grid australia
BACKBONE OF THE NEM

1 March 2012

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Via website: www.aemc.gov.au

Dear John

Proposed Rule Change: Cost Pass Through Arrangements for NSPs

1. Introduction

Grid Australia is making this submission in response to the AEMC's Consultation Paper: *National Electricity Amendment (Cost pass through arrangements for network service providers) Rule 2012.*

The AEMC's Consultation Paper has been issued in connection with the Rule Change Proposal submitted by Grid Australia covering a number of changes to the current National Electricity Rules ('the Rules') in order to allow Transmission Network Service Providers (TNSPs) to more efficiently utilise the cost pass through provisions in clause 6A.7.3 of the Rules.

Grid Australia provided a detailed discussion at the time of submitting its Rule Change Proposal on the issues with the current Rules which the Proposal seeks to address, and how the Proposed Rule will contribute to the National Electricity Objective ('the NEO'). This discussion covered many of the areas and questions raised by the AEMC in its Consultation Paper. Grid Australia has not therefore repeated these issues in this submission. Nor has it sought to provide a comprehensive response to all of the questions raised by the AEMC.

The focus of this submission is instead on highlighting what Grid Australia sees as a mischaracterisation by the AEMC of the fundamental issue addressed by the Proposed Rule Change. Rather than the Proposed Rule Change seeking to transfer risks from Network Service Providers (NSPs) to customers, the proposed Rule Change is about how much customers pay to manage the risk of uncertain, high cost events that are outside the reasonable control of NSPs. Grid Australia considers that the fundamental question in evaluating the Rule Change Proposal is therefore whether a framework under which customers pay for insurance (at potentially very high premiums) against such events, regardless of the event occurring, is more likely to meet the NEO than one in which customers pay for the costs of an uncertain event, only if it in fact occurs.

This submission also covers the following points, in response to some of the specific questions raised by the AEMC in the Consultation Paper:

1. There is no part of the framework used under the Rules to calculate the WACC which would be affected by a change in the way asymmetric risks are managed. Therefore it would not be appropriate to adjust the WACC for inclusion of a new cost pass through event.

2. There are already incentives within the Rules for NSPs to take steps to mitigate the cost impact of uncertain, high cost events that are outside their reasonable control. Grid Australia does not consider that further changes to the Rules are necessary.

3. The Rules already ensure that there can be no 'double-dipping' by TNSPs in relation to recovering costs via both the capex re-opening provisions and the cost pass through provisions. As a consequence, the existence of a capex re-opening should not act to limit the scope of cost pass throughs, or change the justification for TNSPs to be able to propose cost pass throughs.

4. Including specific cost pass through events for a natural disaster and an insurance cap event will provide a greater degree of transparency and regulatory certainty than relying only on a nominated pass through.

2. Focus of Proposed Rule Change is on cost efficient management of risks, rather than risk transfer

In its consultation paper, the AEMC discusses the allocation of risk between market participants.[1] Specifically the AEMC highlights two potential means of addressing the allocation of the risk of 'unexpected cost rises or unexpected costs':

- allocate the risk to the network business; or
- allocate the risk to end consumers.

The AEMC characterises commercial insurance and self-insurance as examples of where the risk is allocated to the NSP, and cost pass through as an example of where risk is allocated to customers.

Grid Australia does not consider that the distinction drawn by the AEMC is appropriate in the case of the risk of uncertain events beyond an NSPs' reasonable control, which is the focus of the Rule Change Proposal. The fundamental issue in this case is who bears the cost associated with managing the risk, and how the risk can be managed in the most cost efficient way. In the case of uncertain events beyond the NSPs' reasonable control, it is customers who bear the cost of that risk, whether that risk is managed by insurance or by a cost pass-through. Specifically:

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[1] AEMC Consultation Paper, Section 5.1

- Where the NSP takes out either commercial insurance, or self-insures to cover the cost of this risk, the cost of such risk management[2] is borne by customers, through higher operating expenditure forecasts (regardless of whether the event actually occurs);
- Where there are cost pass-through provisions (as proposed in the Rule Change Proposal), customers bear the risk that they will need to pay the full costs associated with the event (but only if the event actually occurs).

