Statement of principles for the regulation of electricity transmission revenues

Position paper

Pass-throughs and revenue-cap re-openers

December 2005

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Glossary

ACCC	Australian Competition and Consumer Commission
AEMC	Australian Energy Market Commission
AER	Australian Energy Regulator
CAPM	Capital asset pricing model
Capex	Capital expenditure
Code	National Electricity Code
DB	Distribution business
DNSP	Distribution network service provider
DRP	Draft statement of regulatory principles for the regulation of electricity transmission revenues
ESC	Essential Services Commission of Victoria
Guidelines	Compendium of electricity transmission regulatory guidelines
IPART	Independent Regulatory and Pricing Tribunal of New South Wales
MAR	Maximum allowed revenue
NEC	National Electricity Code
NEM	National Electricity Market
NER	National Electricity Rules
NEL	National Electricity Law
NSW	New South Wales
Ofgem	Office of Gas and Electricity Markets (United Kingdom)
Opex	Operating and maintenance expenditure
SRP	Statement of regulatory principles for the regulation of electricity transmission revenues
TNSP	Transmission network service provider
TPA	Trade Practices Act 1974 (Cth)
WACC	Weighted average cost of capital

1 Introduction

1.1 Statement of the issue

This paper discusses the Australian Energy Regulator's (AER's) considerations on the best way to adjust an electricity transmission network service provider's (TNSP's) revenue allowance for exogenous events, the cost impact of which cannot be reasonably forecast at the time of the regulatory reset and which will have a material impact on the viability of the business ('exogenous events').

Interested parties are invited to make written submissions by 24 February 2006. The AER hopes to release a final determination on the issues raised in this paper in April.

1.2 Context of this review

In August 2005, the AER released a compendium of electricity transmission regulatory guidelines (the Guidelines) outlining the AER's approach to regulation. The Guidelines adopted the Statement of regulatory principles (SRP) developed by the ACCC.

In the Guidelines the AER said that it would monitor the effectiveness of its approach to regulation and would incorporate 'best-practice' approaches to regulation over time. This review is part of that process.

The SRP detailed the ACCC's preference for a 'revenue cap re-opener' mechanism to take account of events that could significantly alter the level of revenue required to fund efficient investment. However, following the release of the SRP, the ACCC implemented a 'pass-through mechanism' in the TransGrid and EnergyAustralia decisions, given that National Electricity Code (NEC) changes, seen to be necessary to implement the re-opener provision, had not occurred.

The formulation of detailed pass through rules by the ACCC (similar to the mechanism in the appendix to this paper) and favourable industry responses to those rules have led the AER to reconsider its approach to dealing with the cost impacts of exogenous events.

The AER needs to clarify its position on pass-throughs and re-openers for the Powerlink review process. The AER is committed to engaging with industry and other interested parties when developing Guidelines or modifying the SRP, and this paper is being released in this context.

1.2.1 AEMC Review

The AEMC is currently conducting a review of Chapter 6 of the NER covering transmission revenue setting and pricing principles. The review is scheduled for completion by 1 July 2006 for transmission revenue setting and 1 January 2007 for pricing issues.

The AER understands that the AEMC will be releasing its proposed amendments to Chapter 6 of the NER in early February 2006 and these proposals are likely to address the issues of re-openers and pass-throughs. The AER asks interested parties to take into account the AEMC draft proposals when responding to this position paper. The AER, in finalising its position, will reflect the regulatory framework proposed by the AEMC and will make necessary amendments.

1.3 The regulatory framework

Responsibility for the regulation of electricity transmission was transferred from the ACCC to the AER effective from 1 July 2005. The AER's power to perform these functions is set out in the National Electricity Law (NEL) and the National Electricity Rules (NER) which supersede the NEC.

The NEL and the NER prescribe the form of regulation to be applied in the regulation of TNSP revenues. Under the NEL, the AER, in making a transmission revenue determination, must:

- perform this function in a way that is likely to contribute to the achievement of the national electricity market objective set down in s. 7 (s. 16(1)(a))

- provide a reasonable opportunity for a TNSP to recover the efficient costs of complying with its regulatory obligations (s. 16(2)(a))

- provide effective incentives to the TNSP to promote economic efficiency, including promoting efficient investment outcomes and service delivery (s. 16(2)(b)).

The NER makes no explicit provision for dealing with cost impacts arising from exogenous events. However, the AER must consider:

- clause 6.2.4(a) which provides that economic regulation applied to transmission services must be of the CPI-X form, or some incentive-based variant

- the potential for efficiency gains (6.2.4(c)(3)) and the need to provide TNSPs with incentives to increase efficiency (6.2.3(d)(1), and see also 6.2.2(b) and 6.2.2(d)-(f))

- the provision of a return on efficient investment and operating expenditure (6.2.4(c)(5), 6.2.3(d)(4) and 6.2.2(b)(2)), service standards (6.2.4(c)(2) and 6.2.4(c)(3)), taxes (6.2.4(c)(6)), network support service payments to generators (6.2.4(c)(7)) and the ongoing commercial viability of the transmission industry (6.2.4(c)(8))

- the need to provide certainty and consistency in regulatory processes, balance the interests of users and TNSPs and minimise the costs of regulation (6.2.3(d), 6.2.2(a) and 6.2.2(i)-(k)).

The AER's regulatory review process is designed to assess all necessary and efficient costs, so that appropriate revenues are provided to TNSPs. Because this process is performed 'ex ante' the AER is required to determine an allowance to cover a TNSP's costs before the beginning of a regulatory period. The AER's regime also provides the regulated firm with an incentive to 'beat' that target and earn above-market returns on investment. It can do this by minimising costs and controlling risk, within the context of its service and investment obligations.

The AER recognises that some events are unpredictable and largely beyond control of a TNSP, and that cost impacts of these exogenous events can change TNSPs' efficient costs. The difficulty for the AER is in distinguishing between those cost impacts that a TNSP can and cannot control.

If an adjustment mechanism is not available to realign revenue with efficient costs after an exogenous event, then the allowed revenue may differ from the level required to fund efficient investment.

There are several adjustment or risk-allocation mechanisms that can be used to deal with the cost impacts of exogenous events. For example, a regulator could:

- provide an allowance to the TNSP to purchase insurance against the cost impacts of exogenous events
- provide the TNSP with an allowance for self insurance
- adjust a TNSP's revenue allowance when an exogenous event occurs.

A regulator will use a combination of these measures to ensure that appropriate compensation is made for the risk posed by exogenous events. The optimal approach for any particular type of risk will vary.

This paper covers issues related to adjusting a TNSP's revenue allowance within a regulatory period when (and if) an exogenous event occurs.

1.3.1 Adjusting a TNSP's revenue allowance within a regulatory period

There are three options available to the AER to adjust a TNSP's revenue allowance when and if an exogenous event occurs:

(1) As part of the revenue cap, the AER could prescribe the criteria for an adjustment to a TNSP's Maximum Allowable Revenue (MAR). This is described as a 'pass-through' option in this paper.

This option could be implemented without a rule change, as long as the pass-through mechanism is objective and self-executing. Clause 6.2.4 of the NER does not allow the AER to exercise discretion in varying a revenue cap allowance during a regulatory period. This means that pass-through events need to be defined tightly, and pass-through rules can not confer any additional functions or powers on the AER.

(2) As part of a revenue cap decision, the AER could indicate that, if an exogenous event with material cost consequences were to occur within the regulatory control period, the AER would adjust the revenue cap at the next reset to place the TNSP in the same financial position as if the current revenue cap compensated for that event.

