1 March 2012

Australian Energy Market Commission
PO Box A2449
Sydney South
New South Wales 1235

Dear Sir/Madam

ENERGEX welcomes the opportunity to comment on the Australian Energy Market Commission's consultation paper on the National Electricity Amendment (cost pass through arrangements for network service providers) Rule 2012.

The proposed changes largely seek to address network service providers (NSPs) exposure to low probability, high impact events which are beyond the reasonable control of NSPs. ENERGEX supports the proposed improvements to the cost pass through arrangements, noting that these are more substantial for Transmission Network Service Providers (TNSPs) than Distribution Network Service Providers (DNSPs). ENERGEX considers the rule change proposal promotes the National Electricity Objective by allowing for more cost efficient management of the risk associated with low probability high cost events and the Revenue and Pricing Principles by providing NSPs with a reasonable opportunity to recover at least efficient costs they incur in providing direct control services.

ENERGEX recognises the importance of having a regulatory framework that provides and maintains incentives for NSPs to manage the risks of owning and operating networks. ENERGEX, for instance, actively manages its exposure to severe weather events (i.e. storms) each summer within the efficient expenditure allowance for emergency response and storms as determined by the Australian Energy Regulator (AER) under the regulatory framework. However, to the extent that NSPs are exposed to events that are uncontrollable, unexpected and high impact, the beneficiaries of the services provided by NSPs, should reasonably be expected to bear the prudent and efficient costs associated with such risk events. Under the National Electricity Rules (NER) any application for a positive pass through event is thoroughly assessed by the AER to ensure that only prudent and efficient costs can be passed onto customers. The AER is required to consider any action by the NSP or failure of the NSP to act which contributed to the costs incurred. This places a strong incentive on the NSP for robust governance frameworks to manage the risks of unforeseeable events to the extent they are able.

The rule change proposal would allow ENERGEX to potentially recover costs associated from a pass through event which occurs in the "dead zone" and provide greater certainty for future determinations by codifying natural

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disasters and insurance cap events as pass throughs events. The current pass through arrangements under ENERGEX's determination provide for a general nominated pass through which would likely include natural disaster and insurance cap events. As such, ENERGEX does not consider that the proposed changes would materially adjust ENERGEX's current risk profile or the way in which ENERGEX manages risk associated with owning and operating its network.

Attached are responses to the specific questions raised in the AEMC's consultation paper. If any further information is required, please contact Louise Dwyer, Group Manager Regulatory Affairs on (07) 3664 4047.

Yours sincerely

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Question		ENERGEX's Response
Question 1 - Allocation of risk		
(a)	What is the appropriate level of risk to be attributed to the network service provider? How should the distinction be drawn between risk to be attributed to the network service provider and risk to be passed through to the end Consumer?	Risk should be attributed to network service providers (NSPs) where NSPs have the ability to manage risk through mechanisms such as self insurance, commercial insurance, making efficient investment decisions which seek to weather proof assets, executing a robust asset maintenance program and the establishment of emergency plans to protect assets in extraordinary events. Where a NSP has no or very limited ability to manage the risk of high impact events, consumers who are ultimately the beneficiaries of the services provided by NSPs, should reasonably be expected to bear the prudent and efficient costs associated with such non-diversifiable risk events. The point of distinction is whether the NSP has any ability to control/mitigate the risk, which in some instances will require judgement on the part of the regulator. For example, ENERGEX is exposed to and manages the risk of severe weather events (i.e. storms) each summer having been funded for an efficient level of expenditure for this purpose. While most summer storms are uncontrollable and to some degree unexpected (in terms of severity/location), these events are generally not high impact and are generally allowed for in the funding allowances.
(b)	Where the business has the ability to partially manage or mitigate a cost, how should that be factored into consideration of whether to allow a cost pass through?	The ability of a NSP to partially manage a risk/cost for positive change event is already considered under the National Electricity Rules. Clause 6.6.1(j)(3) requires that AER to take into account in the case of a positive change event, the provider's decisions and actions in relation to the risk of the positive change event, including whether the provider has failed to take any action that could reasonably be taken to reduce the magnitude of the eligible pass through amount and whether the provider has taken or omitted to take any action where such action or omission has increased the magnitude of the amount in respect of that positive change event. Grid Australia's proposed rule change seeks to extend such safeguards to include, for positive change events, consideration of any amounts recoverable under insurance policies, the availability of insurance and the extent to which a network business has been funded to self insure. In the event of a natural disaster for instance, a regulator would need to employ some judgement around actions taken/not taken given that circumstances are far from business as usual.