The difference between the two risk management approaches leads to different levels of costs being borne by customers, and the occurrence of these costs differing:

- In the case of insurance (either commercial insurance or self insurance), the cost is the level of insurance premium included in operating expenditure and reflected in network charges. This is a cost that customers bear, whether or not the event actually occurs. If the event actually occurs, customers do not bear any additional costs;
- In the case of a cost pass-through, customers bear the full costs associated with the event (as determined by the AER) if the event actually occurs. If the event does not occur, customers do not bear any costs.

With one exception, it is <u>not</u> the case that the new proposed cost pass through provisions would take 'a risk that was previously attributed to the network businesses, and [... move] it to the end consumer'.[3]

The exception is in the case of events which lead to the TNSP's incurring costs above insurance limits, which Grid Australia is proposing would be addressed under the pass through provisions in the Rules as a new 'insurance cap event'. Currently the only option open to TNSPs to manage the risk of events resulting in costs above insurance limits is to try to agree higher limits with commercial insurance companies, which either come with a higher premium (which is ultimately borne by customers), or are simply not available. The current wording of the Rules makes it difficult for TNSPs to seek self-insurance for these costs. In addition, the AER has been reluctant to consider such costs as eligible for self-insurance, given the difficulty in establishing what would be an efficient allowance for self-insurance in this case. The Rule Change proposal would address this current deficiency in the Rules by providing a clear avenue under which the risk of events occurring which result in costs above insurance limits could be addressed.

The risks highlighted in Grid Australia's Rule Change Proposal are risks that arise as a consequence of an uncertain event, outside the NSPs' reasonable control. The Rule Change Proposal does not cover events which are within the control of the NSPs,[4] or 'unexpected cost rises' more generally. Grid Australia recognises that the current regulatory framework under Chapter 6A of the Rules places the risk of events that are within the NSPs' reasonable control with the businesses, to provide them with the incentive (and associated rewards and penalties) to

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2 The AEMC in its Consultation Paper (p. 10) appears to draw a distinction between 'managing the risk' and 'obtaining commercial insurance or undertaking self-insurance'. In the context of uncertain events beyond the NSPs' reasonable control, the latter insurance options are the approaches taken to 'managing the risk'. Although the NSPs are the parties taking out the insurance (or self-insuring), they are managing the risk on behalf of customers, who ultimately pay for this risk management through their network charges.

3 AEMC Consultation Paper, p. 15. The AEMC makes this statement at the start of Section 5.3.

4 As a consequence, the AEMC's discussion in section 5.1 of the business choosing to manage the risk through 'performance of normal business operations' does not apply in the case of the uncertain events outside of the reasonable control of NSPs which are the subject of the Rule Change Proposal.

manage these risks efficiently. Grid Australia continues to support this general approach in relation to risks which are within the NSPs' control.

Having the costs associated with the risks of uncertain events beyond the NSPs' reasonable control being borne by customers is consistent with the Revenue and Pricing Principles in the National Electricity Law, in particular:

> (2) A regulated network service provider should be provided with a reasonable opportunity to recover at least the efficient costs the operator incurs in—
>
> (a) providing direct control network services [..][5]

The fundamental question in evaluating whether expanding the potential range of events which would qualify for cost pass through is likely to better meet the NEO, is whether a framework under which customers pay for insurance (at potentially very high premiums) regardless of the event incurring is more cost efficient than one in which customers pay for the full costs of an external event, but only if it actually occurs.

The AEMC highlights in its Consultation Paper that it:

> [..] will need to assess whether the rule change request is likely to better balance the need to attract sufficient investment in the networks with the need to minimise prices for consumers.

