



DRAFT DECISION
TransGrid transmission
determination
2018 to 2023

Attachment 13 – Pass through
events

September 2017

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Note

This attachment forms part of the AER's draft decision on TransGrid's transmission determination for 2018–23. It should be read with all other parts of the draft decision.

The draft decision includes the following documents:

Overview

Attachment 1 – Maximum allowed revenue

Attachment 2 – Regulatory asset base

Attachment 3 – Rate of return

Attachment 4 – Value of imputation credits

Attachment 5 – Regulatory depreciation

Attachment 6 – Capital expenditure

Attachment 7 – Operating expenditure

Attachment 8 – Corporate income tax

Attachment 9 – Efficiency benefit sharing scheme

Attachment 10 – Capital expenditure sharing scheme

Attachment 11 – Service target performance incentive scheme

Attachment 12 – Pricing methodology

Attachment 13 – Pass through events

Attachment 14 – Negotiated services

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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
CCP	Consumer Challenge Panel
CESS	capital expenditure sharing scheme
CPI	consumer price index
DMIA	demand management innovation allowance
DRP	debt risk premium
EBSS	efficiency benefit sharing scheme
ERP	equity risk premium
MAR	maximum allowed revenue
MRP	market risk premium
NEL	national electricity law
NEM	national electricity market
NEO	national electricity objective
NER	national electricity rules
NSP	network service provider
NTSC	negotiated transmission service criteria
opex	operating expenditure
PPI	partial performance indicators
PTRM	post-tax revenue model
RAB	regulatory asset base
RBA	Reserve Bank of Australia
repex	replacement expenditure
RFM	roll forward model
RIN	regulatory information notice

Shortened form	Extended form
RPP	revenue and pricing principles
SLCAPM	Sharpe-Lintner capital asset pricing model
STPIS	service target performance incentive scheme
TNSP	transmission network service provider
TUoS	transmission use of system
WACC	weighted average cost of capital

13 Pass through events

During the regulatory control period, a service provider can apply to us to pass material changes in its costs arising from pre-defined exogenous events through to customers, in the form of higher or lower network charges. These events are called cost pass through events. Positive pass throughs exist in the rules as a mechanism to allow service providers to recover their efficient costs incurred as a result of events that could not be forecast as part of their proposal that otherwise would have a significant financial effect on the ability of networks to invest in and operate their networks.¹

The NER include 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

In addition to these prescribed events, other (nominated) pass through events may be specified in a determination for a regulatory control period.³

This attachment sets out our draft decision on the nominated pass through events that will apply to TransGrid for the 2018-22 regulatory control period.

13.1 Draft decision

Our draft decision is to accept TransGrid's nominated pass through events.

13.2 TransGrid's proposal

TransGrid proposed four nominated pass through events as set out in Table 13-1.⁴

Table 13-1 TransGrid's proposed pass through events

Proposed event	Proposed definition
Insurance Cap Event	An insurance cap event occurs if: <ol style="list-style-type: none">1. TransGrid makes a claim or claims and receives the benefit of a payment or payments under a relevant insurance policy.2. TransGrid incurs costs beyond the policy limit of the relevant insurance

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). Each of these prescribed events is defined in Chapter 10 (Glossary) of the NER.

³ NER, cl. 6A.7.3(a1)(5).

⁴ TransGrid, Revenue Proposal 2018-19 to 2022-23, p. 225.

Proposed event	Proposed definition
	<p>policy at the time of the event that gives rise to the relevant claim</p> <p>3. the costs beyond the relevant policy limit materially increase the costs to TransGrid in providing prescribed transmission services.</p> <p>For this insurance cap event a relevant insurance policy is an insurance policy held during the 2018/19 – 2022/23 regulatory control period or a previous regulatory control period in which TransGrid was regulated.</p> <p>Note: in making a determination on an insurance cap event, the AER will have regard to, amongst other things:</p> <ul style="list-style-type: none"> i. the insurance policy for the event ii. the level of insurance that an efficient and prudent TNSP would obtain in respect of the event iii. any assessment by the AER of TransGrid's insurance documented in respect of its transmission determination for the relevant period.
Insurer Credit Risk Event	<p>An insurer's credit risk event occurs if:</p> <p>A nominated insurer of TransGrid becomes insolvent, and as a result, in respect of an existing, or potential, claim for a risk that was insured by the insolvent insurer, TransGrid:</p> <ul style="list-style-type: none"> 1. is subject to a materially higher or lower claim limit or a materially higher or lower deductible than would have otherwise applied under the insolvent insurer's policy; or 2. incurs additional costs associated with self-funding an insurance claim, which would otherwise 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"> i. TransGrid's attempts to mitigate and prevent the event from occurring by reviewing and considering the insurer's track record, size, credit rating and reputation, and ii. in the event that a claim would have been made after the insurance provider became insolvent, whether TransGrid had reasonable opportunity to insure the risk with a different provider.
Natural Disaster Event	<p>Natural Disaster Event means any natural disaster including but not limited to fire, flood or earthquake that occurs during the 2018/19 – 2022/23 regulatory control period that increases the costs to TransGrid in providing prescribed transmission services, provided the fire, flood or other event was not a consequence of the acts or omissions of the service provider.</p> <p>Note: In assessing a Natural Disaster Event pass through application, the AER will have regard to, amongst other things:</p> <ul style="list-style-type: none"> i. whether TransGrid has insurance against the event; and ii. the level of insurance that an efficient and prudent NSP would obtain in respect of the event.
Terrorism Event	<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 section of the public, in fear) and which increases the costs to TransGrid in providing prescribed transmission services.</p> <p>Note: In assessing a terrorism event pass through application, the AER will</p>

Proposed event	Proposed definition
	<p>have regard to, amongst other things:</p> <ul style="list-style-type: none"> i. whether TransGrid has insurance against the event ii. the level of insurance that an efficient and prudent NSP would obtain in respect of the event iii. whether a declaration has been made by a relevant government authority that an act of terrorism has occurred.

