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21 June 2012

Mr Neville Henderson
Acting Chairman
Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Dear Mr Henderson,

RE: AEMC Draft Rule Determination – National Electricity Amendment (Cost pass-through arrangements for network service providers) Rule 2012

Ausgrid welcomes the opportunity to provide comments on the AEMC's draft determination of Grid Australia's rule change request (rule request) to cost pass-through arrangements for network service providers.

Ausgrid is largely supportive of Grid Australia's proposed rule changes and would like to take the opportunity to raise several issues with respect to the AEMC's draft determination. In summary, Ausgrid:

- is supportive of the AEMC's decision to amend cost pass-through provisions to reflect the 'dead zone' and requests that similar amendments be made to Chapter 11 of the National Electricity Rules (NER) to reflect this decision;
- generally supports the AEMC's decision to allow transmission network service providers (TNSPs) to propose additional pass-through events in their determinations, however, we note that TNSPs have the ability to manage their risks via additional mechanisms such as the contingent project and capex re-opener provisions, which are not currently available to distribution network service providers (DNSPs);
- is concerned that there may be some misunderstanding among stakeholders regarding the intent of the proposed rule change and how the cost pass-through provisions operate;
- does not agree with AEMC's decision to reject the proposed pass-through categories, in particular its reasons for rejecting the 'insurance cap' event;
- argues that an 'insurance event' which is available to TNSPs as a prescribed pass-through category should be made available to DNSPs; and
- has made comments regarding the proposed nominated pass-through considerations.

Ausgrid's submission will predominantly focus on apparent misunderstandings among stakeholders; our reasons for not agreeing with AEMC's rejection of the proposed pass-through categories; and our suggestions for how the proposed nominated pass-through considerations could be refined to provide further clarity and guidance to network service providers.

If you have any queries or wish to discuss this matter in further detail please contact Keith Yates on (02) 9269 4171.

Yours sincerely,

Peter Birk
Executive General Manager System Planning and Regulation

Attachment: *Ausgrid's response to the AEMC's draft determination*

Attachment: Ausgrid's response to the AEMC's draft determination

The need for further amendments to reflect the 'dead zone'

Ausgrid strongly supports the AEMC's decision to amend the cost pass through provisions to allow for network service providers to seek cost recovery for pass through events which occurred in the 'dead zone.' The amendment will provide network service providers with greater certainty regarding opportunities for cost recovery and will promote efficient investment and the efficient provision of network services. We request that the AEMC also make any corresponding amendments to Chapter 11 of the National Electricity Rules (NER) to ensure that New South Wales (NSW) DNSPs and ActewAGL are afforded the same opportunity as other network service providers to seek recovery in relation to any pass through events during the 'dead zone' and for which a pass through application is made within current regulatory control period.

Clarifying stakeholder misunderstandings

Ausgrid does not agree with the AEMC's decision to not accept Grid Australia's proposed pass through categories and shares Grid Australia's concerns that there appears to be some misunderstanding regarding the intent of the proposed rule change. The rule change is not aimed at transferring risks from the network service provider to customers but rather at addressing ambiguities in the NER regarding how risks associated with low probability or uncertain, high cost events beyond network service providers reasonable control should be managed.

The proposed rule change helps to address some of the ambiguity regarding the relationship between self insurance and cost pass throughs by clarifying that events that have a low probability of occurrence (or are uncertain), that have the potential to have a high magnitude impact and which are beyond a network service providers reasonable control are more appropriately addressed via cost pass throughs. Cost pass throughs are a more cost efficient means of managing this type of risk as quantifying a self insurance allowance for risks of this nature would be either subjective due to the nature of the risk and a wide range of possible values, or could potentially expose the network service provider to catastrophic financial consequences if the risks were to eventuate. This is consistent with the AER's position in relation to these types of events and with the revenue pricing principles in the National Electricity Law (NEL).[1]

Ausgrid believes that the proposed 'natural disaster' event and 'insurance cap' event can be clearly characterised as events which are uncertain, have a low probability of occurrence, possible high magnitude impact and are beyond the reasonable control of network service providers. Prescribing these events as cost pass through categories would not lead to any material change in network service provider's risk profiles or how network service providers manage the risks associated with owning an operating a network. From our perspective, the proposed 'natural disaster' and 'insurance cap' event merely codifies existing arrangements in most jurisdictions.[2] We believe that prescribing these events in the NER would provide greater regulatory certainty and transparency for network service providers and would be administratively more efficient. An alternative would be to craft the "insurance cap event" so that it met all circumstances where a network service provider is left exposed to events for which insurance could not be efficiently obtained or the consequences of which go beyond insurance which was in place. This would cover the existing "terrorism" event and the proposed "natural disaster" and "third party liability" event.