Grid Australia agrees that consideration of 'the need to minimise prices for consumers' is a relevant factor in evaluating the Rule Change Proposal. However it also notes that it is a factor which may ultimately support the proposed revisions to the Rules, even considered in isolation.[6]

Grid Australia considers that the AEMC's mischaracterisation of the Rule Change Proposal as primarily shifting the allocation of risk between NSPs and customers, rather than one which primarily alters the costs that customers are bearing to address risks outside of the reasonable control of NSPs, has led to an imbalance in the discussion in the Consultation Paper. For example, in discussing the allocation of risk (Question 1), the AEMC asks:

> (1)(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 those risks?

A more appropriate question would be whether it is appropriate for customers under the current Rules to be paying excessive insurance premiums in order to manage the risk of uncertain, external events, or whether a more cost efficient management of risks can be achieved by amending the Rules so that customers instead bear the full costs associated with an unexpected external event, but only if that event actually occurs.

Finally, Grid Australia notes the AEMC's comment in the Consultation Paper that:

> The efficient level of costs can, however, be difficult for the AER to determine for a one off event that is experienced by only one network service provider.[7]

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5 National Electricity Law, Part 7A.

6 Grid Australia notes and supports the AEMC's intention to also consider the need to attract sufficient investment in the networks as part of evaluating the proposed Rule Change.

7 AEMC Consultation Paper, p. 12.

This comment appears to be made in the context of potential concerns with expanding the scope of the cost pass through provisions, and the difficulty in the AER ensuring that customers only bear the efficient costs associated with uncertain events that are outside the reasonable control of NSPs.

Grid Australia recognises that establishing the efficient costs arising from such an event may be challenging. However it is not clear that such an exercise is of a totally different nature for the AER compared to, for example, establishing the efficient costs of a proposed network augmentation. In each case there will be specific factors which drive the overall cost, and which will be 'one-off' in nature, and specific to that NSP. More fundamentally, it is also important to note that continuing with the current Rules provisions, under which the NSP is often self-insuring for risks of uncertain, high cost events outside its reasonable control, does not avoid the difficulty with estimating the potential costs of such events.

In order to establish an efficient allowance for self-insurance costs, the AER currently needs to form a view as to the costs that would be associated with the event occurring, as well as the probability of the event occurring. Establishing what is an efficient self-insurance cost is acknowledged to be a difficult area. Indeed, one advantage of the Rule Change Proposal is that this assessment would no longer need to be made by the AER for events covered by the new provisions. Instead, under the Rule change, these costs can be assessed after the event occurs.

3. Risk profile and rate of return

The AEMC's characterisation of the Rule Change Proposal as one which transfers risk away from the NSPs has also led it to raise a number of questions in the Consultation Paper in relation to the rate of return (the WACC) applied to NSPs.

As discussed above, currently the risk of uncertain, high cost events that are outside the reasonable control of NSPs can be managed by the NSP through taking out commercial insurance or by self-insuring. In both cases the cost of such insurance is reflected in the NSP's operating expenditure forecast, and borne by customers.

As highlighted in Grid Australia's Rule Change Proposal, uncertain, high cost events that are outside the reasonable control of NSPs are asymmetric in nature. That is, costs for the NSPs are more likely to increase as a consequence of a natural disaster or a liability claim above insured limits, rather than to decrease. The WACC does not capture the risk of asymmetric events. Specifically, the CAPM model (which is used to calculate the return on equity) only considers systemic risk, and does not include any measures which would capture changes in asymmetric risks. In addition, whether an NSP is taking out insurance to address the risk of asymmetric events or is able to pass through the cost of such events under the Rules is unlikely to be a factor which materially affects the cost of debt. As a consequence, there is no part of the framework used under the Rules to calculate the WACC which would be affected by a change in the way in which asymmetric risks are managed.

In response to the AEMC's Question 3, Grid Australia considers that:

(a) It would not be appropriate to adjust the WACC for inclusion of a new cost pass through, as the new Rules provisions would not affect any part of the Rules framework used to set the WACC (discussed in more detail above).

(b) The risks of a natural disaster event, or an insurance liability event are asymmetric, as they are more likely to lead to an increase in NSPs' costs than a decrease.

