Draft Decision

ActewAGL distribution determination

2015–16 to 2018–19

Attachment 15: Cost pass through

November 2014

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Note

This attachment forms part of the AER's draft decision on ActewAGL's 2015–19 distribution determination. It should be read with other parts of the draft decision.

The draft decision includes the following documents:

Overview

Attachment 1 – Annual revenue requirement

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 – Demand management incentive scheme

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Attachment 18 – Connection policy

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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	aggregate service revenue requirement
augex	augmentation expenditure
capex	capital expenditure
CCP	Consumer Challenge Panel
CESS	capital expenditure sharing scheme
CPI	consumer price index
CPI-X	consumer price index minus X
DRP	debt risk premium
DMIA	demand management innovation allowance
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

Shortened form	Extended form
NEL	national electricity law
NEM	national electricity market
NEO	national electricity objective
NER	national electricity rules
NSP	network service provider
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
RPP	revenue pricing principles
SAIDI	system average interruption duration index
SAIFI	system average interruption frequency index
SLCAPM	Sharpe-Lintner capital asset pricing model
STPIS	service target performance incentive scheme
WACC	weighted average cost of capital

15 Pass through events

The pass through mechanism of the NER recognises that a distributor can be exposed to risks beyond its control, which may have a material impact on its costs. A cost pass through enables a distributor to recover (or pass through) the costs of defined unpredictable, high cost events that are not built into our distribution determination. The NER includes the following prescribed pass through events for all DNSPs:

- a regulatory change event
- a service standard event
- a tax change event
- a retailer insolvency event
- in addition to those defined events, an event specified in a determination for a regulatory control period (nominated pass through event).[1]

This chapter sets out our draft decision about which of ActewAGL's nominated pass through events we will accept as an additional pass through event for the regulatory control period.

15.1 Draft decision

The AER accepts that, in certain circumstances, a pass through of costs may be justifiable. However, the AER does not accept these nominated pass through events as drafted by ActewAGL. Instead, the AER substitutes its own definition for the insurance cap event. We do not accept the following proposed events:

- insurer credit risk event
- general pass through event
- Demand Management and Embedded Generation Connection Incentive Scheme (DMEGCIS) event.

15.2 ActewAGL's proposal

ActewAGL's proposed nominated pass through events and definitions are set out in table 15.1.

Table 15.1 ActewAGL's proposed pass through events

Proposed event	Proposed definition
Insurance cap event	ActewAGL Distribution proposes a liability above insurance cap event defined to occur if (a) ActewAGL Distribution makes a claim on an insurance policy that it holds; (b) ActewAGL Distribution incurs costs beyond the policy limit for the relevant insurance policy; and

[1] NER, cl. 6.5.10.

	(c) ActewAGL Distribution must bear the costs that are in excess of the policy limit.
Insurer credit risk event	An insurer credit risk event occurs if as a result of the insolvency of an insurer, ActewAGL Distribution: (a) Incurs higher or lower costs for insurance premiums than those allowed for in the distribution determination; or/and (b) In respect of a claim for a risk that would have been insured by ActewAGL Distribution's insurers, is subject to higher of lower claim limit or higher of lower deductible than would have applied under that policy (c) Incurs additional costs associated with self funding an insurance claim, which would have otherwise been covered by the insolvent insurer.
General pass through event	A general nominated pass through event occurs when: (1) ActewAGL Distribution could not reasonably prevent the event from occurring or substantially mitigate the cost impact of the event; and (2) the event does not fall into any definition listed in clause 6.6.1(a1)(1) to (4) of the NER.
DMEGCIS event	A DMEGCIS pass through event occurs if: (a) ActewAGL Distributions incurs or is likely to incur an increase or decrease in costs as a result of participation in a replacement of the demand management and embedded generation connection incentive scheme at the time of the subsequent regulatory proposal; and (b) the event does not fall into any definition listed in clause 6.6.1(a1)(1) to (4) of the NER.

Source: ActewAGL, *Regulatory proposal, 2015–19 Subsequent regulatory control period Distribution services provided by the ActewAGL Distribution electricity network in the Australian Capital Territory*, 2 June 2014 (resubmitted 10 July 2014), pp. 380–392.

15.3 AER's assessment approach

We must decide which of ActewAGL's proposed nominated pass through events will apply for the 2015–19 regulatory control period. Pass through events transfer financial risks from the NSPs to consumers. If one of the nominated events occurs, the costs of the event that we assess as meeting the factors set out in the NER are passed through to consumers and network charges increase.[2]

Our approach has been guided by the National Electricity Objective (NEO) and the Revenue and Pricing Principles. It provides the NSP with a reasonable opportunity to recover at least the efficient costs the operator incurs,[3] while also providing effective incentives to promote economic efficiency.[4] It promotes a balance between the economic costs and risks for promoting efficient investment.[5]

[2] NER, cll. 6.6.1(d),(g) and (j).
[3] NEL, s.7A(2).
[4] NEL, s.7A(3).
[5] NEL, s.7A(6).