From reading stakeholder submissions on the consultation paper we understand that some stakeholders have expressed concerns regarding Grid Australia's proposed changes. Ausgrid is particularly troubled by the view that the creation of additional pass through categories or a change to cost pass through provisions will erode incentives and result in an "automatic right" to pass through the costs to customers.[3] In Ausgrid's opinion, this view is unfounded and stems from an incomplete understanding of how the cost pass through provisions in the NER work.

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[1] AER, Victorian electricity distribution network service providers Distribution determination 2011-2015, *Draft Decision June 2010,* pp 711-713. See also section 7A(2)(a) and (b) of the NEL.

[2] New South Wales (NSW) , the Australian Capital Territory (ACT), Queensland (QLD) and South Australia (SA) are able to propose a general nominated pass through, which the AER has indicated is likely to include such events as a 'natural disaster' and 'insurance cap' event. In Victoria these events are nominated pass through events.

[3] TRUenergy submission on the consultation paper, March 2012, p. 4.

Under the NER, the AER is not required to approve a cost pass through merely because a pass through event has occurred. A network service provider must first demonstrate to the AER that a positive or negative pass through event has occurred. In the case of a positive change event, the network service provider must prove that the pass through event falls within one of the prescribed pass through categories and that the pass through event has materially increased the costs of providing standard control services. [4]

Effectively, each cost pass through event merely operates as a gateway for network service providers to access the pass through approval process under clause 6.6.1 of the NER, which in turn provides a mechanism for further analysis and determination by the AER in accordance with the provisions contained under clause 6.6.1. These provisions enable the AER to apply the same level of scrutiny and assessment to these applications as it would to a regulatory proposal. Ausgrid notes from its own experience that this is how the AER approaches this task.[5]

Specifically in determining the amount to be passed through, the AER must take a number of factors into account.[6] In the case of a positive change event, the AER must apply an efficiency test to the additional costs incurred or likely to be incurred. In particular, the AER must consider the efficiency of the network service provider's decisions and actions in relation to the risk the 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 the positive change event and whether the provider has taken or omitted to take any actions where such action or omission has increased the magnitude of the amount in respect of the positive change event.[7]

Each pass through application is examined by the AER on a case by case basis. The fact that a pass through event has occurred does not create an automatic right for network service providers to pass through costs to consumers. Demonstrating that an event meets the requisite definition of the prescribed pass through category and materially increases costs is an rigorous task for network service providers, and is often one in which they are unsuccessful. For instance, Ausgrid (then known as EnergyAustralia) was unsuccessful in its application to pass through costs associated with complying with the NSW solar bonus scheme (SBS).[8] The AER rejected Ausgrid's application on the basis that Ausgrid's costs did not meet the materiality threshold and hence did not constitute a positive change event.[9]

The AER's recent decision of Powercor's pass through application for costs associated with the implementation of the Victoria Bushfire Royal Commission's (VBRC) recommendations clearly demonstrates that the establishment of a positive change event does not result in an automatic right to pass through. Powercor proposed $85.14 million to be recovered from customers for costs associated with complying with the VBRC's recommendations. Of this amount, only $73.98million was allowed to be passed through. The AER reduced Powercor's proposed pass through amount by $11.16million (or 13%) to reflect areas which it considered might lead to over recovery or where the AER was not satisfied that Powercor had demonstrated the efficiency of its costs.

Given the steps involved in the pass through application process, designating an additional category of pass through events in the NER does not give rise to any automatic rights to pass on increased costs to customers in relation to those events. On the contrary, the process under the NER is designed to impose a series of rigorous regulatory checks and balances that preclude inappropriate risk transfer to customers. For these reasons, we believe that prescribing properly crafted pass through events which can be demonstrated to meet a risk or situation faced by all network service providers would provide greater regulatory certainty and transparency, in addition to being administratively more efficient.