13.3 Assessment approach

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

The NER include the following pass through events for all transmission determinations:⁵

- a regulatory change event
- a service standard event
- a tax change event
- an insurance event.

They also allow a service provider to propose other events be specified in a determination as a pass through event for that determination.⁶ Our draft decision must include a decision on the additional (nominated) pass through events that are to apply for the regulatory control period.⁷

Our assessment approach is guided by the National Electricity Objective (NEO) and the Revenue and Pricing Principles. These provide the service provider with a reasonable opportunity to recover at least the efficient costs incurred in providing services and complying with its obligations.⁸ They also provide incentives to promote economic efficiency.⁹ Together, they promote a balance between the economic costs and risks of the potential for under and over investment by a service provider, to promote efficient 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

⁵ NER, cl. 6A.7.3(a1)(1)–(4). Each of these prescribed events is defined in Chapter 10 (Glossary) of the NER.

⁶ NER, cl. 6A.7.3(a1)(5).

⁷ NER, cl. 6A.14.1(9).

⁸ NEL, s. 7A(2).

⁹ NEL, s. 7A(3).

¹⁰ NEL, s. 7A(6).

may arise as a result of any change in the efficient operation of, and ability and incentive if, a service provider to invest in its network.¹¹

In determining whether we accept a nominated pass through event, we must take into account the nominated pass through event considerations:¹²

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 6.6.1(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.

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

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

¹² NER, cl. 6A.6.9(b); NER Chapter 10: Glossary, definition of 'nominated pass through event considerations'.

unavailable. That is, a cost pass through event is the least efficient option for managing the risk of unforeseen events¹³

- 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

In turn, this protects the incentive regime under the NER by limiting the erosion of incentives on service providers 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, one additional matter¹⁷ we take into account is consistency in our approach to assessing nominated pass through events across our electricity determinations and gas access arrangements.¹⁸

13.4 Interrelationships

The pass through mechanism is not the only way in which service providers can manage their risks under a transmission determination. It is interrelated with other parts of this decision, in particular with the forecast opex and 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.

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)

¹³ AEMC 2012, *Cost pass through arrangements for Network Service Providers, Rule Determination*, 2 August 2012, Sydney, p. 19.

¹⁴ AEMC 2012, *Cost pass through arrangements for Network Service Providers, Rule Determination*, 2 August 2012, Sydney, p. 20.

¹⁵ AEMC 2012, *Cost pass through arrangements for Network Service Providers, Rule Determination*, 2 August 2012, Sydney, p. 8.

¹⁶ AEMC 2012, *Cost pass through arrangements for Network Service Providers, Rule Determination*, 2 August 2012, Sydney, p. 8.

¹⁷ NER, Chapter 10: Glossary, definition of 'nominated pass through event considerations', cl. (e).

¹⁸ AEMC 2012, *Cost pass through arrangements for Network Service Providers, Rule Determination*, 2 August 2012, Sydney, p. 18.

- self-insurance (putting aside funds to manage the likely costs associated with a 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.¹⁹

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.²⁰ This is reflected in the materiality threshold that applies to applications for cost pass through determinations.²¹

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 under the EBSS and CESS.²²

Cost pass through amounts that have already been recovered in a regulatory period cannot be recovered again in the roll-forward of the regulatory asset base (RAB) for the next regulatory period.²³

13.5 Reasons for draft decision

Our draft decision is to accept TransGrid's nominated pass through events.

We are satisfied that these four nominated pass through events are consistent with the nominated pass through event considerations:

- They are not covered by a prescribed pass through event under the NER
- The nature and type of these events can be clearly identified at the time of our decision, and where there is room for doubt appropriate parameters can be applied through our assessment of a pass through application
- While a prudent service provider could take steps to reduce the likelihood and cost impacts of these events, and could insure or self-insure against them, expenditure beyond a certain level aimed at completely eliminating the risk is likely to be imprudent or inefficient. In such circumstances we consider a sharing of risk

¹⁹ AEMC 2012, *Cost pass through arrangements for Network Service Providers, Rule Determination*, 2 August 2012, Sydney, 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, Sydney, p. 186.

²¹ NER, Chapter 10: Glossary, definition of 'materially'.

²² 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.

²³ NER, cl. S6A.2.1(f)(1)(ii).

between the TNSP and its customers is appropriate and more likely to be in the long term interest of consumers with respect to price.

The four nominated pass throughs are consistent with events accepted in numerous of our previous decisions, and the definitions are either identical or correspond closely with the definitions in those earlier decisions.²⁴

²⁴ Our most recent electricity transmission decision adopted identical definitions for Insurer Credit Risk, Natural Disaster and Terrorism Event as those proposed by ElectraNet, and a substantially identical definition of Insurance Cap Event: AER, Final Decision - AusNet Services Transmission Determination 2017 - 2022, April 2017, p. 18. See also our May 2016 determinations for the Victorian electricity distribution businesses (AusNet Services, United Energy, Powercor, Jemena and CitiPower) for 2016-20. Also: AER, Final Decision - ActewAGL Distribution Access Arrangement 2016 to 2021, May 2016; AER, Final Decision - AGN South Australia Distribution Access Arrangement 2016 to 2021, May 2016; AER, Final Decision - Amadeus Gas Pipeline Access Arrangement 2016 - 2021, May 2016.

