

Decision

Powerlink nominated cost pass through events

Application to amend

Powerlink's 2012–17 transmission determination

March 2013

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Overview

The pass through mechanism of the National Energy Rules (NER) recognises that a transmission network service provider (TNSP) can be exposed to risks beyond its control, which may have a material impact on its costs. A cost pass through enables a business to recover (or pass through) the costs of defined unpredictable, high-cost events which are not included in the expenditure allowances in the AER's transmission determination.

The NER specifies certain pass through events that are applicable to all TNSPs:¹

- a regulatory change event
- a service standard event
- a tax change event
- an insurance event
- any other event specified in a transmission determination as a pass through event for the determination.²

In August 2012, the Australian Energy Market Commission (AEMC) changed the NER's cost pass through provisions to give TNSPs the ability to nominate additional pass through events as part of their revenue proposals.³

The AEMC set out transitional arrangements that enabled Powerlink to apply for an amendment to its 2012–17 transmission determination to include additional pass through events to apply during the regulatory control period.⁴ On 30 October 2012, Powerlink nominated three pass through events.

Powerlink's 2012–17 transmission determination was made on the basis that the AEMC rule change was foreseeable and that Powerlink would have the ability to nominate additional pass through events. It was also made on the basis that Powerlink did not include operating expenditure costs associated with events for which it is now seeking nominated pass throughs. Our decision regarding the nominated pass through events to apply to Powerlink is consistent with the position held at that time.

¹ NER, clauses 6A.7.3.

² An insurance event is different to the nominated insurance cap event.

³ AEMC, *Rule determination, National electricity amendment (cost pass through arrangements for network service providers) rule 2012*, 2 August 2012.

⁴ NER, clause 11.49.3.

1 Decision

Powerlink sought our approval to include three nominated pass through events:

- general nominated pass through event
- property damage above insurance cap event
- liability above insurance cap event.

We do not accept a general nominated pass through event should apply to Powerlink.

Furthermore, we do not approve Powerlink's proposed definitions for property damage above insurance cap event or a liability above insurance cap pass through event.

Instead our decision is to approve for inclusion in Powerlink's 2012–17 transmission determination an insurance cap event defined as follows:

An insurance cap event occurs if:

- (a) Powerlink makes a claim on an insurance policy during the regulatory control period
- (b) Powerlink receives an insurance payment pursuant to that insurance claim
- (c) The insurance policy limit does not cover the costs incurred by the service provider for the event the subject of the insurance claim (where those costs would have been recovered under the insurance policy had the limit not been exhausted), and
- (d) The outcome of (c) is a material increase in the costs to Powerlink of providing prescribed transmission services.

Where Powerlink makes a formal application that one of these events has occurred, our assessment will have regard to, among other relevant factors:

- (i) Any insurance premium proposal submitted by Powerlink in its revenue proposal
- (ii) The forecast operating expenditure allowance approved in the AER's final decision
- (iii) The reasons for that decision, and
- (iv) The terms of any insurance payment, court order or settlement of litigation arising out of the events for which Powerlink is insured.

The AER will make the necessary consequential amendments to Powerlink's 2012–17 determination to give effect to this decision, to be published separately to this decision.⁵

⁵ NER, clause 11.49.3(e).

1.1 Policy review

Powerlink's 2012–17 transmission determination was made on the basis that the AEMC rule change was foreseeable and that Powerlink would have the ability to nominate additional pass through events. It was also made on the basis that Powerlink did not include operating expenditure costs associated with events for which it is now seeking nominated pass throughs. Our decision regarding the nominated pass through events to apply to Powerlink consistent with this position at the time the 2012–17 determination was made.

We are currently reconsidering our previous position of approving nominated pass through events in determinations. As an initial step in this process we sought expert actuarial advice on our current approach to nominated pass through events, and on the practical implications of an insurance cap event in particular. Based on that report there appear to be grounds for revising the AER's approach to nominated pass throughs, to better reflect appropriate risk sharing arrangements between service providers and their customers. That is, the implications of the actuarial advice received are that a risk sharing arrangement, implemented through the operating expenditure allowance, is likely to result in lower imposts on customers overall.

Any such revised approach would mean that there would be an increased emphasis in future determinations on compensating network service providers through operating expenditure allowances for insurance premiums that cover low probability, high risk events, rather than through pass through events. We intend to consult more widely on these matters before firming our views on the need for such insurance pass through events.

2 Background

On 2 August 2012, the AEMC changed the cost pass through provisions in the NER to allow TNSPs to nominate additional pass through events in their revenue proposals. These nominated pass through events are additional to the pass through events that are already prescribed by the NER.

The rule change included transitional provisions which allowed Powerlink 90 days to apply to the AER to amend its transmission determination for the 2012–17 regulatory control period (made in April 2012) to include nominated pass through events.

On 30 October 2012, Powerlink applied to the AER to amend its 2012–17 transmission determination to include three nominated pass through events.