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[4] Glossary, Chapter 10, National Electricity Rules.

[5] AER Decision – Ausgrid pass through NSW Solar Bonus Scheme 2010.

[6] Clause 6.6.1(j), National Electricity Rules

[7] Clause 6.6.1(j), National Electricity Rules

[8] AER Decision – Ausgrid pass through NSW Solar Bonus Scheme 2010.

[9] Note, that the AER based its conclusion not to accept Ausgrid's cost pass through application based on its approach to the meaning of the terms ' materiality' and 'costs.' Ausgrid does not agree with the AER's interpretation of these terms and maintains that this is contrary to the National Electricity Rules.

Specific concerns regarding the 'insurance cap'

As mentioned above, Ausgrid does not support the AEMC's decision to not accept the proposed pass through categories. Ausgrid strongly supports the move to codify an 'insurance cap' event and would like to respond to the AEMC's reasons for rejecting the 'insurance cap' event. Currently, the NER recognise four core events as events which may give rise to a pass through of costs or savings if they occur during a regulatory control period. For the reasons set out below and in the Grid Australia rule change request[10] Ausgrid submits that an appropriately crafted "insurance cap" event should be added to those events, and if it is, then the terrorism event may be removed.

In the draft determination the AEMC has accepted the principle that network service providers should not bear risk above available insurance.[11] However, in its analysis of the 'insurance cap' event the AEMC later rejects the event on the basis that it may remove incentives for network service providers to obtain prudent and efficient insurance and that the lack of consistency between the proposed definition and the AER's demonstrated that true consensus is yet to be reached. Ausgrid respectfully requests that the AEMC reconsider its position on this issue and give further consideration to whether an appropriately crafted "insurance cap event" would in fact be consistent with the overall policy objective of a pass through regime and the incentive regime more broadly. The principle underpinning the pass through regime is that network service providers should have an opportunity to recover costs (or be required to return savings) arising from unknown, uncontrollable or highly uncertain events which could not be foreseen and which could not reasonably have been reflected in the expenditure forecasts which formed the basis of the current distribution determination. An insurance cap event with the features discussed in the Grid Australia rule change request clearly satisfies this principle.

The fact that the drafting of Grid Australia's proposed definition of an 'insurance cap' event differs from the AER's definition does not point to a lack of consensus for such event but rather that it would be appropriate for some resources to be dedicated to achieving consensus within the industry and National Electricity Market (NEM) bodies on the appropriate drafting of such a provision. The AEMC is currently well placed to lead such an exercise in the context of the current rule change request. In addition, it is unclear from the AEMC's reasoning why the issue of prudent and efficient insurance could not be addressed as either part of the assessment of the event or even in the definition itself (i.e. the AER would need to be satisfied that the network service provider had efficiently and prudently obtained insurance).

The fact that network service providers have an additional avenue under which they may be eligible to pass through costs, does not provide service providers with any incentive to not operate in a prudent and efficient manner. As outlined above, network service providers have significant incentive to ensure that they have operated in a prudent and efficient manner and have taken appropriate steps to mitigate both the risk of the event and the impact. This is implicit in meeting the requirements of clause 6.6.1(a) and 6.6.1(j) of the NER. A network service provider risks having to absorb the full costs associated with the event if they are unable to demonstrate that the event falls within the prescribed pass through category or meets the materiality threshold or alternatively it risks having to absorb a portion of the cost, if the AER does not accept the efficiency of the network service providers costs. Further, the deductible contained within insurance policies, provides a major incentive for a network service provider to manage any risk covered by a cost pass through mechanism. Therefore there is ample evidence to suggest that a network service provider has significant incentive to minimise the costs incurred beyond an insurance cap.

Ausgrid also notes that an 'insurance cap' event would alleviate the need for network service providers to put forward and the AER to assess, nominated pass through events for terrorism, natural disasters and third party claims. This is because network service providers are mainly seeking a means of recovery for costs above its insurance cap for these types of events. Prescribing an 'insurance cap' event in the NER would provide network service providers with greater regulatory certainty then under a nominated or general nominated pass through event. The AER would then only need to assess additional nominated pass through events which are truly

[10] At section 2.5.2, p 16 and following.