This option is also possible. This option carries regulatory risk, as the AER is not bound to adjust for past exogenous events in a future revenue cap. A pass-through mechanism that allows the AER to adjust a revenue cap within a regulatory period would address this concern and therefore this option is not considered further in this paper.

(3) The AER could seek to amend the NER to allow the AER to revoke, remake or vary a revenue cap decision within a regulatory control period. The absence of such an amendment led to the ACCC departing from the approach outlined in the SRP and formulating detailed pass-through rules for the TransGrid and EnergyAustralia revenue resets.

1.4 History: dealing with the cost impact of exogenous events

The ACCC's approach to dealing with the cost impacts of exogenous events developed from the broad principles in the DRP. The decision on pass-throughs which formed the ACCC's template for dealing with pass-through issues was the SPI PowerNet Decision in 2002. This decision established four categories of opex pass-through:

- a change in taxes event
- a service standards event
- a terrorism event
- an insurance event.

These pass-through events have been applied in all subsequent revenue cap decisions. The only additional pass-through event - for network support (grid support), was established in the Transend revenue cap decision (December 2003). In the TransGrid and EnergyAustralia Decisions (April 2005) the ACCC included these five pass-through events.

The ACCC developed a set of model pass-through rules in August 2004, in consultation with industry, which set out in detail how the ACCC's pass-through regime would work. A version of these rules is in Appendix A, and has been amended to incorporate the AER's preferred positions on pass-through events and materiality as outlined below.

1.4.1 Statement of regulatory principles

The Statement of regulatory principles (SRP) released in December 2004 stated the ACCC's preference for a revenue cap re-opener mechanism to take into account the cost impacts of events that could significantly alter a TNSP's efficient costs. The ACCC also stated that there may be some circumstances in which it would consider a pass-through of the cost impact of an exogenous event without re-opening all aspects of a revenue cap.

Under the re-opener mechanism, a TNSP would propose that a revenue cap be reopened and there would be no limit on the nature of the re-opener event. However, re-opening the revenue cap would be conditional on:

- the TNSP being materially adversely affected by the event
- the event being beyond the firm's control
- the event not having been contemplated at the time the revenue control decision was made
- the benefits of revoking the revenue control outweighing the detriment to the TNSP's customers from revoking the control.

In the SRP, the ACCC preferred the revenue cap re-opener mechanism because of difficulties associated with the pass-through mechanism such as:

- the difficulty of separating exogenous and endogenous costs
- the difficulty of calculating the extent that risks have already been compensated for in the maximum allowed revenue
- possible double counting and the negative effects this has on efficiency incentives.

1.4.2 Other jurisdictions

A review of the approaches of state regulators of electricity distribution businesses provides useful background for the AER's considerations on this matter.

Most state regulators have adopted pass-through arrangements that specify a materiality test, and are symmetrical (pass-through are for both costs and savings). Most jurisdictional regulators have retained the right to initiate pass-through assessments.

Independent Regulatory and Pricing Tribunal of New South Wales (IPART)

IPART (2004[1]) introduced two cost pass-through mechanisms for NSW electricity distributors: a specific cost pass-through provision and a general cost pass-through provision. IPART allowed specific cost pass-through for four known events, whose likelihood of occurrence was uncertain and whose resulting changes and cost implications could not be assessed by IPART. These events were:

- changes in occupational health and safety requirements governing live-line working procedures
- potential amendments to the Electrical Supply Act seeking to clarify the definition of 'electrical installation and point of supply'
- possible changes to requirements to make customer payments for breaches of the guaranteed customer service standards
- possible changes in the government's policy on interval/time based metering.

IPART did not adopt a materiality threshold for these specific events.

IPART also provided a general cost pass-through mechanism to allow for pass-through of costs associated with changes in tax and regulatory obligations. IPART excluded insurance and terrorism events, citing the administration costs of including such events and moral hazard risk. IPART set a materiality threshold of 1 per cent of the DNSP's average annual smoothed revenue requirement over the regulatory period for general events. This threshold was intended to limit pass-through to events that significantly affect a DNSP's costs.

[1] Independent Regulatory and Pricing Tribunal, *NSW Electricity Distribution Pricing Determination 2004/5—2008/9*, released June 2004

IPART considered that the general cost pass-through mechanism should be symmetrically applied, with events that both increase and decrease costs for DNSPs being eligible for pass-through. IPART also reserved the right to initiate the process of approving the pass-through of cost savings after such an event.

Independent Competition and Regulatory Commission of the ACT (ICRC)

The ICRC (2004[2]) indicated that the following pass-through events would be considered:

- change in taxes
- change in service standards
- act of terrorism
- major natural disaster.

The ICRC considered that such pass-through events should be limited to material changes in costs. It defined a materiality threshold as an event that would severely restrict the distributor's ability to provide services, and impose a total annualised cost on the distributor for the remainder of the regulatory period of more than $7.5 million (in 2002-03 dollar terms). Alternatively, the annualised cost incurred, or forecast to be incurred must be at least $1.0 million in 2002–03 dollar terms (approximately 1 per cent of ActewAGL's regulated revenue) in any one year.

The ICRC reserved the right to initiate pass-through assessments,based on the defined pass-through events.

Queensland Competition Authority (QCA)

The QCA (2005[3]) considered that it was not practical or appropriate to pre-qualify certain events as accepted pass-through events, and preferred that each event be assessed on its merits against set criteria. The QCA defined a pass-through event as a major exogenous and unforeseen event outside the control of the DNSPs. It would be of such an unusual and unexpected nature, and likely to have such impact on the returns of a business that the cost impact of that event should be passed through immediately to customers.

The QCA also adopted a materiality threshold of 1 per cent of actual annual regulated revenue per event, based on the regulated revenue in the year of the event. The cost pass-through mechanism was symmetrical, with events that both increase and decrease costs for DNSPs being eligible for pass-through. The QCA reserved the right to initiate a process of review.

[2] Independent Competition and Regulatory Commission, *Prices for electricity distribution services in the Australian Capital Territory—Final Decision*, released March 2004

[3] Queensland Competition Authority, *Regulation of Electricity Distribution 2005—2010—Final Determination*, released April 2005

Essential Services Commission of Victoria (ESC)

The ESC (2005[4]) stated that the reopening of a price determination was only appropriate if a distributor is materially adversely affected by an event that is beyond the control of the distributor and that was unforeseen at the time of the price review. The ESC did not consider it appropriate to allow pass-throughs for unspecified events, as the incentive effects of the regulatory framework would be reduced if distributors were allowed to pass on general increases in costs.

4 Essential Services Commission of Victoria, *Electricity Distribution Price Review 2006-2010, Volume I—Statement of Purpose and Reasons*, released October 2005

2 Reviewing revenue caps within a regulatory period

This chapter outlines the arguments for an arrangement to review or revisit a TNSP's revenue allowance after an exogenous event or events during a regulatory period. The AER's obligations under the NER provide the framework for the assessment of these arguments.

2.1 Requirements under the National Electricity Rules (NER)

The actual expenditure outcomes in the regulatory period incurred by a TNSP are likely to differ from the revenue allowance made by the AER. These cost differences can be endogenous, that is, due to circumstances within the TNSP's control, and exogenous, that is, due to the occurrence of unforecast events predominantly outside the TNSP's control.

When the costs of exogenous events are so large that a TNSP would suffer a material financial penalty in responding to that event, the allowance set by the AER may not cover a TNSP's efficient costs, and may compromise the ongoing commercial viability of the transmission industry. These are issues that the AER must have regard to in determining a TNSP's revenue under clause 6.2.4 of the NER. Ways in which a TNSP's revenue allowance can incorporate an allowance to cover such exogenous costs should then be considered.