The NER includes the following nominated pass through event considerations which we must have regard to when assessing nominated pass through events.[6]

> 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.

These considerations involve an assessment of the incentives on NSPs to manage their risks efficiently.

For systemic risks, NSPs are compensated through the allowed rate of return. NSPs also face business-specific, or residual, risks. These activities are generally compensated through the opex and capex allowances. Beyond this an NSP may manage other risks through a number of other strategies, including:

- prevention (avoiding the risk)
- mitigation (reducing the negative effect or probability of the risk)
- insurance (transferring the risk to another party)
- self-insurance (putting aside funds to manage the likely costs associated with a risky event).

An efficient business will manage its risk by employing the most cost effective combination of these strategies. For example, if a cost is reasonably predictable a business should factor it into its opex and capex proposed expenditure. In addition, an NSP may invest in its networks to mitigate the impact of certain events occurring. Alternatively, if the probability of events occurring can be readily estimated then the event should be insurable.

Pass through events cover those limited circumstances for which the risks cannot be managed efficiently in these ways and for which the NSP should be able to recover its efficient costs.

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6 NER, cl. 6.5.10(b); NER glossary, definition of 'nominated pass through event considerations'.

A factor for us to consider, which is reflected in the pass through event considerations, is who is best placed to manage risk. Generally the party who is in the best position to manage the risk should bear the risk. If the NSP, or customers, are fully exposed to a risk this may lead to adverse outcomes.

For example, where it is not possible for an NSP to insure against a risk, NSPs may need to share that risk with customers, to ensure that the service can continue to be provided if the event happens. The uninsurable risk may be outside the control of the NSP and have a low probability of occurring, but it might also have a significant cost impact. The most efficient and prudent solution to manage that type of risk may be to require customers to accept some of the burden of that risk, by allowing a pass through in the unlikely event that the risk eventuates. On the other hand, if the NSP is able to pass through all the costs of such an event, this may reduce the NSP's incentive to take prudent actions to prevent or mitigate the potential cost impact of the risk. Accordingly, while customers may need to accept some of the burden of the risk, the NSP will need to share some of the risk too. That might be achieved, for example, by making a pass through conditional on the NSP demonstrating that it has acted prudently and efficiently in managing the potential impact of the event.

We consider all of these issues when assessing a nominated pass through event with the aim of achieving the right balance, in the long term interests of consumers, in accordance with the nominated pass through event considerations.

As a matter of good regulatory practice, an additional factor we take into account is consistency in our approach to assessing nominated pass through events across our determinations where possible.[7]

15.3.1 Interrelationships

As we mentioned above, pass through events are not the only mechanism in this determination by which ActewAGL can manage its risks. The nominated pass through events are interrelated with other parts of this determination, in particular with the proposed opex and capex allowances and the rate of return. These interrelationships require the AER to balance the incentives in the various parts of its decision.

15.4 Reasons for draft decision

This section sets out our reasons for:

- proposing amendments to the insurance cap event
- not accepting the insurer credit risk event, DMEGCIS event, or the general pass through event.

Insurance cap event—propose new definition

We do not accept the proposed definition of an insurance cap event. We have amended the proposed definition to incorporate factors that we will have regard to when assessing a claim for a pass through.

The insurance cap event would allow ActewAGL to recover material costs incurred which exceed its insurance claim limit.[8] It is funded through its opex allowance to obtain an appropriate level of insurance for these types of risks. We accept that the insurance cap event would protect it from high cost impact events which would be uneconomical to insure against. We consider consumers benefit

7 NER, glossary, definition of 'nominated pass through event considerations', paragraph (e).

8 ActewAGL, *Regulatory proposal, 2015–19 Subsequent regulatory control period Distribution services provided by the ActewAGL Distribution electricity network in the Australian Capital Territory, 2 June 2014 (resubmitted 10 July 2014),* p. 387.

because they are not required to fund excessive premiums where insurance, if available, would be uneconomic. Consumers then only bear the risk should an insurance cap event occur.