We are now required to assess that application and make a decision whether to amend Powerlink's 2012–17 transmission determination accordingly.

3 Powerlink nominated cost pass through events

Powerlink sought approval to amend its 2012–17 transmission determination to include three nominated pass through events:

- general nominated pass through event
- property damage above insurance cap event
- liability above insurance cap event.

Powerlink's application is available on the AER's website under its [2012–17 transmission determination](#).

3.1 General nominated pass through event

Powerlink proposed a general nominated pass through event defined as:

An uncontrollable and unexpected event that occurs during the regulatory period, the effect of which could not have been prevented or mitigated by prudent operation risk management.

Powerlink stated that the proposed general nominated pass through event is designed to manage the risks of other unforeseen, potentially high cost impact events and listed the following two examples:

- A terrorism event – previously defined under chapter 6A of the rules.
- A cyber security event – which relates to computer and/or monitoring, control and other technology intrusion and the spread of malicious code which can affect the availability, integrity and confidentiality of information and potentially cause critical and lengthy disruption to operations.

3.2 Insurance cap events

Powerlink proposed an insurance cap event as two separate events: one for property damage and the other for third party liability claims.

3.2.1 Property damage above insurance cap event

Powerlink defined a property damage event as:

An event which causes property damage to Powerlink assets in excess of Powerlink's insured level at the time of occurrence of the event.

Powerlink noted:

- A number of perils such as floods, earthquakes, windstorm, cyclones, tsunamis or natural disasters could cause property damage above the insurance cap. While it operates its network to a standard resilient to withstand weather events, to do so beyond what is prudent would not be reasonable as a preventative measure.
- It has taken out insurance for circumstances which may cause damage to Powerlink assets up to a cap on reasonable commercial terms.

- As part of its 2012–17 determination the AER assessed that its insurance proposal reasonably reflected the costs of a prudent operator. Powerlink considered that it would not be economic to procure insurance for property damage beyond the proposed level of cover.
- Its transmission determination did not provide a self insurance allowance for above insurance cap events.

3.2.2 A liability above insurance cap event

Powerlink defined a property damage event as:

An event which results in losses or liability claims from a third party which exceed the limit of cover in insurances.

Powerlink noted:

- Insurance for such liabilities are typically capped.
- While cover above the cap may be available it tends to be at very high premiums which are uneconomic.
- The AER concluded that an above insurance cap event was appropriate in its previous determinations for Victorian distribution network service providers and Aurora.

4 Assessment approach

The fundamental regulatory policy principle is one of efficient risk allocation: the risk should be allocated to the entity best placed to manage the risk. The nature of the risks contemplated for cost pass through should be low probability but high impact events. While the event itself may not be controllable (for example, a natural disaster) the ability to manage the costs and mitigate the risk is to some extent within a service providers control.

In deciding whether to accept Powerlink's proposed nominated pass through events, regard must be had to the nominated pass through event considerations, namely:⁶

1. whether the event is covered by another category of pass through event
2. whether the nature or type of event can be clearly identified
3. whether a prudent service provider could reasonably prevent an event of that nature from occurring or substantially mitigate the cost impact of such an event
4. whether the relevant service provider could insure against the event, having regard to:
 - a. the availability (including the extent of availability in terms of liability limits) of insurance against the event on reasonable commercial terms; or
 - b. 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.

The matters that we are required to take into account in assessing whether to accept a nominated pass through event are similar to the 'Relevant Factors' that we must take into account under clause 6A.7.3(j) when assessing the amount in a cost pass through application.

We also had regard to the National Electricity Objective (NEO) and the revenue and pricing principles in the National Electricity Law (NEL) in coming to our decision. Expert actuarial advice on the practical implications of an insurance cap event was also obtained.

4.1 Relevant regulatory requirements

The relevant NER clauses are:

- The nominated cost pass through events considerations (NER, chapter 10)
- Cost pass through (NER, clause 6A.7.3)
- Pass through events (NER, clause 6A.6.9)
- Transitional arrangements for Powerlink (NER, clauses 11.49.2 and 11.49.3).

⁶ NER, clause 6A.6.9(b); NER, definition of '*nominated event pass through considerations*', chapter 10.

5 Reasons for decision

5.1 General nominated pass through event

We do not accept a general nominated pass through event for the following reasons:

- The proposed event definition is inconsistent with the nominated pass through event considerations set out in the NER. In particular, we must have regard to whether the nature or type of event can be clearly identified. We consider that the general nominated pass through event cannot be clearly identified or defined.
- Because the event is not clearly identified, it is difficult to assess whether a prudent service provider could reasonably prevent an event of that nature occurring or substantially mitigate the cost impact of that event. It is also difficult to assess whether a service provider could insure or self-insure against such an event occurring.
- We did not accept a general pass through event in the 2011–15 Victorian distribution determination for this reason.⁷ That decision stated

at this time, and unless there is good reason for the reintroduction of such event, the AER intends that its refusal of the general pass through event will apply in future distribution determinations.⁸

In considering Powerlink's application, we have not found any evidence or reason that would lead us to depart from this position.

