



OFFICE OF THE CHIEF EXECUTIVE

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Mr Warwick Anderson
General Manager
Network Regulation North Branch
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

Dear Warwick

Nominated Pass Through Events

On 2 August 2012, the AEMC released its Final Determination and Rule on cost pass through arrangements for network service providers in response to Grid Australia's Rule change proposal.

Under section 11.49.3 of the new Rule, transitional arrangements provide for Powerlink to apply to the AER to amend its transmission determination for the current (2012/13 to 2016/17) regulatory period to include one or more nominated pass through events. Consistent with this provision, Powerlink seeks the AER's approval to include the following nominated pass through events for the current regulatory period:

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

Each of these nominated events is discussed in the detailed attachment, including demonstration that Powerlink has considered the nominated pass through event considerations in the Rules in preparing its proposal.

If the AER requires any further information or clarification in relation to this proposal, please contact Jennifer Harris on (07) 3860-2667 or via email at jharris@powerlink.com.au in the first instance.

Yours sincerely

A handwritten signature in black ink that reads "Merryn York".

Merryn York
CHIEF EXECUTIVE

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Attachment

POWERLINK PROPOSED NOMINATED PASS THROUGH EVENTS

1. Property Damage Above Insurance Cap Event

Powerlink defines 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.

In proposing this event, Powerlink has had regard to the nominated pass through event considerations in the Rules as follows:

- (a) a property damage event is not a pass through event for a transmission determination specified in clause 6A.7.3(a1)(1) to (4) of the Rules. That is, it is not a regulatory change event, a service standard event, a tax change event or an insurance event as defined in the Rules for transmission. For clarification, an insurance event under the Rules is defined as:

An event for which the risk of its occurrence is the subject of insurance taken out by or for a Transmission Network Service Provider, for which an allowance is provided in the total revenue cap for the Transmission Network Service Provider and in respect of which:

- (a) the cost of the premium paid or required to be paid by the Transmission Network Service Provider in the regulatory year in which the cost of the premium changes is higher or lower than the premium that is provided for in the maximum allowed revenue for the provider for that regulatory year by an amount of more than 1% of the maximum allowed revenue for the provider for that regulatory year;
- (b) the risk eventuates and, as a consequence, the Transmission Network Service Provider incurs or will incur all or part of a deductible where the amount so incurred or to be so incurred in a regulatory year is higher or lower than the allowance for the deductible (if any) that is provided for in the maximum allowed revenue for the provider for that regulatory year by an amount of more than 1% of the maximum allowed revenue for the provider for that regulatory year;
- (c) insurance becomes unavailable to the Transmission Network Service Provider; or
- (d) insurance becomes available to the Transmission Network Service Provider on terms materially different to those existing as at the time the revenue determination was made (other than as a result of any act or omission of the provider which is inconsistent with good electricity industry practice).
- (b) Powerlink considers that the nature and type of event, as defined above, can be clearly identified at the time the AER makes its determination on the nominated pass through events by reference to the definition provided above.
- (c) A number of perils could eventuate and cause a property damage event above the insurance cap to occur. For example, floods, earthquake, windstorm, cyclone, tsunami or natural disaster. Powerlink considers that while it invests, operates and maintains its network to a standard and/or level of resilience to withstand weather events of varying nature and other events (depending upon

geographic location), to do so beyond what is prudent would not be reasonable as a preventative measure. Notwithstanding this, Powerlink considers that there remains a risk that were any one of the stated perils to eventuate, the cost impact could be so significant that it would be of an order of magnitude to activate a property damage event above the insurance cap.

Powerlink therefore considers that it has taken all reasonable, prudent and efficient steps to minimise the impact of such a property damage event on its network. Ultimately, an event of this nature is not foreseeable and is outside Powerlink's control.

- (d) Powerlink has taken out insurance for circumstances which may cause damage to Powerlink assets up to a cap on reasonable commercial terms. The level of insurance currently held by Powerlink for this purpose is [REDACTED]

As part of Powerlink's 2012/13 to 2016/17 revenue determination process, the AER assessed that Powerlink's proposed insurances and the proposed level of cover taken out reasonably reflects the costs of a prudent operator. At the time of lodging its Revenue Proposal and, based upon the information available at the time, Powerlink considered that it would not be economic to procure insurance for property damage beyond the proposed level of cover (insurance cap).