We expect that ActewAGL will obtain efficient levels of insurance cover commensurate with its business risk as reflected in its opex allowance and note the following:

- the extent to which ActewAGL is able to reasonably prevent costs being incurred which exceed its insurance cap, or take steps to mitigate incurring costs above the cap is limited
- the coverage of insurance should be capped at a level beyond which it is unable or uneconomic to insure, having regard to the cost of premiums and the likelihood of the event.

We note that if a pass through event of this kind were to occur, in assessing ActewAGL's application to pass through costs, we will consider the efficiency of ActewAGL's decisions and actions. We would consider whether it failed to take reasonable action to reduce the magnitude of the amount being claimed and whether any act or omission it took in response to the event increased the magnitude of the amount claimed.[9] This gives ActewAGL an incentive to mitigate the risks associated with the event including through acquiring an appropriate level of insurance and implementing other practical risk minimisation strategies in its operations.

The definition proposed should be amended to clarify some factors to which we will have regard when assessing a claim. Accordingly, we have proposed a new definition as set out at section 15.5.

After making this amendment we consider that including the insurance cap event provides an incentive for ActewAGL to obtain an efficient level of insurance.[10]

Insurer credit risk event—do not accept

We do not accept the insurer credit risk event as a pass through event because a prudent service provider could reasonably prevent an event of that nature from occurring.[11]

The proposed insurer credit risk event occurs if as a result of the insolvency of an insurance provider:[12]

- the cost of the insurance premium materially changes from the allowance
- the business is subject to a higher or lower claim limit, or incurs a materially higher or lower deductible (excess)
- the business incurs additional costs with self funding an insurance claim which would have otherwise been covered by the insolvent insurer.

A key consideration is whether a prudent service provider could reasonably prevent an insurer credit risk event occurring.[13] We consider that a prudent service provider would use an insurance provider

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9 NER, cl. 6.6.1(j)(3).

10 We note that we have not explicitly excluded insurance cap events that arise due to a finding of negligence. Negligence suggests the NSP may have some control over the event or some opportunity to limit the magnitude of the event. This may be a factor that we would have regard to in assessing such a pass through application. However, we do not consider it would be appropriate to exclude all events where the suggestion of negligence on behalf of the business has been raised. We further note that unlawful conduct and gross negligence would not be covered by an insurer and that acts or omissions resulting from such unlawful conduct or gross negligence would be relevant considerations when assessing a pass through event application, having regard to the relevant factors set out in the NER.

11 NER, glossary, definition of 'nominated pass through event considerations', paragraph (c).

12 ActewAGL, *Regulatory proposal,* p. 386.

13 NER, glossary, definition of 'nominated pass through event considerations', paragraph (c).

that has the capacity to satisfy any claims under a policy. NSPs can assess the viability of an insurer by reviewing its track record, size, credit rating and reputation. If we allow an insurer credit risk event we may encourage NSPs to obtain insurance from providers who are not capable of paying large claims or to not monitor or review the viability of their insurance provider. Under this scenario, in the event that the insurance provider fails and a claim is made, the NSP may simply seek a pass through of the costs.

We also do not consider there is sufficient reason why ActewAGL will incur a higher or lower deductible, or why the insurance premium should vary materially, as a consequence of an insurer becoming insolvent.

Including the insurance credit risk event removes the incentive for ActewAGL to obtain insurance from a reputable provider who is able to pay a claim. We consider ActewAGL is able to take steps to mitigate or prevent this event from occurring. Accordingly, we do not accept the insurer credit risk event.

General pass through event—do not accept

We do not accept the general event as a pass through event in our draft determination because:

- the event cannot be clearly identified at the time the determination is made.[14] ActewAGL has sought to make the general pass through event more specific by excluding the prescribed pass through events and events where ActewAGL could mitigate the cost impact of events or the likelihood of the event occurring. However, even with these limitations, we do not consider a general pass through event can be clearly identified.
- we cannot consider whether a provider could insure against the event.[15] Without knowing what the event is we cannot say whether a provider could insure against the event. ActewAGL stated that it cannot obtain insurance for events it is unable to forecast that might occur.[16] However, ActewAGL's general nominated pass through event is not in any way limited to events which it cannot forecast.

ActewAGL stated that if the AER's view is that the general nominated event is inconsistent with paragraph (b) of the pass through event considerations, that is whether the event can be clearly identified, then the AER should allow it as it contributes to the achievement of the NEO,[17]

> If the AER maintains its view that the nature of a general nominated pass through event cannot be clearly identified, then to contribute to the achievement of the National Electricity Objective and facilitate ActewAGL Distribution’s recovery of efficient costs, the AER should accept the nominated event irrespective of its inconsistency with consideration b.

