



DRAFT DECISION

Directlink

Transmission Determination

2020 to 2025

Attachment 12

Pass through events

October 2019

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Note

This attachment forms part of the AER's draft decision on Directlink's 2020–25 transmission determination. It should be read with all other parts of the draft decision.

The draft decision includes the following attachments:

Overview

Attachment 1 – Maximum allowed revenue

Attachment 2 – Regulatory asset base

Attachment 3 – Rate of return

Attachment 4 – Regulatory depreciation

Attachment 5 – Capital expenditure

Attachment 6 – Operating expenditure

Attachment 7 – Corporate income tax

Attachment 8 – Efficiency benefit sharing scheme

Attachment 9 – Capital expenditure sharing scheme

Attachment 10 – Service target performance incentive scheme

Attachment 11 – Pricing methodology

Attachment 12 – Pass through events

Contents

Note	12-2
Contents	12-3
Shortened forms	12-4
12 Cost pass through events.....	12-5
12.1 Draft decision	12-5
12.2 Directlink's proposal.....	12-5
12.3 Assessment approach.....	12-7
12.4 Interrelationships	12-8
12.5 Reasons for draft decision.....	12-9

Shortened forms

Shortened form	Extended form
AARR	aggregate annual revenue requirement
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
ASRR	annual service revenue requirement
augex	augmentation expenditure
capex	capital expenditure
CESS	capital expenditure sharing scheme
CPI	consumer price index
EBSS	efficiency benefit sharing scheme
F&A	framework and approach
MAR	maximum allowed revenue
NEL	national electricity law
NEM	national electricity market
NEO	national electricity objective
NER	national electricity rules
NSP	network service provider
opex	operating expenditure
PTRM	post-tax revenue model
RAB	regulatory asset base
repex	replacement expenditure
RFM	roll forward model
RPP	revenue and pricing principles
STPIS	service target performance incentive scheme
TNSP	transmission network service provider
WACC	weighted average cost of capital

12 Cost pass through events

During the regulatory control period Directlink can apply to pass through to its customers, in the form of higher or lower network charges, certain material changes in its costs caused by pre-defined exogenous events. These events are called cost pass through events. 'Positive' pass throughs allow Directlink to recover the efficient costs incurred as a result of events that could not be forecast as part of its regulatory proposal that otherwise would have a significant financial effect on Directlink's ability to invest in and operate its networks.¹

The NER prescribe the following pass through events for all transmission determinations:²

- a regulatory change event
- a service standard event
- a tax change event
- an insurance event
- an inertia shortfall event
- a fault level shortfall event.

In addition to these prescribed events, other pass through events may be 'nominated' by a service provider for a regulatory control period.³ This attachment sets out our draft decision on the nominated pass through events to apply to Directlink for the 2020–25 regulatory control period.

12.1 Draft decision

Our draft decision pursuant to clause 6A.14.1(9) is to accept Directlink's nominated pass through events, as they apply to its interconnector.

Accordingly, we propose that the following are pass through events for the purposes of clause 6A.7.3(a1)(5) of the rules:

- insurer's creditor risk event
- terrorism event.

12.2 Directlink's proposal

Directlink proposed two nominated pass through events as set out in Table 12–1. Directlink proposed that the pass through events apply to prescribed transmission

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

² NER cl. 6A.7.3(a1)(1)–(4).

³ NER, cl. 6A.6.9(a), cl. 6A.7.3(a1)(5).

services in the transmission network.⁴ Directlink has not provided any definitions for its proposed pass through events, as such, in the circumstances, we intend to use definitions consistent with previous decisions.⁵