2.2 Cost pass-through mechanisms and incentive regulation

The starting point for this paper's discussion of dealing with exogenous costs is the decision in the SRP that a cost pass-through mechanism of some type is required to ensure that the AER can consider the issues set down in the NER. That is, to ensure that TNSPs are compensated for efficient investment within the framework on an incentive based regime, and to ensure the ongoing viability of the transmission industry.

The AER considers that the arguments for cost pass-throughs should apply equally to both capex and opex, and that both should be covered by the same pass-through provisions. Exogenous events are likely to affect both categories of expenditure and substantial changes to efficient costs of either type will raise the same concerns about a fair and efficient return.

The AER considers that a pass-through event should:

- be beyond the control of the TNSP
- have a material impact on the TNSP
- affect the TNSP, but not the market generally (systematic or market risk should be addressed in the WACC parameters)
- not already be compensated in the forecast opex or other revenue cap costs

Such events are those for which commercial or self insurance are not available, either because it would be difficult to quantify the likelihood of the event or the insurable amount, or because the cost would be so large that it would be uneconomic to insure.

Preliminary position

The AER considers that it is appropriate for the AER to adopt a revenue adjustment mechanism to enable it to adjust a TNSP's revenue allowance within a regulatory period in the face of material cost impacts of exogenous events.

3 Determining the form of cost pass-through

The chapter examines the options for the various forms of cost pass-through. First, issues relevant to the consideration of a pass-through mechanism are outlined, and then two options for the design of the mechanism are proposed. Second, the relative merits of these options are considered. The chapter then proposes a preferred mechanism of dealing with the cost impact of exogenous events.

3.1 Relevant issues

To evaluate options open to the AER in designing a pass-through mechanism, it is necessary to consider the problems that such a mechanism is trying to address:

- One issue is the **separation of controllable and uncontrollable costs**. To avoid providing TNSPs with an allowance for the same costs twice, (once through the revenue cap and again through a pass-through mechanism), a regulator must seek to separate out and clearly define the uncontrollable event that will be the subject of the pass-through mechanism. This is difficult given that TNSPs are able to take some steps to mitigate the likelihood and impact of most cost events, including those largely outside of their control. A regulator's judgment on whether pass-through risks can be clearly defined before the beginning of a revenue cap is an important determinant of the type of regime that a regulator will implement.

- The provision of an incentive to manage the controllable part of risks faced by the TNSP is needed to avoid another problem of pass-through mechanisms, that of **''moral hazard''**. The moral hazard problem arises when a TNSP is not provided with the incentive to minimise the costs or likelihood of occurrence of exogenous events (for example through spending on insurance, safety or security measures). An incentive to optimally manage risks will be provided by making the TNSP responsible for controllable costs, either through carefully defining the events eligible for pass-through, and/or making TNSPs liable for some of the cost of exogenous events.

- A regulatory regime should seek to **maximise certainty** for the operation and outcomes of a pass-through mechanism. TNSPs should be able to predict how the regime will be implemented by the regulator, and to understand its operation before a regulatory period begins. An ideal regime will strive for transparent, low cost, and predictable arrangements.

These considerations relate to the objectives stated in 6.2.4 of the NER. Specifically, the AER must aim to provide TNSPs with recovery (but not over or under-recovery) of efficient costs, provide incentives for TNSPs to adopt efficient behaviour, and provide regulatory outcomes that encompass high levels of certainty and predictability in both process and outcome.

3.2 Options available to the AER

Models to adjust a TNSP's revenue cap for the cost impacts of material and exogenous events during a regulatory period include:

- the implementation of a re-opener mechanism through which the cost impacts of an unlimited range of events can be passed on to consumers by the resetting of a revenue allowance. This is the arrangement detailed in the SRP

- the implementation of a pass-through regime where cost impacts of a defined set of exogenous events can be passed on to consumers.

These options are considered in turn.

3.3 The revenue cap re-opener model

There are various ways that a revenue cap re-opener model could be applied. However, the chief characteristic of such a model is that the events that would trigger the reopening are not defined in advance. Rather, a cost threshold is usually formulated and if an event or events occur that reach this threshold, a full or limited review of the revenue cap is undertaken.

The re-opener model outlined by the ACCC in the SRP is used here to highlight the merits and disadvantages of the re-opener model more generally. In the SRP, the ACCC proposed a re-opener model with the following characteristics:

- The revenue cap could be re-opened during the regulatory period. In some circumstances the ACCC would consider passing the cost of the event through without re-opening all aspects of the revenue cap.

- Only TNSPs would be able to propose that the revenue cap be re-opened.

- There was no proposed limitation as to the nature of the event that could give rise to a re-opening of the cap, although a TNSP would need to demonstrate that it meets the basic requirements that characterise a cost pass-through event (see below).

The ACCC considered that a re-opening of a revenue cap would be conditional upon:

- the TNSP being materially adversely affected by the event

- the event being beyond the firm's control

- the event not having been contemplated at the time the revenue control decision was made

- the benefits of revoking the revenue control outweighing the detriment to the TNSP's customers of revoking the control.

The SRP's re-opener mechanism did not attempt to define events before the regulatory period began. In the SRP the ACCC considered that the difficulty involved in defining pass-through events meant that it would be prudent to re-open the entire revenue cap or particular affected parts of it when exogenous events occurred.

This feature of the re-opener mechanism has both positive and negative features. On the one hand, a re-opener mechanism of this kind is able to accommodate all exogenous risks that may occur given that it does not restrict the events that can give rise to a revenue cap re-opening. However, this can give rise to a broad problem of moral hazard, discussed in section 3.1, given that a TNSP is aware that all substantial risks will be passed through to consumers.

Another advantage of this mechanism is that, in not seeking to define the nature of events that will be eligible for consideration, the difficulty of setting out such events up front is avoided. However, this problem is shifted rather than solved given that a regulator will have to decide on the breakdown of controllable and uncontrollable elements of the cost impact of exogenous events when they occur. It may be easier to make a forensic distinction once the event has occurred (although this is not always likely to be the case) but this problem is not solved by a re-opener mechanism.

On the question of incentives and the moral hazard problem, a re-opener mechanism has strengths and weaknesses. By not specifying what the eligible events will be, the mechanism avoids giving a TNSP an incentive to reduce expenditure on mitigating the likelihood and impact of the relevant risk (assuming that most risks will have a controllable element). However, the re-opener mechanism could also give rise to perverse incentives. This is because a TNSP will know that all risks with a cost impact above a certain amount are likely to be considered for a pass-through of costs. Under this circumstance, a TNSP may have an incentive to reduce expenditure on mitigation strategies across a range of areas, knowing that a regulator will consider a pass-through of costs for all categories.

The re-opener mechanism sacrifices the certainty that would be gained by setting out defined events in advance, for the ease of assessing events after they have occurred. Under a re-opener provision, unless the regulator commits to passing through all and any costs applied for by the TNSP, TNSPs will not be certain of what a regulator will consider an eligible event. It will also not be clear to a TNSP how controllable and uncontrollable costs will be defined during the assessment process. Although the re-opener mechanism does provide the regulator with broad discretion on how it will consider providing allowances for exogenous events, this is at the expense of certainty for TNSPs.

3.4 The pass-through model

Under a pass-through mechanism, exogenous events that can lead to a pass-through of costs are defined in advance, usually with a high degree of precision. This means that pass-through events can be considered in isolation, and the regulator need not re-assess elements of the revenue allowance that have not been affected directly by the exogenous event.