Powerlink considers that the AER's conclusions in relation to liability above insurance cap events equally apply here. That is, the AER acknowledged that an NSP could optimise its risk management by designing its network and externally insuring to a certain level of risk. Further, and consistent with the AER's view, Powerlink considers that under this approach it is more efficient to leave some losses above the insurance cap uninsured.¹

Self-insurance

Powerlink does not consider that a property damage event above the insurance cap can be self-insured as the potential loss to Powerlink is potentially commercially catastrophic and could have a significant impact upon Powerlink's ability to provide prescribed services. In addition, it should be noted that Powerlink's revenue determination did not provide a self-insurance allowance for above insurance cap events.

In light of these considerations, Powerlink is of the view that the inclusion of a property damage above insurance cap event as a nominated pass through represents the most efficient option for managing this risk during its 2012/13 to 2016/17 regulatory period. For clarification, the Rules only allow for pass through of costs in this regard where the occurrence of the event materially increases the costs incurred by Powerlink but for the event. In this way, customers will only be impacted if the low probability risk eventuates and the cost impact of this event exceeds 1% of Powerlink's maximum allowable revenue (MAR) for that regulatory year. In other words, the cost impact must exceed between \$8.26m to \$10m before the pass through provisions can be activated.

¹ AER (2011), Aurora 2012-17 Draft Distribution Determination, p39.

2. Liability Above Insurance Cap Event

These are events which result in losses or liability claims from a third party which exceed the limit of cover in insurances. As with property damage to Powerlink above the insurance cap (discussed in section 1 above), there are a number of events which may give rise to a liability event of this nature. While service providers may insure to manage the risk of these liability claims, such insurances are typically capped at a certain amount. Further, while cover over and above the cap may be able to be obtained in the insurance market, this tends to be at very high premiums, which makes it uneconomic to take out additional cover.

Powerlink has had regard to the nominated pass through event considerations in the Rules in proposing this event as follows:

- (a) A liability event above the insurance cap is not a pass through event for a transmission determination specified in clause 6A.7.3(a1)(1) to (4). That is, it is not a regulatory change event, a service standard event, a tax change event or an insurance event as defined in the Rules for transmission.
- (b) Powerlink considers that the event can be clearly identified at the time the AER makes its determination on the nominated pass through events. To assist the AER with this task, Powerlink proposes that the event be defined as follows:

Either:

- (i) *Powerlink incurs a liability or liabilities; or*
- (ii) *an event occurs,*

where:

- (iii) *the incurring of that liability or those liabilities or the occurrence of that event would, but for the existence of a relevant policy limit, entitle the provider (or another person on its behalf) to receive a payment, or a greater payment, under the insurance policy to which that limit applies; and*
- (iv) *the costs that are incurred or are likely to be incurred by the provider in respect of that liability or those liabilities or in respect of that event, and that would be covered by the insurance policy but for the relevant policy limit, are such as to materially increase the costs to Powerlink of providing prescribed transmission services.*

For the purpose of this event, the relevant policy limit for an insurance policy means any limit on the maximum amount that can be claimed under that insurance policy, including a limit set on the maximum amount of a single claim or on the maximum amount of a number of claims over a certain period of time.

Powerlink notes that the AER was satisfied that a liability above insurance cap event was appropriate in its recent determinations for Aurora (April, 2012) and the Victorian electricity DNSPs (October, 2010).

- (c) The extent to which Powerlink could reasonably prevent a claim which exceeds its insurance cap from occurring, or could substantially mitigate the cost impact of such an event, is limited if at all. In particular, Powerlink considers that a liability above the insurance cap is not foreseeable and is outside its control.

Once again, Powerlink notes that the AER concluded that a liability above insurance cap event satisfied this requirement in its recent determinations for Aurora and the Victorian electricity DNSPs.

- (d) Powerlink has insured against liability events of this nature up to a certain amount. [REDACTED] As part of its regulatory determination process, the AER assessed that Powerlink's proposed insurances and the proposed level of cover taken out reasonably reflects the costs of a prudent operator.