Table 12–1 Directlink's nominated pass through events

Pass through event	Definition
Insurer's creditor risk ⁶	<p>An insurer's credit risk event occurs if:</p> <ul style="list-style-type: none"> • A nominated insurer of Directlink becomes insolvent, and as a result, in respect of an existing or potential claim for a risk that was insured by the insolvent insurer, Directlink: <ul style="list-style-type: none"> ○ Is subject to a higher or lower claim limit, or a higher or lower deductible than would have otherwise applied under the insolvent insurer's policy; or ○ Incurs additional costs associated with funding an insurance claim, which otherwise would have been covered by the insolvent insurer. <p>Note: In assessing an insurer's credit risk event pass through application, the AER will have regard to, amongst other things:</p> <ul style="list-style-type: none"> • Directlink's attempts to mitigate and prevent the event from occurring by reviewing and considering the insurer's track record, size, credit rating and reputation. • In the event that a claim would have been made after the insurance provider became insolvent, whether Directlink had reasonable opportunity to insure the risk with a different provider.
Terrorism ⁷	<p>A terrorism event occurs if:</p> <p>An act (including, but not limited to, the use of force or violence or the threat of force or violence) of any person or group of persons (whether acting alone or on behalf of or in connection with any organisation or government), which from its nature or context is done for, or in connection with, political, religious, ideological, ethnic or similar purposes or reasons (including the intention to influence or intimidate any government and/or put the public, or any sections of the public, in fear) and which increases the costs to Directlink in providing prescribed transmission services.</p> <p>Note in assessing a terrorism event pass through application, the AER will have regard to, amongst other things:</p> <ul style="list-style-type: none"> • Whether Directlink has insurance against the event; • The level of insurance that an efficient and prudent NSP would obtain in respect of the event, and • Whether a declaration has been made by a relevant government authority that a terrorism event has occurred.

⁴ Directlink, *Revenue Proposal 2020-25*, January 2019, p. 93.

⁵ AER, *Final Decision, TasNetworks Transmission and Distribution Determination 2019 to 2024, Overview*, April 2018, p. 60; AER, *Final Decision, Ausgrid Distribution Determination 2019 to 2024, Overview*, April 2018, p. 46.

⁶ Directlink, *Revenue Proposal 2020-25*, January 2019, p. 93.

⁷ Directlink, *Revenue Proposal 2020-25*, January 2019, p. 93.

12.3 Assessment approach

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

Our assessment approach is guided by the National Electricity Objective (NEO) and the Revenue and Pricing Principles. These provide, in part, that the service provider should have a reasonable opportunity to recover at least the efficient costs of providing services and complying with regulatory obligations.⁸ They also reflect the importance of incentives to promote economic efficiency,⁹ and balance the risks of under and over investment.¹⁰

In the context of pass through events, we have particular regard to the impact on price, quality, reliability and security of supply that may arise as a result of any change in the efficient operation of, and ability and incentive of, a service provider to invest in its network. This is a similar approach to that taken by the AEMC when it considered amendments to the pass through provisions in the NER.¹¹

In determining whether we accept a nominated pass through event, we must take into account the 'nominated pass through event considerations' as defined, which are as follows:¹²

- whether the event proposed is an event covered by a category of pass through event specified in clause 6.6.1(a1)(1) to (4) (in the case of a distribution determination) or in clause 6A.7.3(a1)(1) to (4) (in the case of a transmission determination)
- whether the nature or type of event can be clearly identified at the time the determination is made for the service provider
- 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
- whether the relevant service provider could insure against the event having regard to:
 - the availability (including the extent of availability in terms of liability limits) of insurance against the event on reasonable commercial terms; or

⁸ NEL, s. 7A(2).

⁹ NEL, s. 7A(3).

¹⁰ NEL, s. 7A(6).

¹¹ NEL, s. 7; AEMC 2012, *Cost Pass through arrangements for Network Services Providers, Rule Determination*, 2 August 2012, p. 6.

¹² NER, Chapter 10, definition of nominated pass through event considerations.

- whether the event can be self-insured on the basis that:
 - it is possible to calculate the self-insurance premium
 - the potential cost to the relevant service provider would not have a significant impact on the service provider's ability to provide network services.
- any other matter the AER considers relevant and which the AER has notified Network Services Providers is a nominated pass through event consideration.