The ACCC and jurisdictional regulators have accumulated a body of experience in implementing pass-through arrangements since the establishment of the NEM. Most recently, the ACCC established model pass-through rules which formed part of the TransGrid and EnergyAustralia revenue cap decisions. These rules were released after consultation on and specification of the ACCC’s preference for a revenue re-opener provision detailed in the SRP. These model rules were produced after consultation with industry and the AER considers that they represent a workable model for pass-through rules to be implemented by the AER.

The pass-through rules that formed part of the TransGrid and EnergyAustralia decisions set out:

- the definition of applicable pass-through events

- the method used to assess the size of the pass-through allowance
- the period over which the allowance would apply, and the form of the allowance
- the process to be used to initiate a pass-through application
- the information requirements required to support an application
- procedural issues
- the verification process to be followed by the regulator in processing an application.

The rules are detailed and enable the mechanism to operate without the need for the regulator to exercise discretion. The rules provide detailed specification of triggers that can initiate the pass-through process and a defined procedure for dealing with a TNSP's application.

To separate controllable and uncontrollable costs, this pass-through mechanism defines eligible events at the beginning of the regulatory period. In the TransGrid and EnergyAustralia decisions, several events were approved as pass-through events and precise definitions of these events were included as part of the revenue cap decision. The ACCC considered that its experience in dealing with pass-through applications over previous years enabled it to judge what pass-through events should be specified and how these should be defined to minimise the inclusion of controllable elements in the pass-through mechanism.

With regard to the moral hazard problem, the success of the incentive arising from defined pass-through rules will depend on the extent to which controllable risks have been excluded from defined pass-through events. One advantage of the pass-through rules specified in the TransGrid and EnergyAustralia decisions is that they are tightly defined and limited in terms of the number and scope of events. Given that the possibility of a general allowance to cover the cost impact of any event is not a feature of this mechanism, TNSPs have an incentive to spend to mitigate risks across their business to ensure that risks not covered by the pass-through arrangements are minimised.

With regard to regulatory certainty and transparency of the regime, a pass-through mechanism delivers a high degree of certainty to TNSPs. The setting out of the mechanism in detail allows TNSPs to plan according to these specified rules. In addition, the detailed setting out of the pass-through rules provides transparency and regulatory certainty on the methodology adopted to assess and administer the pass-through scheme. The certainty provided by this mechanism is enhanced in the case of the ACCC rules given that they have developed out of a body of experience and observable operation.

3.5 Conclusion

At the time of the formulation of the SRP, the ACCC had not finalised the model pass-through rules which formed the basis of the pass-through regime which was implemented in the TransGrid and EnergyAustralia decisions. Since the release of the SRP, the ACCC and the AER have had time to consider the model pass-through rules which were developed at the time of these decisions. The AER regards the development of these rules as a successful attempt to define a workable set of arrangements to deal with exogenous events and as such, given that this regime provides a level of certainty to TNSPs with regard to the arrangements that will apply to them, is the preferable regime.

Preliminary position

The AER favours the introduction of a pass-through regime into the SRP. The key desirable features of such a regime should be that the pass-through rules should only allow recovery for an event:

- that is not already provided for in the TNSP's allowance
- that is identified in advance with its scope precisely defined
- that is beyond the control of the TNSP
- that has a material financial impact on the TNSP
- that affects the TNSP, and not the market generally

4 Implementing a pass-through regime

This chapter examines how the cost pass-through mechanism preferred by the AER could work, and the strengths and weaknesses of various approaches. This discussion involves:

- consideration of whether the AER should require a materiality threshold to be met as part of a pass-through application
- consideration of the type of events that trigger a pass-through application
- consideration of whether parties other than the affected TNSP should be able to instigate a pass-through application
- consideration of the appropriate process for considering a pass-through application.

The AER has nominated a preliminary position for each of these issues.

4.1 Materiality threshold

In considering the implementation of a cost pass-through regime, the AER's starting point is its obligations under the NER. The relevant principles of the NER and important features of the regime are that:

- the objective of the cost pass-through mechanism should be to protect the viability of the TNSP and its capacity to invest. Therefore, the AER believes that pass-throughs should only apply when the actual cost deviates from forecast costs by a material amount
- the regime should minimize regulator involvement in the TNSP's business to lower regulatory costs for the regulator and the TNSP
- incentives should be provided for TNSPs to invest efficiently. Therefore the AER considers that it is preferable to encourage TNSPs to manage endogenous elements of pass-through events.

The requirements of the NER would appear to be met by some form of 'hurdle' or threshold that the cost or benefit needs to exceed before the TNSP passes the cost or benefit on to consumers. A relevant consideration of the costs and benefits is the cost to all parties of administering a pass through events regime. Introducing a materiality threshold avoids the possibility that these costs will make up a large portion of any given pass through application.

The use of a materiality threshold would limit the need for close involvement by the regulator in approving small cost changes in the operations of a business. In addition, a 'materiality threshold' provides an incentive for TNSPs to minimise the cost impacts of small exogenous events that would not be passed-through, through insurance or other risk-mitigation strategies. Finally, the AER considers that a 'materiality threshold' approach would provide a clear objective signal on the operation of the regime which would enhance regulatory certainty for service providers.

There are also arguments against adopting a materiality threshold. A threshold may remove some flexibility in the scheme in that exogenous events that have cost consequences close to, but not exceeding, the threshold level are not compensated.

Finally, depending on the way the materiality threshold is defined, the application of the threshold may lead to inconsistent outcomes across TNSPs: what is material to one service provider may not be material to another service provider.

Preliminary position

The AER considers that it is preferable to implement a materiality threshold mechanism. The financial impact of events specified in any pass-through mechanism should cater for significant rather than smaller costs arising from cost fluctuations that arise from the normal operations of a TNSP's business.

4.2 Defining the materiality threshold

The pass-through rules in the TransGrid and EnergyAustralia revenue cap determinations specified that to qualify as a pass-through event, the cost impact of an exogenous event would need to be 'material'. The term 'material' was not defined in any detail.

The AER considers that, in the interest of regulatory certainty, it may be appropriate to further define 'materiality' for the purposes of future pass-through arrangements. A 'materiality threshold' could be expressed as a:

- uniform monetary amount for all service providers, or
- percentage figure or the result of a formula designed to incorporate differences in TNSP revenues.

The AER considers that adopting a test that accounts for the relative sizes of the TNSPs is preferable to the adoption of a scheme that does not. By varying the threshold to account for the size of a TNSP, uniformity in application of the test can be maintained, while recognising that what is a material cost impact for one service provider may not be for others.

In seeking to determine an appropriate percentage figure or formula, there are a range of options that could be considered, such as setting the threshold equal to a fixed percentage of revenue, profit or other variable.

The AER considers that the materiality threshold should be defined in terms of its effects on the efficient costs of the TNSP which the regulator has determined in the setting of the revenues of the firm. The AER believes that the effect of the event on the costs and the revenues of the firm most closely align with the intent of the NER to ensure that TNSPs are compensated for efficient expenditure.

In terms of the absolute percentage level, the AER notes that a materiality threshold of approximately 1 per cent of annual revenue per event, based on the regulated revenue received by the service provider in the year of the event has been adopted as part of several electricity distribution price reviews. This has appeared to work well. The AER proposes to build on the experience of other regulators and adopt a 1 per cent threshold.

Preliminary position

The AER proposes to adopt a materiality threshold of 1 per cent of the TNSP's average maximum allowed revenue for a financial year, estimated at the time of the revenue cap determination. A TNSP would be required to demonstrate that the cost impacts of the exogenous event exceed this level, before an application was considered. If this test is met, then the AER proposes that a TNSP will be entitled to recover the full efficient cost impact of the event.