Powerlink suggested that the general nominated pass through event could capture losses arising from a terrorism event or a cyber security event. We consider that a general nominated pass through event is unnecessary for potential terrorism costs, and inappropriate for a potential cyber security costs for the following reasons:

- The previous 'terrorism pass through event' that was set out in the NER prior to the AEMC's amendments will apply to Powerlink for the remainder of its current regulatory control period (clause 11.49.2, savings and transitional provisions).
- A cyber security event may well be covered by the definition of a terrorism event if the intention of the intrusion was for political or religious reasons, but it possibly may not fit within the definition otherwise. While the insurance market is still developing for cyber security and obtaining insurance coverage might be difficult,⁹ it is still a risk that is best managed by the business through insurance, self-insurance and risk mitigation.

5.2 Insurance cap events

We do not approve Powerlink's proposed definitions for property damage above insurance cap event or a liability above insurance cap pass through event. Instead our decision is to approve an alternative insurance cap event.

⁷ AER, *Victorian Distribution determinations 2011–13 – draft decision*, p.711.

⁸ AER, *Victorian Distribution determinations 2011–13 – final decision*, p. 795.

⁹ ElectraNet, *Pass through event proposal*, p. 6.

Property damage above insurance cap event

We do not accept the proposed property damage above insurance cap event for the following reasons:

- We consider that the nature and type of event is not sufficiently clear or identified. This raises a number of issues:
 - It is not clear from the definition whether Powerlink is seeking a pass through for all costs above its insurance level at the time the event occurred, or just those costs that would have been covered under its insurance policy had the policy not been exhausted. We consider that it is important that only those costs that would have been covered by the insurance policy (but for the policy limit) be passed through. This means that costs that would not have been covered by an insurance policy will not be passed through to customers. These costs may include costs arising from unlawful conduct or gross negligence, or costs that could have been mitigated by the service provider.
 - The timing of the event proposed by Powerlink is ambiguous. It suggests that Powerlink's ability to make an application to recover costs under the proposed pass through will be triggered at the time of the occurrence of the event which causes property damage. However, property damage that occurs due to the event may not be clearly identifiable or apparent until a substantial period after an event. We consider that this will create difficulties for us in estimating the costs of property damage within the period of time specified in the Rules. We consider that it will be prudent if any costs are assessed by the relevant insurer (or court) before any pass through application is made. This will provide the AER with more certainty that the only costs that are passed onto customers are costs that would have been covered by an insurance policy but for the policy limit. It will also insure that costs that are recoverable from insurance are not passed onto customers.
- We consider that by requiring the event to occur once an insurance payment has been made (or would have been made, but for the relevant policy limit) means that:
 - the timing of when an event occurs will be clearer
 - there is greater certainty that only those costs that are over and above an insurance policy limit will be passed through to customers.

Liability above insurance cap event

We do not accept Powerlink's proposed pass through event definition for liability above insurance cap event.

- We consider that the definition proposed by Powerlink for liability above insurance cap event is problematic as it lacks sufficient certainty regarding when the event occurs. Powerlink proposes that the event occurs either when: (i) Powerlink incurs a liability or liabilities *which exceed the limit of cover in insurances*; or (ii) *the event which results in losses or liability claims from a third party occurs*. This may mean that the AER will need to assess costs arising from one event twice: once directly after an event which gives rise to the loss occurs; and again after Powerlink incurs a liability or liabilities. It is also not clear at what point in time Powerlink will apply to have its costs

passed through to its customers. It is not clear whether this will be before or after its liabilities to third parties are assessed by an insurer.

- If Powerlink incurs liability under its proposed event definition prior to that liability being assessed by an insurer, it will be difficult for us to assess whether those liabilities would or would not be covered by the relevant insurance policy. We therefore consider that it will provide greater certainty if the event occurs when Powerlink actually receives an insurance payment from its insurer, after it submits a claim. This ensures that the costs that will potentially be passed onto customers will be actual costs above the relevant insurance cap. It will also provide comfort that the insurer considers that those costs would have been covered by the relevant policy, but for the policy limit (for instance, that the costs are not incurred due to gross negligence or unlawful conduct).

In our previous determinations, the insurance cap event encompassed property damage and liability to third parties as a single event. We consider that the definition of an insurance cap event which encompasses both property damage and liability to third parties set out in section 1 is the more appropriate event to include in Powerlink's 2012–17 determination. The event definition provides greater certainty as to when the event occurs: that is, when Powerlink makes a claim on an insurance policy during the regulatory control period, and Powerlink receives an insurance payment pursuant to that insurance claim. It provides certainty that only those costs that would have been met under an insurance policy, but for the relevant policy limit, are passed through to customers.