The AEMC described the purpose of the nominated pass through event considerations as:

To incorporate and reflect the essential components of a cost pass through regime in the NER. It was intended that in order for appropriate incentives to be maintained, any nominated pass through event should only be accepted when event avoidance, mitigation, commercial insurance and self-insurance are unavailable.¹³

That a pass through event should only be accepted when it is the least inefficient option and event avoidance, mitigation, commercial insurance and self-insurance are found to be inappropriate. That is, it is included after ascertaining the most efficient allocation of risks between a service provider and end customers.¹⁴

This protects the incentive regime under the NER by limiting erosion of a service provider's incentives to use market based mechanisms to mitigate the cost impacts that would arise.¹⁵ This promotes the efficient investment in, and efficient operation and use of, network services for the long term interests of consumers with respect to price.¹⁶

As a matter of good regulatory practice, we also take into account the desirability of consistency in our approach to assessing nominated pass through events across our electricity determinations and gas access arrangements.¹⁷

12.4 Interrelationships

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

¹³ AEMC 2012, *Cost Pass through arrangements for Network Services Providers, Rule Determination*, 2 August 2012, p. 19.

¹⁴ AEMC 2012, *Cost Pass through arrangements for Network Services Providers, Rule Determination*, 2 August 2012, p. 20.

¹⁵ AEMC 2012, *Cost Pass through arrangements for Network Services Providers, Rule Determination*, 2 August 2012, p. 8.

¹⁶ AEMC 2012, *Cost Pass through arrangements for Network Services Providers, Rule Determination*, 2 August 2012, p. 8.

¹⁷ AEMC 2012, *Cost Pass through arrangements for Network Services Providers, Rule Determination*, 2 August 2012, p. 8.

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

- prevention (avoiding the risk)
- mitigation (reducing the probability and impact of the risk)
- insurance (transferring the risk to another party)
- self-insurance (putting aside funds to manage the likely costs associated with the risk event).

An efficient business will manage its risk by employing the most cost effective combination of these strategies. In order to maintain appropriate incentives under our determinations, we only accept nominated pass through events where we are satisfied that event avoidance, mitigation, commercial insurance and self-insurance under approved forecasts of prudent and efficient opex and capex are either unavailable or inappropriate.¹⁸

In general, in respect of smaller projects a service provider should be using up its existing expenditure allowance, or reprioritising or substituting its projects, to avoid seeking cost recovery through the pass through mechanisms.¹⁹ This is reflected in the materiality threshold that applies to cost pass through applications.²⁰

Cost pass through amounts approved in a regulatory control period are added to (or in the case of a negative pass through deducted from) forecast opex and capex for the purpose of calculating efficiency carryover amounts from the EBSS and CESS.²¹

Cost pass through amounts that have already been recovered in a regulatory period cannot be recovered again in the roll-forward of the RAB for the next regulatory period.²²

12.5 Reasons for draft decision

Directlink's nominated events are substantially the same as those approved in our recent decisions.²³ As noted at section 12.2 above, Directlink has not provided any definition for these events and in these circumstances we will apply definitions for the

¹⁸ AEMC 2012, *Cost Pass through arrangements for Network Services Providers, Rule Determination*, 2 August 2012, pp. 19–20.

¹⁹ AEMC 2012, *Cost Pass through arrangements for Network Services Providers, Rule Determination*, 2 August 2012, pp. 19–20.

²⁰ AEMC, 2012, *Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services, Final Position Paper*, 29 November 2012, p. 186.

²¹ AER, *Efficiency Benefit Sharing Scheme for Electricity Network Service Providers*, November 2013, p. 9; AER, *Capital Expenditure Incentive Guideline for Electricity Network Service Providers*, November 2013, p. 18.

²² NER, cl. S6A.2.1(f)(1)(ii).

²³ AER, *Final Decision, TasNetworks Transmission and Distribution Determination 2019 to 2024, Overview*, April 2018, p. 60; AER, *Final Decision, Ausgrid Distribution Determination 2019 to 2024, Overview*, April 2018, p. 46.

pass through events that are consistent with these recent decisions. We consider these events are supported by the nominated pass through considerations set out in the NER:²⁴

- the proposed events are not covered by an existing category of pass through event
- the nature of the events are clearly identifiable at this time
- a prudent service provider could not reasonably prevent an event of that nature or type occurring or substantially mitigate its cost impact, and could not insure (or self-insure) against the events.

With regard to the latter point, while Directlink could take some steps to reduce its exposure to these events, expenditure beyond a certain level aimed at completely eliminating the risk is likely to be imprudent or inefficient. In that context, sharing the risk between Directlink and its customers is appropriate and more likely to be in the long-term interests of consumers with respect to price.

²⁴ NER, Chapter 10: Glossary.