



DRAFT DECISION

TasNetworks Distribution Determination 2019 to 2024

Attachment 14 Pass through events

September 2018

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Note

This attachment forms part of the AER's draft decision on TasNetworks' 2019–24 distribution determination. It should be read with all other parts of the draft decision.

The draft decision includes the following attachments:

Overview

Attachment 1 – Annual revenue requirement

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 – Demand management incentive scheme

Attachment 12 – Classification of services

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Attachment 14 – Pass through events

Attachment 15 – Alternative control services

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Shortened forms

Shortened form	Extended form
ACS	alternative control services
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
augex	augmentation expenditure
capex	capital expenditure
CCP	Consumer Challenge Panel
CESS	capital expenditure sharing scheme
CPI	consumer price index
DRP	debt risk premium
DMIAM	demand management innovation allowance (mechanism)
DMIS	demand management incentive scheme
distributor	distribution network service provider
DUoS	distribution use of system
EBSS	efficiency benefit sharing scheme
ERP	equity risk premium
Expenditure Assessment Guideline	Expenditure Forecast Assessment Guideline for Electricity Distribution
F&A	framework and approach
MRP	market risk premium
NEL	national electricity law
NEM	national electricity market
NEO	national electricity objective
NER	national electricity rules
NSP	network service provider
opex	operating expenditure

Shortened form	Extended form
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
RPP	revenue and pricing principles
SAIDI	system average interruption duration index
SAIFI	system average interruption frequency index
SCS	standard control services
SLCAPM	Sharpe-Lintner capital asset pricing model
STPIS	service target performance incentive scheme
WACC	weighted average cost of capital

14 Pass through events

During the regulatory control period TasNetworks 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 TasNetworks 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 TasNetworks' ability to invest in and operate its networks.¹

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

- a regulatory change event
- a service standard event
- a tax change event
- a retailer insolvency 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 TasNetworks for the 2019–24 regulatory control period.

14.1 Draft decision

Our draft decision pursuant to clause 6.12.1(14) of the rules is to accept TasNetworks' nominated pass through events as they apply to its distribution network.

Accordingly we propose that the following are pass through events for the purpose of clause 6.6.1(a1)(5) of the rules:

- Insurance cap event
- Terrorism event
- Natural disaster event.

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

² NER, r. 6.6.1(a1)(1)–(4). Each of these prescribed events is defined in Chapter 10 (Glossary) of the NER.

³ NER, r. 6.6.1(a1)(5), r. 6A.7.3(a1)(5).

14.2 TasNetworks' proposal

TasNetworks proposed three nominated pass through events as set out in Table 14-1. TasNetworks proposed that the pass through events apply to standard control services and alternative control services in both the transmission and distribution networks.⁴

Table 14-1 TasNetworks' nominated pass through events

Pass through event	Definition
Insurance cap event ⁵	<p>An insurance cap event occurs if:</p> <ol style="list-style-type: none"> 1. TasNetworks makes a claim or claims and receives the benefit of a payment or payments under a relevant insurance policy; 2. TasNetworks incurs costs beyond the relevant policy limit; and 3. the costs beyond the relevant policy limit materially increase the costs to TasNetworks in providing direct control services or prescribed transmission services. <p>For this insurance cap event:</p> <p>a relevant insurance policy is an insurance policy held during the 2019-24 regulatory control period or a previous regulatory control period in which TasNetworks was registered as a NSP for the purposes of s.11 of the NEL.</p> <p>Note: In making a determination on an insurance cap event, the AER will have regard to, amongst other things:</p> <ol style="list-style-type: none"> i. the relevant insurance policy for the event; ii. the level of insurance that an efficient and prudent NSP would obtain in respect of the event; and iii. any assessment by the AER of TasNetworks' insurance in making its transmission and distribution determination for the relevant period.
Terrorism event ⁶	<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</p>

⁴ TasNetworks, Tasmanian Transmission Revenue and Distribution Regulatory Proposal, Regulatory Control Period 1 July 2019 to 30 June 2024, January 2018, pp. 211.

⁵ TasNetworks, Tasmanian Transmission Revenue and Distribution Regulatory Proposal, Regulatory Control Period 1 July 2019 to 30 June 2024, January 2018, pp. 211–212.

⁶ TasNetworks, *Tasmanian Transmission Revenue and Distribution Regulatory Proposal, Regulatory Control Period 1 July 2019 to 30 June 2024*, January 2018, p. 212.

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 TasNetworks in providing direct control services or prescribed transmission services.

Note: In assessing a terrorism event pass through application, the AER will have regard to, amongst other things:

- i. whether TasNetworks has insurance against the event;
- ii. the level of insurance that an efficient and prudent NSP would obtain in respect of the event; and
- iii. whether a declaration has been made by a relevant government authority that a terrorism event has occurred.

Natural disaster event means:

Any natural disaster including but not limited to fire, flood, or earthquake that occurs during the 2019-24 regulatory control period and that increases the costs to TasNetworks in providing direct control services or prescribed transmission services, provided the fire, flood or other event was not a consequence of the acts or omissions of the service provider.

Natural disaster event⁷

Note: In assessing a natural disaster event pass through application, the AER will have regard to, amongst other things:

- i. whether TasNetworks has insurance against the event; and
- ii. the level of insurance that an efficient and prudent NSP would obtain in respect of the event.

14.3 AER's 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

⁷ TasNetworks, Tasmanian Transmission Revenue and Distribution Regulatory Proposal, Regulatory Control Period 1 July 2019 to 30 June 2024, January 2018, pp. 212–213.

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 considering pass through event rule changes.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

- (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.

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 Service Providers, Rule Determination, 2 August 2012, p. 6.

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

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

14.3.1 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 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

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

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

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

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

¹⁷ AEMC 2012, Cost pass through arrangements for Network Service Providers, Rule Determination, 2 August 2012, p. 18.

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 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.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 throughs 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 under 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 regulatory asset base (RAB) for the next regulatory period.²²

14.4 Reasons for draft decision

TasNetworks' nominated events and associated definitions are substantially the same as those approved in our recent decisions.²³ Consistent with those decisions, we

¹⁸ AEMC 2012, Cost pass through arrangements for Network Service Providers, Rule Determination, 2 August 2012, pp. 19–20.

¹⁹ AEMC 2012, Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services, Final Position Paper, 29 November 2012, p. 186.

²⁰ NER, Chapter 10: Glossary, definition of 'materially'.

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. S6.2.1(e)(1)(ii), 6A.2.1(f)(1)(ii).

²³ E.g. AER, Draft Decision, ElectraNet Transmission Determination 2018 to 2023, Attachment 13 Pass Through Events, October 2017, pp. 13-6, 13-7; AER, Draft Decision, TransGrid Transmission Determination 2018 to 2023, Attachment 13 Pass Through Events, October 2017, pp. 13–6, 13–7.

consider these events are supported by the nominated pass through event 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 from occurring or substantially mitigate its cost impact, and could not insure (or self-insure) against the events.

With regard to the latter point, TasNetworks 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 TasNetworks 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.