(c)	How do the businesses currently manage and mitigate their risk profile?	ENERGEX's manages its risk profile by employing a combination of tools including self insurance, commercial insurance (where possible), by making efficient investment decisions based on the environmental conditions (including high susceptibility to electrical storms) and establishing and testing emergency plans for severe weather events. ENERGEX would reinforce the views expressed by Grid Australia, that commercial insurance for network assets is rarely available on terms and conditions which make it commercially feasible. ENERGEX has established strong governance frameworks to manage risks to the network assets in response to weather events and emergencies. ENERGEX prepares an annual Summer Preparedness Plan in accordance with the Electricity Industry Code and has a Corporate Emergency Management Plan in place (which was rigorously tested in South East Queensland's 2011 flood event). In extreme situations, ENERGEX would ultimately rely on seeking passthrough arrangements under the current determination which provides for a general nominated pass through event with a materiality threshold of 1% of the smoothed revenue allowance.
(d)	Amending the rules to broaden the scope of the cost pass through provisions transfers the risk to end customers. Is it appropriate for end customers to bear these risks?	The rule change proposal only seeks to broaden the scope to allow for extraordinary events with a low probability. Customers fund network service providers' efficient operating and capital expenditure in the ordinary course of business. It is reasonable that beneficiaries of services bear the prudent and efficient costs incurred to address extraordinary circumstances that are outside the control of network service providers.
(e)	Is clause 6A.7.3(j)(3) sufficient to maintain the incentives to efficiently manage part of the costs but still provide the business with an opportunity to recover Efficient costs? Is there a more preferred mechanism to achieve this?	The clause 6A 7.3(j)(3) operates well in terms of maintaining incentives for network service providers. The AER is able to conduct a thorough examination of any pass through application and to the extent that the AER does not believe that network providers have operated prudently or efficiently, the AER will not allow associated costs to be passed through. The onus is placed on network services providers to clearly demonstrate that the costs incurred were unavoidable and efficient.
Question 2 - Interaction between cost pass throughs, capex re-openers and contingent events		
(a)	Is the AEMC's intent to leave the re-opener for "large, shipwreck-type events" and make the cost	(a)-(e) The type and magnitude of event will dictate the type of recourse a NSP pursues. ENERGEX understands that cost pass through, capex re-openers and

pass through as the primary means of redress still appropriate? (b) Should cost pass throughs be more limited where a capex re-opener exists? (c) Should cost pass throughs be limited to operating expenditure and capex be left to the capex re-opener? (d) Should the cost pass through override the capex re-opener as it currently does or should cost pass throughs only apply where the capex re-opener doesn't? (e) Does the existence of a re-opener change the justification for the ability to propose cost pass throughs?	contingent projects will be mutually exclusive mechanisms available to TNSP. The capex re-opener threshold trigger is very substantial and requires a more onerous process of revoking and substituting a revenue determination. The cost pass through mechanism should not be limited given the capex re-opener threshold.
Question 3 - Cost pass throughs, risk and return	
(a) Is it appropriate to adjust the WACC for the inclusion of a new cost pass through?	ENERGEX does not consider there is any case to adjust WACC for inclusion of a new cost pass through. ENERGEX's risk profile would not change as a result of the rule change proposal being successful. ENERGEX would continue to bear all risks of owning and operating the network, with the exception of specific and general nominated pass through events allowed for under its determination and the NER codified pass through events providing the materiality threshold is met. Investors require a reasonable return to underpin ongoing investment in the industry.
(b) Are the risks referred to in the rule change request asymmetric?	ENERGEX concurs with Grid Australia's view that the risks of high impact external events are asymmetric as these unfunded events invariability lead to an increase in costs in providing services. Whereas for risks (e.g. storms) funded under the regulatory framework, there are a range of outcomes in terms of outturn costs compared with expenditure allowance.
(c) Are these risks or the expected value of bearing this	ENERGEX is funded under the determination for emergency response/storms.