However, the AER acknowledges that there is a range of numbers that could be used. The AER will consider any proposals that interested parties have on this matter.

4.3 Nature of events that can trigger a pass-through application

Pass-through events could include any exogenous event that materially affects TNSP costs during a regulatory control period. Pass-through events approved by the ACCC include:

- a change in law or taxes
- terrorism or force majeure events
- insurance
- network control ancillary services payments.

4.3.1 Other events

The AER considers that there is a also a case for including other events that are not identified above on a case by case basis in the context of each TNSP's revenue reset. The inclusion of other events will depend upon the assessment of those events against the criteria identified at the end of chapter 3 of this paper. Any application for pass-through will need to be accompanied by a thorough explanation of the need for the pass-through event.

For example the AER sees merit in considering the provision of an allowance for grid support payments within a TNSP's revenue cap. However, the inclusion of grid support payments as a pass-through event may not be appropriate in every instance. The AER will consider applications for the inclusion of further defined events on the merits of any case presented to it.

The rules developed in TransGrid and EnergyAustralia determinations have undergone a substantial consultation process, both in their development and through the release of the draft and final decisions. The AER proposes these rules for consideration in this paper.

Preliminary position

The AER proposes to adopt the following pass through events:

(a) a change in taxes event
(b) an insurance event
(c) a service standards event
(d) a terrorism event
(e) other events (subject to the approval of the AER before a revenue cap begins)

4.4 Who can apply for re-evaluation of a revenue cap?

In specifying a pass-through mechanism, the AER has the choice of:

- specifying that only a TNSP can make an application to the AER for a re-assessment of its revenue allowance or

- specifying that a TNSP, or a party or parties other than the TNSP (such as the regulator or a TNSP's customers) can initiate a re-assessment of a TNSP's revenue allowance.

The question of who can initiate a pass-through application is closely aligned with consideration of information asymmetry issues. The main disadvantage of only providing TNSPs with the ability to initiate a revenue cap re-assessment is that TNSPs have an incentive to only present applications for revenue increases rather than both increases and decreases.

Alternatively, were a party or parties other than a TNSP able to initiate a re-assessment, they may make spurious claims of falls in costs. This could make the regime difficult to administer. Investigating these claims may well be time-consuming and disruptive to the TNSP.

In addition, due to the information asymmetry problem that favours the regulated entity, it is unlikely that a party other than a TNSP would ever be sufficiently informed to quantify cost decreases bought about by the occurrence of an exogenous event.

Given that one of the fundamental aims of mechanisms to deal with exogenous costs is to protect against large-scale disasters that threaten investor returns or the viability of the industry, the AER believes that there would not be substantial risks in limiting the power to instigate a pass-through. The AER considers that, at the level of materiality proposed in this paper, it is unlikely that there would be substantial benefit in providing parties other than an affected TNSP with the ability to request a re-assessment of the revenue allowance, and proposes to limit the ability to initiate an application to the affected TNSP.

Preliminary position

Only a TNSP would be able to initiate a pass-through application.

4.5 Pass-through assessment process

Process-related issues are addressed in section 3 of the model pass-through rules attached to this paper. The AER welcomes feedback on the model rules and will work with interested parties on such issues if appropriate.

5 Preliminary position

This chapter summarises the AER's position on the design of a pass-through mechanism, and contains other details relevant to the public consultation process.

5.1 Summary of positions

The AER's preliminary positions are summarised below:

The AER considers that it should adopt a revenue-adjustment mechanism to enable a TNSP's revenue allowance to be adjusted within a regulatory period in the face of material cost impacts bought about by exogenous events.

The AER considers that the SRP should be revised to reflect a preference for a pass-through regime. The key, desirable features of such a regime should be that the pass-through mechanism should only allow recovery for an event:

- not already provided for in the TNSP's allowance
- identified in advance with its scope precisely defined
- beyond the control of the TNSP
- that has a material financial impact on the TNSP
- that affects the TNSP, and not the market generally.

The AER considers that it is appropriate to adopt a materiality threshold of 1 per cent of the TNSP's average maximum allowed revenue for a financial year, estimated at the time of the revenue cap determination. A TNSP would be required to demonstrate that the cost impacts of the exogenous event exceed this level. If this test is met, a TNSP will be entitled to recover the full efficient cost impact of the exogenous event.

Pass-through events would be limited to:

(a) a change in taxes event
(b) an insurance event
(c) a service standards event
(d) a terrorism event
(e) other events (subject to the approval of the AER before a revenue cap began)

Only a TNSP would be able to initiate a pass-through application.

These positions are incorporated into the model pass-through rules that form an appendix to this paper.

5.2 Submissions

The AER is seeking submissions from interested stakeholders on the merits of the approaches discussed in this paper, and interested parties are invited to make written submissions to the AER in response to the AER's proposals.

Submissions can be sent electronically to: AERInquiry@aer.gov.au. Alternatively, written submissions in either Word 8.0 or PDF format can be sent to:

Mr Sebastian Roberts
General Manager
Transition Group
Australian Energy Regulator
GPO Box 520
Melbourne VIC 3001

Interested parties are invited to make written submissions by 24 February 2006. The AER hopes to release a final determination on the issues raised in this paper in April.

Appendix A: Model Pass-through Mechanism

[Name of TNSP] Transmission Network Revenue Cap

Pass-Through Mechanism

1. Introduction

In accordance with the National Electricity Rules, the Australian Energy Regulator (*AER*) in a final decision dated **[date]** (‘Date of Determination’) set a *revenue cap* (‘Revenue Cap’) to apply to **[name of TNSP]** (‘TNSP’) for the *regulatory control period* (‘Regulatory Control Period’) from **[date]** (‘Commencement Date’) to **[date]** (‘End Date’). The Revenue Cap includes the following Pass-Through Mechanism.

2. Regulated Pass-Through

2.1 Mechanism forms part of Revenue Cap

This Pass-Through Mechanism forms part of the Revenue Cap. Any Pass-Through Amount determined in accordance with this Pass-Through Mechanism forms part of the *maximum allowed revenue* determined by the Revenue Cap.

2.2 Pass-Through Events

Each of the following is a Pass-Through Event:

(a) a Change in Taxes Event;

(b) an Insurance Event;

(c) a Service Standards Event;

(d) a Terrorism Event.

2.3 Entitlement or requirement to Pass-Through

If a Pass-Through Event has taken effect or will take effect, then, if the Pass-Through Amount (determined under clause 2.4) for that Pass-Through Event is:

(a) positive, the *maximum allowed revenue* is increased by that Pass-Through Amount provided that the procedure set out in clause 3 is satisfied; or

Note: Clause 3 allows the TNSP, where the Pass-Through Amount is positive, to elect not to pass through that amount, or to pass through only part of that amount, within the Regulatory Control Period. For example, the TNSP may decide to seek to recover part of the amount at a future *revenue cap* reset in order to avoid a significant increase in *transmission service* prices during the Regulatory Control Period.

(b) negative, the *maximum allowed revenue* is decreased by that Pass-Through Amount.

2.4 Pass-Through Amount

The Pass-Through Amount for a Pass-Through Event is determined as follows:

(a) Subject to clauses 2.4(e)-(i), where the Pass-Through Event is a Change in Taxes Event, the Pass-Through Amount is:

(i) Subject to clause 2.4(a)(ii):

(1) the increase or decrease in the amount that the TNSP is required or will be required to pay in a *financial year* within the Regulatory Control Period in providing *prescribed transmission services*;

(2) as compared to the basis upon which the Revenue Cap was set for that *financial year*;

(3) as a direct result of the Change in Taxes Event.