(c) Currently the cost of bearing the risk of uncertain events that are outside the reasonable control of NSPs is reflected in the insurance premiums (both commercial insurance and self insurance) incorporated in the NSPs' operating expenditure allowances. Customers pay for these costs. The proposed Rule Change would remove the need to compensate NSPs for bearing this risk (in the case of self insurance) and the need to pay commercial insurance businesses to bear this risk.

4. Incentives on NSPs to take steps to mitigate cost impacts

The AEMC raises the following question in the Consultation Paper:

> 'Is it appropriate to remove any incentive on network service providers to protect their equipment against natural disasters?'[8]

The AEMC asks a similar question more broadly under Question 1:

> (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?
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> (e) Is clause 6A.7.3(j)(3) sufficient to maintain the incentives to efficient [sic] 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?

As identified by the AEMC in its Consultation Paper,[9] under NER clause 6A.7.3(j)(3) in making a determination in relation to a pass through amount, the AER must take into account:

> [..] the efficiency of 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* in respect of that *positive change event* 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 is of the view that clause 6A.7.3(j)(3) directly addresses the potential concern raised by the AEMC in relation to maintaining the incentive for NSPs to take steps to mitigate or manage the costs arising as a result of an uncertain event outside their reasonable control. Clearly, in the case of a natural disaster event, if the NSP had failed to take reasonable steps to protect their equipment then the AER would have the ability to take this into account in making its determination on the eligible pass through amount.

Grid Australia considers that it is appropriate for NSPs to continue to have incentives to take steps to mitigate the potential cost impact of an uncertain, high cost event outside its reasonable control (such as taking reasonable steps to protect equipment from natural disasters). However Grid Australia also considers that this incentive is currently reflected in the Rules (and in particular 6A.7.3(j)(3)), and that no further amendments to the Rules are required. Grid Australia also notes that expenditure incurred in order to mitigate the potential cost impacts would be

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8 AEMC Consultation Paper, p.7.

9 AEMC Consultation Paper, p.12.

'prudent and efficient', and therefore should be reflected in the expenditure allowances determined by the AER at the time of a regulatory determination.

Finally, Grid Australia notes that the AEMC has asked a very specific question as part of its Question 5 in relation to the insurance cap event, namely:

> (f) Is it appropriate that TNSPs are allowed to pass through costs to end consumers where they are found to be negligent?

Grid Australia notes that all businesses will typically have insurance in relation to third party liability claims, including where those claims arise from negligence. That is, taking out coverage for instances of negligence is part and parcel of normal business practice. Grid Australia also notes that the legitimacy of TNSPs being able to pass costs through to end consumers where they are found to be negligent has been accepted by the AER.[10]

However, as discussed in Grid Australia's Rule Change Proposal, the wording of the proposed insurance cap event would not cover a TNSP in the event that it does not meet the criteria for being able to call upon its insurance cover. For example, in a case where there has been 'wilful negligence' and that is not covered by the insurance policy, the NSP would not be able to apply for a cost pass through. Grid Australia considers that the proposed wording provides a suitable safeguard in terms of ensuring that the costs passed through to consumers reflect a genuine event for which an insurance company would accept liability. Grid Australia further notes that the underlying issue is more appropriately characterised, not as whether or not the TNSP should be allowed to pass through costs associated with negligence to customers, but what level of costs customers should be bearing to address the risk of third party liability claims due to negligence: the cost of potentially excessive insurance premiums, regardless of whether the event occurs, or the costs associated with the event if it in fact occurs.

5. Interaction between cost pass through events, capex re-openers and contingent events

Grid Australia notes the discussion in the AEMC's Consultation Paper of the different mechanisms currently available to TNSPs under the Chapter 6A Rules to address uncertainty.