risk reflected somewhere else in the building block approach or other incentive mechanism? Are the network businesses currently bearing this risk with no level of remuneration as is implied by the Grid Australia submission?	ENERGEX actively manages the risks of these weather events within the operating expenditure allowance. However these allowances are generally determined based on historical experience for storm and severe weather event which generally occur during the summer months. These allowances do not include significant uncontrollable, unexpected and high impact events such as Natural Disasters.
Question 4 - Incorporation of a new natural disaster pass through event in the rules	
(a) How would this new pass through event change how a network service provider manages its risk? (b) In the event that a new pass through event is included in the rules, what is the appropriate level at which consumers bear the risk of natural disasters? (c) Would the inclusion of a new natural disaster pass through event alter the incentives and cost structure of network service providers? (d) Would the inclusion of a new natural disaster pass through event provide regulatory certainty and transparency to the rules? (e) Would the inclusion of a new natural disaster pass through event be more administratively efficient, as opposed to a nominated cost pass through?	(a) As stated above, ENERGEX actively and efficiently manages its risks and would not anticipate any change as a result of the new natural disaster pass through event. (b) The transfer of risk to beneficiaries of network services should occur where the event is uncontrollable, unexpected and high impact. (c) ENERGEX does not consider the inclusion of a new natural disaster pass through event will alter incentives. ENERGEX will continue to seek to mitigate the risks of natural disaster where possible, as was recently demonstrated during the South East Queensland January 2011 flood event where for example ENERGEX took pre-emptive action by interrupting supply to remove network equipment prior to inundation. The inclusion of a new natural disaster pass through event per se will not change ENERGEX's cost structure, however should a high impact, uncontrollable event occur the cost structure may change depending on the magnitude and type of event (for instance without a pass through mechanism a NSP may need to seek further borrowings or other funding alternatives). (d) –(e) The inclusion of a new natural disaster pass through event will provide greater certainty and transparency for NSPs and will be marginally more administratively efficient as NSPs may not seek to have this type of event recognised as a specific or general nominated pass through event in their regulatory determinations.

Question 5 - Incorporation of a new insurance cap event in the rules	
(a) How would this new pass through event change how a network service provider manages its risk? (b) In the event that a new pass through event is included in the rules, is it appropriate that consumers bear the risk of insurance liabilities? (c) Would the inclusion of a new insurance cap pass through event alter the incentives and cost structure of network service providers? (d) Would the inclusion of a new insurance cap pass through event provide regulatory certainty and transparency to the rules? (e) Would the inclusion of a new insurance cap pass through event be more administratively efficient, as opposed to a nominated cost pass through? (f) Is it appropriate that TNSPs are allowed to pass through costs to end consumers where they are found to be negligent?	Refer to comments provided to question 4.
Question 6 - Ability for TNSPs to propose additional pass through events as part of its regulatory determination	
(a) How would the ability of TNSPs to propose a nominated cost pass through change how it manages its risk? (b) Would the inclusion of the ability for TNSPs to propose a nominated cost pass through alter the incentives and cost structure of TNSPs? (c) Is it appropriate to include the natural disaster and insurance cap events as defined pass through events in the rules, if TNSPs have the ability to nominate	Not applicable.

pass through events as part of their revenue proposals? (d) Should the criteria developed by the AER be codified in determining past through applications to promote administrative efficiency?	
Question 7 - Addressing the dead zone	
(a) Would addressing the 'dead zone' change how a network service provider manages its risk? (b) How would addressing the 'dead zone' ensure that network service providers are able recover their efficient costs and encourage efficient investment in, and operation of, electricity networks? (c) How would addressing the 'dead zone' provide regulatory certainty and transparency for network service providers? (d) How would addressing the 'dead zone' promote administrative efficiency for network service providers? (e) Is Grid Australia's proposal the most effective way of addressing the dead zone? Is its scope broader than is needed to address the 'dead zone'	Allowing NSPs to potentially recover efficient costs associated with a pass through event which occurred in the 'dead zone' will not change how a NSP will manage its risk. This is because any application for a positive change event will be thoroughly scrutinized by the AER with only prudent and efficient costs to be allowed to be recovered. NSPs are incentivised to appropriately manage risks to the extent possible; otherwise the pass through arrangements will effectively not be available to NSPs. Addressing the 'dead zone' would provide NSPs with some certainty that should an uncontrollable, unexpected and high impact event occur within the 'dead zone' some recourse may be available to these businesses. Similarly, the addressing the 'dead zone' issue will be more administratively efficient, albeit probably marginally, as NSPs may not seek to have this issue addressed through their regulatory determinations.