(ii) Where the Change in Taxes Event is part of a package of changes, the amount determined under clause 2.4(a)(i) must be adjusted by the financial effect of the other changes in the package in the relevant *financial year*.

Note: Clause 2.4(a)(ii) is intended to deal with the case where, for example, the introduction of a new Relevant Tax is intended to be offset in whole or in part by a subsidy or a reduction in another Relevant Tax. Clause 2.4(a)(ii) will also cover the case where, for example, two or more new Relevant Taxes are introduced as part of a package.

(b) Subject to clauses 2.4(e)-(i), where the Pass-Through Event is an Insurance Event:

(i) In the case of paragraph (a) of the definition of Insurance Event, the Pass-Through Amount is:

(1) the increase or decrease in premium that the TNSP is required to pay for the relevant *financial year*;

(2) as compared to the premium provided for in the Revenue Cap for that *financial year*.

(ii) In the case of paragraph (b) of the definition of Insurance Event, the Pass-Through Amount is:

(1) the difference between the deductible that the TNSP has incurred or will incur;

(2) as compared to the allowance for that deductible (if any) provided for in the Revenue Cap.

(iii) In the case of paragraphs (c) and (e) of the definition of Insurance Event, the Pass-Through Amount is:

(1) the decrease or increase in the premium that the TNSP is required to pay for the relevant *financial year*;

(2) as compared to the premium provided for in the Revenue Cap for that *financial year*.

(iv) In the case of paragraphs (d) and (f) of the definition of Insurance Event, the Pass-Through Amount is:

(1) the cost, loss or damage that the TNSP has incurred or will incur within the Regulatory Control Period;

(2) as a direct result of the Insurance Event;

(3) to the extent that the cost, loss or damage is not compensated for under any Insurance, and would have been compensated for under the Insurance that was provided for in the Revenue Cap;

(4) less the reduction in premium that the TNSP was required to pay as a result of the Insurance Event (to the extent that the *maximum allowed revenue* has not already been adjusted by this amount).

Note: Clause 2.4(b)(iv)(4) is intended to deal with the case where, for example, the TNSP has discontinued the relevant Insurance but the decrease in premium for the relevant *financial year* was not passed through because the amount was not Material.

(c) Subject to clauses 2.4(e)-(i), where the Pass-Through Event is a Service Standards Event, the Pass-Through Amount is:

(i) the increase or decrease in cost that the TNSP is required or will be required to pay in a *financial year* within the Regulatory Control Period in providing *prescribed transmission services*;

(ii) as compared to the basis upon which the Revenue Cap was set for that *financial year*;

(iii) as a direct result of the Service Standards Event.

(d) Subject to clauses 2.4(e)-(i), where the Pass-Through Event is a Terrorism Event, the Pass-Through Amount is:

(i) the cost, loss or damage that the TNSP has incurred or will incur within the Regulatory Control Period in providing *prescribed transmission services*;

(ii) as a direct result of the Terrorism Event (including action taken in controlling, preventing or suppressing the Terrorism Event).

(e) Where the amount determined under clauses 2.4(a), (b), (c) or (d) is:

(i) positive, the amount must be reduced by the extent to which the TNSP is unable to demonstrate that no act or omission of the TNSP that is inconsistent with *good electricity industry practice*:

(1) caused or aggravated the Pass-Through Event; or

(2) caused or increased the resulting amount;

(ii) negative, the amount must be increased by the extent to which any act or omission of the TNSP that is inconsistent with *good electricity industry practice* reduced the potential savings resulting from the Pass-Through Event.

(f) An amount determined under clauses 2.4(a), (b), (c) or (d) must be adjusted by the amount (if any) for such a Pass-Through Event included in the operating expenses or other inputs or formulas used to set the Revenue Cap.

(g) An amount determined under this clause 2.4 must be adjusted for the time cost of money.

(h) Where an amount determined under clause 2.4(a), (b)(i), (b)(iii) or (c) is for a *financial year* that is not fully within the Regulatory Control Period, the amount must be pro rated across the period of time that comes within the Regulatory Control Period and the period of time that is outside of the Regulatory Control Period. The adjusted amount for that part of the *financial year* that comes within the Regulatory Control Period is the Pass-Through Amount for that Pass-Through Event.

Note: Clauses 2.4(a), (b)(i), (b)(iii) and (c) require the Pass-Through Amount to relate to a particular *financial year*. (In contrast, under clauses 2.4(b)(ii), (b)(iv) and (d), the Pass-Through Amount is the deductible incurred at a particular point in time within the Regulatory Control Period (in the case of clause 2.4(b)(ii)) or the total cost, loss or damage incurred over the Regulatory Control Period as a result of the Pass-Through Event (in the case of clauses 2.4(b)(iv) and (d))). Where the Commencement Date is not the start of a *financial year* (or the End Date is not the end of a *financial year*), the amount determined under clause 2.4(a), (b)(i), (b)(iii) or (c) may be for a *financial year* that is not fully within the Regulatory Control Period. In this case, the amount must be apportioned to determine the Pass-Through Amount. Clause 2.4(i), which requires a Pass-Through Amount to be Material, includes, in the definition of Material, a corresponding apportioning mechanism.

(i) An amount determined under this clause 2.4 must be Material. If the amount is not Material, the Pass-Through Amount for the Pass-Through Event is zero.

2.5 Period and form of Pass-Through Amount

(a) The period over which the Pass-Through Amount is to be recovered is to be determined by the TNSP subject to the following conditions:

(i) The first day of the period:

(1) must be the start of a *financial year*;

(2) must not be a date earlier than the Commencement Date;

(3) where the Pass-Through Amount is positive, must not be a date earlier than the date upon which the procedure set out in clause 3 is satisfied;

(4) where the Pass-Through Amount is positive and the date upon which the procedure set out in clause 3 is satisfied falls within the period commencing on 15 May and ending on 30 June, must be a date after 1 July of that year; and

Note: For example, if the procedure set out in clause 3 is satisfied on 31 May 2007, the first *financial year* in which the *maximum allowed revenue* could be varied to include the Pass-Through Amount would be 1 July 2008 to 30 June 2009. This is because clause 6.5.7 of the National Electricity Rules requires each *Transmission Network Service Provider* to publish the *transmission service* prices to apply for the following *financial year* by 15 May each year.

(5) must not be a date after the End Date.

(ii) The last day of the period:

(1) must be the end of a *financial year*; and

(2) must not be a date after the End Date.

(iii) The period applied by the TNSP under clause 3.6(b) must have been specified by:

(1) the TNSP in a Notice of Proposed Pass-Through under clause 3.2; or

(2) the *AER* in a notice to the TNSP under clause 3.5.

Note: Although a Pass-Through Amount determined under clause 2.4(a), (b)(i), (b)(iii) or (c) relates to a particular *financial year*, clause 2.5(a) allows the TNSP to spread the resulting impact on prices over one or more *financial years*.

(b) If the period over which the Pass-Through Amount is to be recovered consists of two or more *financial years*, the allocation of the Pass-Through Amount over those *financial years* (being the form of the Pass-Through Amount) is to be determined by the TNSP subject to the following condition:

(i) The form applied by the TNSP under clause 3.6(b) must have been specified by:

(1) the TNSP in a Notice of Proposed Pass-Through under clause 3.2; or

(2) the *AER* in a notice to the TNSP under clause 3.5.