As noted in section 15.3, we have only allowed the nominated pass through events that we are satisfied meet the NEO. Under the revenue and pricing principles the NSPs should be provided with a reasonable opportunity to recover their efficient costs of providing direct control services and complying with a regulatory obligation. NSPs should also be provided with effective incentives to promote economic efficiency. We do not consider this means that NSPs should be allowed a general pass through event which covers any event which is not prescribed and which the NSPs cannot prevent from occurring or mitigate the costs.

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14 NER, glossary, definition of 'nominated pass through event considerations', paragraph (b).
15 NER, glossary, definition of 'nominated pass through event considerations', paragraph (d).
16 ActewAGL, *Regulatory proposal*, pp. 384–385.
17 ActewAGL, *Regulatory proposal*, p. 385.

Accordingly, we are not satisfied that a general pass through event should be included in our draft determination for ActewAGL.

DMEGCIS event—do not accept

We do not accept the DMEGCIS event as a pass through event in our draft determination because the event is likely covered by another category of pass through event.[18] The AEMC has received a number of rule change requests from the COAG Energy Council and other parties in response to its recommendations following its Power of Choice review.[19] One of the rule change requests was in relation to the recommendation to reform the DMEGCIS.[20]

ActewAGL did not provide an explanation why the DMEGCIS event would not already be covered by the regulatory change event. It did mention that:[21]

- it is unclear how a new demand management scheme can apply once a distribution determination has been made
- it may not be able to recover the costs, including incentives, of the new scheme
- it is unknown whether the Rule Change will substantially affect the manner in which ActewAGL provides direct control services and may not satisfy the regulatory change event definition.

If the rule change materially changes ActewAGL's costs, then ActewAGL may be able to make a pass through application to the AER under one of the existing prescribed pass through events.

ActewAGL indicated the NER at present may not allow for the demand scheme that applies to a DNSP to be amended during the regulatory control period. Accordingly, it proposed a nominated pass through event to allow it to receive the incentives of the new scheme.

We expect that if the result of the rule change request is to amend the Demand Management Incentive Scheme (DMIS), then the rule change will specify the affected DNSPs to whom it will apply. Further, if the intention is that the NSW/ACT DNSPs are able to receive any incentives (rewards or penalties) during the 2015–19 regulatory control period, then the rule change will allow those DNSPs to receive any incentives and this can be achieved through transitional rules.

ActewAGL also stated that the new incentive may not be considered to be a change in costs of providing direct control services. Therefore, a pass through application would fail. Accordingly, rather than relying on the regulatory change event it is proposing the DMEGCIS event.

We do not consider that ActewAGL's proposed DMEGCIS event would address this concern. Whether ActewAGL makes a pass through application in respect of a prescribed event or in respect of this nominated event, the AER is still limited to only allowing a pass through for costs incurred as a result of providing direct control services.

Accordingly, we do not consider there is a need to for an additional specific pass through event to cover the potential costs of this event, beyond those set out in the NER or approved in this determination.

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18 NER, glossary, definition of 'nominated pass through event considerations', paragraph (a).
19 AEMC, http://www.aemc.gov.au/Major-Pages/Power-of-choice.
20 AEMC, http://www.aemc.gov.au/Major-Pages/Power-of-choice.
21 ActewAGL, *Regulatory proposal*, p. 391.

15.5 Revisions

We propose an amendment to the definition of the insurance cap event.

> An insurance cap event occurs if:
>
> 1. ActewAGL makes a claim or claims and receives the benefit of a payment or payments under a relevant insurance policy,
>
> 2. ActewAGL incurs costs beyond the relevant policy limit, and
>
> 3. the costs beyond the relevant policy limit materially increase the costs to ActewAGL in providing direct control services.
>
> For this insurance cap event:
>
> 4. the relevant policy limit is the greater of:
>
> a. ActewAGL's actual policy limit at the time of the event that gives, or would have given rise to a claim, and
>
> b. the policy limit that is explicitly or implicitly commensurate with the allowance for insurance premiums that is included in the forecast operating expenditure allowance approved in the AER's final decision for the regulatory control period in which the insurance policy is issued.
>
> 5. A relevant insurance policy is an insurance policy held during the 2015-19 regulatory control period or a previous regulatory control period in which ActewAGL was regulated.
>
> Note for the avoidance of doubt, in assessing an insurance cap event cost pass through application under rule 6.6.1(j), the AER will have regard to:
>
> i. the insurance policy for the event, and
>
> ii. the level of insurance that an efficient and prudent NSP would obtain in respect of the event
>
> iiii. the extent to which a prudent provider could reasonably mitigate the impact of the event.

We do not accept the insurer credit risk event, the general pass through event or the DMEGCIS event.