to the ordinary and natural meaning of the term 'materially'. CitiPower observes in this regard that clause 6.2.6(c) of the Rules (and the example below that clause) contemplates that where the control mechanism for alternative control services uses elements of Part C of Chapter 6, those elements can be modified appropriately. Accordingly, the AER is empowered to modify the materiality threshold otherwise applicable under the Rules in applying clause 6.6.1 in respect of alternative control services.

Applying the pass through provisions in the Rules to alternative control services with the modification proposed by CitiPower is also consistent with the NEO and the revenue and pricing principles. Whether a service is classified as standard control or alternative control should not be a determining factor in deciding whether or not the pass through mechanism should be made available. As a provider of distribution services CitiPower faces risks that would impact on the costs of providing those services. The cost consequence of some of those risks should (in accordance with the pass through provision in the Rules) be borne by the consumer if the risk materialises and has a material impact on the distributor's costs of providing direct control services. In those circumstances a distributor should be able to recover those costs irrespective of how the services were classified by the AER. In particular, this is consistent with the revenue and pricing principle that a distributor should be provided with a reasonable opportunity to recover at least the efficient costs it incurs in providing *direct control services*.

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The AEMC's recent observations regarding the role of a cost pass through mechanism (discussed at the beginning of this chapter) apply equally to alternative control services. In particular, as noted above, the AEMC stated that cost pass throughs, and the specification of nominated pass through events, are necessary to ensure that NSPs are provided with the opportunity to recover their efficient costs where those costs result from unforeseen and uncontrollable events for which insurance is limited or not available on commercial terms and self-insurance is not appropriate.⁷⁶ In the absence of cost pass throughs in these circumstances, the AEMC recognised, efficient investment in, and efficient operation of, a distributor's network would likely be adversely affected over the long term contrary to the NEO.⁷⁷

⁷⁶ AEMC, *Rule Determination National Electricity Amendment (Cost pass through arrangements for Network Service Providers) Rule 2012*, 2 August 2012, pp. 18-19.

⁷⁷ AEMC, *Rule Determination National Electricity Amendment (Cost pass through arrangements for Network Service Providers) Rule 2012*, 2 August 2012, p. 18.