3. Procedure

3.1 Initiation of Pass-Through

If a Pass-Through Event has taken effect or will take effect, then, if the Pass-Through Amount (determined under clause 2.4) for that Pass-Through Event is:

(a) positive, the TNSP may give a Notice of Proposed Pass-Through to the *AER* in accordance with clause 3.2; or

(b) negative, the TNSP must promptly (and, in any event, within three *months* of the TNSP becoming aware that the Pass-Through Event had taken effect or will take effect (as the case may be)) give a Notice of Proposed Pass-Through to the *AER* in accordance with clause 3.2.

3.2 Notice of Proposed Pass-Through

A Notice of Proposed Pass-Through must include:

(a) a description of the relevant Pass-Through Event;

(b) the date on which the relevant Pass-Through Event took effect or will take effect;

(c) if the Notice of Proposed Pass-Through is provided under clause 3.1(b), the date on which the TNSP first became aware that the Pass-Through Event had taken effect or will take effect;

(d) the proposed Pass-Through Amount;

(e) the proposed period over which the Pass-Through Amount should apply;

(f) if the proposed period over which the Pass-Through Amount should apply consists of two or more *financial years*, the proposed allocation of the Pass-Through Amount over the *financial years* (being the form of the Pass-Through Amount); and

(g) the supporting information referred to in clauses 3.3(a) and (b).

3.3 Provision of information

(a) The TNSP must attach to its Notice of Proposed Pass-Through such information and documentation as the *AER* requires to enable the *AER* to form an opinion as to:

(i) whether a Pass-Through Event did take effect or will take effect;

(ii) if the Notice of Proposed Pass-Through is provided under clause 3.1(b), whether the TNSP complied with the requirement to give promptly such Notice to the *AER*;

(iii) whether the proposed Pass-Through Amount complies with clause 2.4;

(iv) the period over which the Pass-Through Amount should apply; and

(v) if the period over which the Pass-Through Amount should apply consists of two or more *financial years*, how the Pass-Through Amount should be allocated over the *financial years*.

(b) Without limiting the generality of the obligation in clause 3.3(a), the supporting information must include, where the Pass-Through Event is:

(i) a Change in Taxes Event – the relevant instrument or decision (if any) upon which the Revenue Cap was set, and the relevant instrument or decision implementing the Change in Taxes Event;

(ii) an Insurance Event – the relevant insurance policy, cover note and premium invoice (as the case may be) upon which the Revenue Cap was set, and the relevant insurance policy, cover note and premium invoice (if any) associated with the Insurance Event;

(iii) a Service Standards Event – the relevant decision or Applicable Law (if any) upon which the Revenue Cap was set, and the relevant decision or Applicable Law implementing the Service Standard Event.

3.4 Procedure to be followed by AER

(a) In considering a Notice of Proposed Pass-Through, the *AER* may decide to seek public comment on the Notice.

(b) Disclosure by the *AER* of the supporting information provided by the TNSP in accordance with clauses 3.2(g) and 3.3 shall be governed by the procedure set out in clauses 6.2.5(e) and 6.2.6 of the National Electricity Rules.

3.5 Verification by AER

(a) The *AER* will, within the Assessment Period, form an opinion on:

(i) if the Notice of Proposed Pass-Through was provided under clause 3.1(b), whether the TNSP complied with the requirement to give promptly such Notice to the *AER*;

(ii) whether the Pass-Through Event specified in the Notice of Proposed Pass-Through did take effect or will take effect;

(iii) if so, the Pass-Through Amount (if any) in respect of the relevant Pass-Through Event (determined in accordance with clause 2.4);

(iv) the period over which the Pass-Through Amount should be applied (which must satisfy clauses 2.5(a)(i) and (ii)); and

(v) if the period over which the Pass-Through Amount should be applied consists of two or more *financial years*, how the Pass-Through Amount should be allocated over the *financial years*,

and notify the TNSP in writing of the *AER's* opinion.

(b) If the *AER* does not give notice to the TNSP under clause 3.5(a) on or before the last day of the Assessment Period, then the *AER* is taken to have notified the TNSP of its opinion that the Pass-Through Amount (and the period over, and form in, which the TNSP will apply the Pass-Through Amount) should be as specified by the TNSP in the Notice of Proposed Pass-Through.

3.6 Application of Pass-Through Amount

(a) If the TNSP has received or is taken to have received a notice under clause 3.5, the TNSP must promptly notify its affected customers and *Co-ordinating Network Service Provider* (if applicable) of:

(i) the Pass-Through Amount (if any) that is set out in the notice from the *AER* under clause 3.5; and

(ii) the period over, and form in, which the Pass-Through Amount is to be applied (to be determined by the TNSP in accordance with clause 2.5).

(b) Where the Pass-Through Amount is:

(i) positive, the TNSP may, in accordance with clause 2.3(a), after providing notice in accordance with clause 3.6(a), increase its *maximum allowed revenue* by the Pass-Through Amount over the period, and in the form, specified by the TNSP in the notice under clause 3.6(a);

(ii) negative, the TNSP must, in accordance with clause 2.3(b), regardless of whether or not the TNSP has provided notice in accordance with clause 3.6(a), decrease its *maximum allowed revenue* by the Pass-Through Amount specified or taken to be specified in the notice from the *AER* under clause 3.5 over the period, and in the form determined by the TNSP in accordance with clause 2.5.

4. Definitions

4.1 National Electricity Rules definitions

In this Pass-Through Mechanism, unless the context otherwise requires:

(a) words appearing in italics have the meaning assigned to them from time to time by the National Electricity Rules; and

(b) if a word in italics is no longer defined in the National Electricity Rules, it will have the meaning last assigned to it by the National Electricity Rules.

4.2 Additional definitions

In this Pass-Through Mechanism, unless the context otherwise requires:

Applicable Law means any legislation, delegated legislation (including regulations), codes, rules, licences, guidelines, determinations and directions relating to the provision of one or more *prescribed transmission services*, and includes the National Electricity Law and the National Electricity Rules.

Assessment Period means:

(a) two *months* from the date the *AER* receives from the TNSP a Notice of Proposed Pass-Through that satisfies the requirements of clauses 3.2 and 3.3; or

(b) if the *AER* so notifies the TNSP prior to the expiry of the initial two *month* period, four *months* from the date the *AER* receives from the TNSP a Notice of Proposed Pass-Through that satisfies the requirements of clauses 3.2 and 3.3.

Note: For example, if the *AER* receives from the TNSP a valid Notice of Proposed Pass-Through on 31 May 2007, the TNSP must receive written notice of the *AER's* opinion on or before 31 July 2007 (or 30 September 2007 in the event that the initial period is extended).

Authority means any government department, instrumentality, minister, agency, statutory authority or other body in which a government has a controlling interest, and includes the *AEMC*, *NEMMCO*, the *AER* and the *ACCC* and their successors.

A **Change in Taxes Event** occurs where the following conditions are satisfied:

(a) the following condition is satisfied:

(i) the way in which, or rate at which, a Relevant Tax is calculated is changed (including a change in the application or official interpretation of a Relevant Tax); or

(ii) a Relevant Tax is removed; or

(iii) a new Relevant Tax is imposed; and

(b) the change, removal or imposition is made:

(i) on or after the Date of Determination; and

(ii) on or before the End Date.

Commencement Date means **[date]**, being the first day of the period covered by the Revenue Cap.

Date of Determination means **[date],** being the date of the *AER's* final decision setting the Revenue Cap.

End Date means **[date]**, being the last day of the period covered by the Revenue Cap.

Insurance means insurance whether under a policy or a cover note or other similar arrangement.