Notwithstanding this, Powerlink considers that there remains a risk that a liability claim above the insurance cap could be made (albeit, low probability) in excess of the insurance cap. More importantly, the consequence of such an event would have a high cost impact. For example, where key generation assets are affected.

The AER acknowledged that an NSP could optimise its risk management by designing its network and externally insuring to a certain level of risk. Further, and consistent with the AER's view, Powerlink considers that under this approach it is more efficient to leave some losses above the insurance cap uninsured.²

Self-insurance

Powerlink does not consider that a liability above insurance cap event can be self-insured as the potential liability under this event could also be potentially commercially catastrophic and could therefore have a significant impact upon Powerlink's ability to provide prescribed services. In addition it should be noted that Powerlink's revenue decision did not provide a self-insurance allowance for above insurance cap events.

Having had regard to the Rules considerations, Powerlink maintains that the inclusion of a liability above insurance cap event as a nominated pass through is the most efficient option for managing this risk during its current regulatory period. As with the proposed property damage above insurance cap event, Powerlink can only seek pass through of relevant costs where the risk eventuates and the associated costs are greater than 1% MAR in that regulatory year.

3. General Nominated Pass through Event

Powerlink also seeks the AER's approval to include a general nominated pass through event to apply during its current regulatory period. The proposed event is designed to provide an appropriate avenue through which to manage the risks of other unforeseen, potentially high cost impact events. For example:

- terrorism events – which were previously defined under Chapter 6A of the Rules as:

An act (including, but not limited to, the use of force or violence or the threat of force or violence) of any person or group of persons (whether acting along or on behalf of or in connection with any organisation or government), which from its nature or context is done for, or in connection with, political, religious, ideological, ethnic or similar purposes or reasons (including the intention to influence or intimidate any government and/or put the public, or any section of the public, in fear) and which materially increases the costs to [Powerlink] of providing prescribed services; and

² AER (2011), Aurora 2012-17 Draft Distribution Determination, p39.

- cyber security events – which relate 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.

Powerlink proposes that the general nominated pass through event be 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;
- the change in costs of providing prescribed transmission services as a result of the event is material (ie. greater than 1% MAR in the regulatory year); and
- the event does not fall into any of the defined pass through events under the Rules for electricity transmission or other nominated pass through events in respect of Powerlink's 2012/13 to 2016/17 revenue determination.

In proposing this event, Powerlink has had regard to the nominated pass through event considerations in the Rules as follows:

- (a) A general nominated pass through event is not a pass through event for a transmission determination specified in clause 6A.7.3(a1)(1) to (4). That is, it is not a regulatory change event, a service standard event, a tax change event or an insurance event as defined in the Rules for transmission.
- (b) As defined above, Powerlink considers that the event can be clearly identified at the time the AER makes its determination on the nominated pass through events.
- (c) As defined above and, as a prudent service provider, Powerlink does not consider it could, in all cases, reasonably prevent an event of this nature from occurring or to substantially mitigate its cost impact.
- (d) Powerlink does not carry insurance for other unforeseen, potentially high cost impact events.

Nominated Pass Through Event Considerations in the Rules

The nominated pass through event considerations are:

- (a) whether the event proposed is an event covered by a category of pass through event specified in clause 6.61(a1)(1) to (4) (in the case of a distribution determination) or clause 6A.7.3(a1)(1) to (4) (in the case of a transmission determination);
- (b) whether the nature or type of event can be clearly identified at the time the determination is made for the service provider;
- (c) whether a prudent service provider could reasonably prevent an event of that nature or type from occurring or substantially mitigate the cost impact of such an event;
- (d) whether the relevant service provider could insure against the event, having regard to:
 - (1) the availability (including the extent of availability in terms of liability limits) of insurance against the event on reasonable commercial terms; or
 - (2) whether the event can be self-insured on the basis that:
 - (i) it is possible to calculate the self-insurance premium; and
 - (ii) the potential cost to the relevant service provider would not have a significant impact on the service provider's ability to provide network services; and
- (e) any other matter the AER considers relevant and which the AER has notified network service providers is a nominated pass through event consideration.