[11] AEMC Draft Determination, *National Electricity Amendment (Cost pass through arrangements for network service providers) Rule 2012,* p.8.

unique to a particular network service provider or to network service providers within a particular jurisdiction.

Customers would only be asked to bear these risks where there is exposure beyond the level of available insurance. Therefore, the creation of an 'insurance cap' event would promote the long term interest of consumers by ensuring that prices are reflective of network operating costs, and that, to the extent that extra costs are passed through in the regulatory control period, those costs are beyond the control of the network service provider.

The creation of a prescribed 'insurance event' for DNSPs

Ausgrid strongly argues in favour of the 'insurance event' pass through category, which is available to transmission network service providers (TNSPs), to be also made available to DNSPs as a prescribed pass through category.

Having recourse to an 'insurance event' pass through category would ensure that DNSPs have the same flexibility to manage their risks via the cost pass through mechanisms in the NER as TNSPs. This would align with the general move for more consistent arrangements between TNSPs and DNSPs and is also consistent with the AER's recent decision to approve an 'insurance credit risk' event as a nominated pass through in the Victorian distribution determination.[12] In the Victoria distribution determination, the AER accepted that the occurrence of increased insurance premiums (or deductibles) from external insurers (where the original insurer becomes insolvent) is largely beyond the control of the DNSP and that the costs associated with higher premiums are also beyond DNSPs control (in that they cannot be mitigated). Accordingly, the AER determined that such an event should be allowed under the regulatory regime as a cost pass through.[13] We note that in essence, the 'insurance credit risk' nominated pass through is consistent with the definition of the prescribed 'insurance event' for TNSPs contained in Chapter 10 of the NER. The occurrence of an 'insurance credit risk' is something that could occur in any jurisdiction and is not unique to Victoria. Consistent with the principles discussed in relation to "insurance cap" event above, this event is also a core event which should be available to all network service providers. Consequently, there would be greater regulatory certainty for DNSPs if an 'insurance credit risk' was codified in the NER as an 'insurance event' (to align with TNSP arrangements) rather than being addressed through a general nominated pass through event.[14]

Comments regarding the AEMC's nominated pass through considerations

Ausgrid supports the AEMC decision to introduce a set of nominated pass through considerations in the NER. We note that the in the past, the AER has varied in its application and interpretation of criteria used to determine nominated cost pass throughs. Codifying the criteria relevant to nominated pass through considerations will provide greater certainty and guidance to network service providers. However, we believe that further discussion and refinement of the considerations is necessary. We note that the considerations are not qualitative in nature. The AEMC's proposed criteria appear to be a set of negative criteria in the sense that the existence of any one of the criteria would be inconsistent with the need for a pass through event.

Ausgrid suggests that the criteria could be improved if it reflected the principle that nominated pass throughs are for events which:

1. cannot be included in expenditure forecasts as the timing or cost impacts of the event are uncertain or cannot be quantified or forecasted with certainty;
2. arise from a risk faced by the network service provider which is not met by any of the prescribed pass through events in the NER
3. the nature of the risk is such that it is most appropriately borne by the DNSP's customers generally rather than DNSP shareholders; and

[12] AER, Victorian electricity distribution network service providers final decision 2011-2015 (29 October 2010).

[13] AER, Victorian electricity distribution network service providers Distribution determination 2011-2015, *Draft Decision June 2010,* p 725.

[14] Currently, in New South Wales (NSW), the Australian Capital Territory (ACT), South Australia(SA) and Queensland (QLD) determinations provide for a general nominated pass through, which is likely to encompass such things as an 'insurance credit risk' accepted as a nominated pass through in the Victorian determination.

4. the event is exogenous in the sense that it is beyond the reasonable control of the network service provider to mitigate or is of a catastrophic nature that it would threaten the financial viability of the network service provider.

Factors which may inform the AER as to whether the first consideration has been met include:

- the availability of external insurance or self insurance on commercial terms
- whether quantifying an amount for self insurance would be subjective in nature or subject to a range of possible values