An **Insurance Event** occurs where, in relation to a risk that was the subject of Insurance and for which a premium was provided for in the Revenue Cap:

(a) the following conditions are satisfied:

(i) the TNSP has paid or is required to pay a premium for that risk;

(1) on or after the Date of Determination; and

(2) on or before the End Date;

(ii) the premium relates to a *financial year* within the Regulatory Control Period; and

(iii) the cost of the premium is higher or lower than the premium provided for in the Revenue Cap for that *financial year*; or

Note: For example, the TNSP may receive, in relation to the relevant risk, an invoice on 1 July 2008 for the period 1 August 2008 to 31 July 2009; and an invoice on 1 July 2009 for the period 1 August 2009 to 31 July 2010. To determine whether a Pass-Through Event has occurred, it would be necessary to determine the total premium paid with respect to the period 1 July 2009 to 30 June 2010.

(b) the following conditions are satisfied:

(i) the risk eventuates within the Regulatory Control Period;

(ii) the TNSP has incurred or will incur, within the Regulatory Control Period, all or part of a deductible; and

Note: For the avoidance of doubt, clause (ii) requires confirmation from the relevant insurance provider that the risk comes within the scope of the relevant Insurance.

(iii) that amount is higher or lower than the allowance for the deductible (if any) provided for in the Revenue Cap; or

(c) the following condition is satisfied:

(i) Insurance for the risk for a *financial year* within the Regulatory Control Period becomes unavailable to the TNSP:

(1) on or after the Date of Determination; and

(2) on or before the End Date; or

(d) the following conditions are satisfied:

(i) Insurance for the risk for a *financial year* within the Regulatory Control Period becomes unavailable to the TNSP:

(1) on or after the Date of Determination; and

(2) on or before the End Date;

(ii) the uninsured risk eventuates within that *financial year* and within the Regulatory Control Period; and

(iii) that event would have been insured by the Insurance that was provided for in the Revenue Cap in relation to that risk; or

(e) the following conditions are satisfied:

(i) Insurance for the risk for a *financial year* within the Regulatory Control Period becomes available to the TNSP on terms materially different from those upon which the Revenue Cap was set:

(1) on or after the Date of Determination; and

(2) on or before the End Date; and

(ii) the TNSP either does not continue the relevant Insurance or continues the Insurance on different terms; or

(f) the following conditions are satisfied:

(i) Insurance for the risk for a *financial year* within the Regulatory Control Period becomes available to the TNSP on terms materially different from those upon which the Revenue Cap was set:

(1) on or after the Date of Determination; and

(2) on or before the End Date;

(ii) the TNSP either does not continue the relevant Insurance or continues the Insurance on different terms;

(iii) the risk eventuates within that *financial year* and within the Regulatory Control Period; and

(iv) that event would have been insured or would have been fully insured by the Insurance that was provided for in the Revenue Cap in relation to that risk.

Material: For the purpose of clause 2.4(i):

(a) Subject to paragraph (b), an amount determined in accordance with clauses 2.4(a)-(h) in relation to a single Pass-Through Event is **Material** if that amount is equal to, or greater than **$X.**

(b) If:

(1) the amount is determined under clause 2.4(a), (b)(i), (b)(iii) or (c);

(2) the amount is for a *financial year* that is not fully within the Regulatory Control Period; and

(3) the amount is adjusted in accordance with clause 2.4(h),

the amount is **Material** if that amount is equal to or greater than $X pro rated using the same formula as for clause 2.4(h).

National Electricity Rules has the meaning assigned to it from time to time by the National Electricity Law set out in the Schedule to the *National Electricity (South Australia) Act 1996* (SA).

Notice of Proposed Pass-Through means a notice described in clause 3.2.

Pass-Through Amount means a variation to the TNSP's *maximum allowed revenue* as a result of a Pass-Through Event determined in accordance with this Pass-Through Mechanism (which forms part of the TNSP's Revenue Cap). A Pass-Through Amount may be positive or negative.

Pass-Through Events means the events specified in clause 2.2.

Regulatory Control Period means the period starting on the Commencement Date and ending on the End Date.

Relevant Tax means any tax, rate, duty, charge, levy, rebate, Authority fee or other like or analogous impost that is:

(a) paid, to be paid, or taken to be paid by the TNSP in connection with the provision of *prescribed transmission services*; or

(b) included in the operating expenses or other inputs used to determine the Revenue Cap,

but excludes:

(c) income tax (or State equivalent tax) and capital gains tax;

(d) penalties and fines (including penalties and interest for late payment relating to any tax, rate, duty, charge, levy, Authority fee or other like or analogous impost);

(e) charges and Authority fees paid or payable in respect of a Service Standards Event;

(f) stamp duty, financial institutions duty, bank accounts debits tax or similar taxes or duties;

(g) any tax, rate, duty, charge, levy, rebate, Authority fee or other like or analogous impost that replaces the imposts referred to in (c)-(f).

Revenue Cap means the *revenue cap* set by the *AER* in accordance with the National Electricity Rules in a final decision issued on the Date of Determination to apply to the TNSP for the Regulatory Control Period.

A **Service Standards Event** occurs where the following conditions are satisfied:

(a) the following condition is satisfied:

   (i) a decision is made by an Authority; or

   (ii) an Applicable Law is introduced or amended;

(b) the decision, introduction or amendment is made:

   (i) on or after the Date of Determination; and

   (ii) on or before the End Date; and

(c) the decision, introduction or amendment has the effect of, within the Regulatory Control Period:

(i) imposing, removing or varying minimum standards on the TNSP relating to *prescribed transmission services*;

(ii) altering the nature or scope of services that comprise the *prescribed transmission services*;

(iii) varying the manner in which the TNSP is required to undertake any activity forming part of *prescribed transmission services*; or

(iv) increasing or decreasing the TNSP's risk in providing the *prescribed transmission services*,

from that upon which the Revenue Cap was set.

A **Terrorism Event** occurs where the following conditions are satisfied:

(a) an act (including, but not limited to, the use of force or violence and/or the threat thereof) by any person or group(s) of persons (whether acting alone or on behalf of or in connection with any organisation(s) or government(s)), 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 any government and/or to put the public, or any section of the public, in fear), occurs; and

(b) the act occurs:

(i) on or after the Date of Determination; and

(ii) on or before the End Date.

TNSP means **[name TNSP and ABN]**, being the **[owner / operator]** of the **[name of transmission network]**

4.3 References to certain general terms

Unless the contrary intention appears, a reference in this Pass-Through Mechanism to:

(a) **(variations or replacement)** a document (including this Pass-Through Mechanism) includes any variation or replacement of it;

(b) **(clauses)** a clause is a reference to a clause in this Pass-Through Mechanism;

(c) **(reference to statutes)** a statute, ordinance, code, rules or other law includes regulations and other instruments under it and consolidations, amendments, re–enactments or replacements of any of them;

(d) **(singular includes plural)** the singular includes the plural and vice versa;

(e) **(person)** the word ‘person’ includes an individual, a firm, a body corporate, a partnership, a joint venture, a syndicate, an unincorporated body or an association, or any Authority;

(f) **(successors)** a particular person includes a reference to the person’s successors, substitutes (including persons taking by novation) and assigns;

(g) **(meaning not limited)** the words ‘include’, ‘including’, ‘for example’ or ‘such as’ are not used as, nor are they to be interpreted as, words of limitation, and, when introducing an example, do not limit the meaning of the words to which the example relates to that example or examples of a similar kind;

(h) **(reference to anything)** anything (including any amount) is a reference to the whole and each part of it.

4.4 Headings

Headings (including those in brackets at the beginning of paragraphs) are for convenience only and do not affect the interpretation of this Pass-Through Mechanism.