Grid Australia appreciates the recognition by the AEMC that the focus of the contingent project mechanism and capex-re-opening provisions differ to the issues which arise in relation to managing the uncertainty in relation to uncertain, high cost events that are outside the reasonable control of NSPs. The shortcomings of these mechanisms in the context of uncertain, external events were discussed in Grid Australia's Rule Change Proposal.[11]

The AEMC also recognises in its Consultation Paper the existing provisions in the Rules which prevent NSPs from 'double-dipping' in recovering the costs of uncertain, external events between the cost pass through mechanism and the capex re-opening provisions.[12] Grid Australia supports

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[10] Specifically, in its Final Decision for the Victorian DNSPs the AER accepted that conduct which is illegal, or a grossly reckless act or omission, is unlikely to be covered by an insurance policy. It also considers that there is merit in SP AusNet's comment that 'a claim against SP AusNet would be unlikely to be successful if the opposing party was unable to establish wrong doing or negligence' (p. 793).

[11] Grid Australia Rule Change Proposal, Section 2.4.

[12] NER 6A.7.1(a)(7)). Grid Australia notes that this clause also ensures that the capex re-opening provisions cannot be used if the event is a contingent project.

the principle that NSPs should not be able to recover the same costs associated with an uncertain, external event more than once.

Given that such costs are likely to cover both opex and capex, and given the substantial threshold for utilising the capex re-opening provisions, Grid Australia considers that it is likely that the appropriate mechanism in most cases would be the cost pass through mechanism. However there may be circumstances where it is more appropriate for the TNSPs to use the capex re-opening provisions. As a consequence, Grid Australia notes that as part of its Rule Change Proposal it has suggested amending the wording of NER 6A.7.1(a)(7) to remove the current subordination of the capex re-opening provisions, whilst continuing to ensure that there can be no 'double-dipping' between the mechanisms. The amended wording proposed by Grid Australia is set out in Appendix A.2 of Grid Australia's Rule Change Proposal.

In response to the specific questions the AEMC has raised under Question 2:

(a) The AEMC's intent to leave the re-opener for 'large, shipwreck-type events' and make the cost pass through the primary means of redress remains appropriate

(b) Given the provisions in the NER to ensure that there is no 'double-dipping', then the existence of a capex re-opener should not act to limit the scope of cost pass throughs.

(c) In terms of regulatory transparency, and the consistency of AER determinations, Grid Australia does not consider that it would be appropriate for cost pass throughs to be limited to operating expenditure, and capex be left to the capex re-opener. Grid Australia also considers that the capex re-opening provisions are inadequate for dealing with the costs of uncertain, high cost events that are outside the reasonable control of NSPs (as discussed in its Rule Change Proposal).

(d) There should continue to be arrangements to ensure that TNSPs can only recover the costs of uncertain, external events once. However it would be more appropriate for the Rules to provide for flexibility in the mechanism adopted, depending on the circumstances (see discussion above).

(e) Given the provisions in the NER to ensure that there is no 'double-dipping', then the existence of a capex re-opener does not change the justification for the TNSPs to be able to propose cost pass throughs.

6. Transparency of the regulatory framework.

The AEMC raises the following question in its Consultation Paper (Question 6(c)):[13]

> (c) Is it appropriate to include the natural disaster and insurance cap events as defined pass through events in the Rules, if the TNSPs have the ability to nominate pass through events as part of their revenue proposals?

The AEMC raises similar points under its Question 4 in relation to the proposed natural disaster event:

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[13] The AEMC also raises a similar question in section 5 of the Consultation Paper: 'Issues for consultation'.

(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?

The AEMC asks the same questions in relation to the proposed insurance cap event (i.e., Questions 5(d) and (e)).

Grid Australia considers that including the two new proposed cost pass through events (i.e. a natural disaster event and an insurance event) would provide a greater degree of regulatory certainty and transparency and would be more administratively efficient than relying solely on a new nominated pass through provision.

A number of pass through events are already codified in the Rules. Incorporating the two new events in the Rules would avoid the AER having to re-consider whether to allow these events at the time of each regulatory determination, which would be administratively inefficient and would introduce a degree of uncertainty. Grid Australia considers that the degree of conformity that has emerged, particularly in relation to the natural disaster event for DNSPs, is a strong argument for codifying additional defined events in the Rules, where appropriate.

Yours sincerely,

Rainer Korte

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