



DRAFT DECISION

Ergon Energy Distribution Determination 2020 to 2025

Attachment 14 Pass through events

October 2019

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Note

This attachment forms part of the AER's draft decision on the distribution determination that will apply to Ergon Energy for the 2020–2025 regulatory control period. 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

Attachment 13 – Control mechanisms

Attachment 14 – Pass through events

Attachment 15 – Alternative control services

Attachment 16 – Negotiated services framework and criteria

Attachment 17 – Connection policy

Attachment 18 – Tariff structure statement

Contents

Note	14-2
Contents	14-3
Shortened forms	14-4
14 Cost pass through events	14-5
14.1 Draft decision	14-5
14.2 Ergon Energy's proposal	14-5
14.3 Assessment approach	14-7
14.4 Interrelationships	14-9
14.5 Reasons for draft decision	14-10

Shortened forms

Shortened form	Extended form
AEMC	Australian Energy Market Commission
AER	Australian Energy Regulator
capex	capital expenditure
distributor	distribution network service provider
NEL	national electricity law
NEO	national electricity objective
NER or the rules	national electricity rules
NSP	network service provider
opex	operating expenditure
RAB	regulatory asset base
RPP	revenue and pricing principles

14 Cost pass through events

During the regulatory control period Ergon Energy 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 Ergon Energy 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 its ability to invest in and operate its network.¹

The National Electricity Rules (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 Ergon Energy's distribution network for the 2020–25 regulatory control period.

14.1 Draft decision

Our draft decision pursuant to clause 6.12.1(14) of the NER is to accept all four of Ergon Energy's proposed nominated pass through events applying to direct control services, but with minor amended definitions so that the drafting of the definitions are consistent with our recent decisions for other network service providers.⁴ Our amended definitions are set out in Table 14.2.

14.2 Ergon Energy's proposal

Ergon Energy's proposed nominated pass through events are set out in Table 14.1.⁵

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

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

³ NER, cl. 6.6.1(a1)(5).

⁴ E.g. AER, Draft Decision, *Ausgrid distribution determination 2019–24, Attachment 14 Pass Through Events*, November 2018, pp. 12–13; AER, Draft Decision, *Essential Energy distribution determination 2019–24, Attachment 14 Pass Through Events*, November 2018, pp. 11–13; AER, Draft Decision, *SA Power Networks distribution determination 2020–25, Attachment 14 Pass Through Events*, October 2019, pp. 12–15; AER, Draft Decision, *Energex distribution determination 2020–25, Attachment 14 Pass Through Events*, October 2019, pp. 11–13.

⁵ Ergon Energy, *1.004 Ergon Energy Regulatory Proposal 2020–25*, January 2019, pp. 108–109.

Table 14.1 Ergon Energy's nominated pass through events

Pass through event	Ergon Energy's proposed definition
Insurance cap	<p>An insurance cap event occurs if:</p> <ul style="list-style-type: none"> • Ergon Energy make a claim or claims and receives the benefit of a payment or payments under a relevant insurance policy, • Ergon Energy incur costs beyond the relevant policy limit, and • the costs beyond the relevant policy limit increase the costs to Ergon Energy in providing direct control services • For this Insurance Cap Event: <ul style="list-style-type: none"> ○ a relevant insurance policy is an insurance policy held during the 2020-25 regulatory control period or a previous regulatory control period in which Ergon Energy was regulated, and ○ Ergon Energy will be deemed to have made a claim on a relevant insurance policy if the claim is made by a related body corporate of Ergon Energy in relation to any aspects of the network or Ergon Energy's business. • Note for the avoidance of doubt, in assessing an insurance cap event through application under rule 6.6.1(i), the AER will have regard to: <ul style="list-style-type: none"> ○ the relevant insurance policy for the event, and ○ the level of insurance that an efficient and prudent NSP would obtain in respect of the event.
Insurer credit risk	<p>An insurer's credit risk event occurs if:</p> <ul style="list-style-type: none"> • An insurer of Ergon Energy becomes insolvent, and as a result, in respect of an existing or potential insurance claim for a risk that was insured by the insolvent insurer, Ergon Energy: <ul style="list-style-type: none"> ○ is subject to a higher or lower claim limit or a higher or lower deductible than would have otherwise applied under the insolvent insurer's policy; or ○ incurs additional costs associated with self-funding an insurance claim, which would otherwise have been covered by the insolvent insurer. <p>Note: In assessing an insurer's credit risk event pass through application, the AER will have regard to, amongst other things,</p> <ul style="list-style-type: none"> • Ergon Energy's attempts to mitigate and prevent the event from occurring by reviewing and considering the insurer's track record, size, credit rating and reputation. • in the event that a claim would have been made after the insurance provider became insolvent, whether Ergon Energy had reasonable opportunity to insure the risk with a different provider.
Natural disaster	<p>Natural Disaster Event means any natural disaster including but not limited to fire, flood or earthquake that occurs during the 2020-25 regulatory control period that increases the costs to Ergon Energy in providing direct control services, provided the fire, flood or other event was not a consequence of the acts or omissions of the service provider.</p> <p>Note: In assessing a Natural Disaster Event pass through application, the AER will have regard to, amongst other things:</p> <ul style="list-style-type: none"> • whether Ergon Energy has insurance against the event, • the level of insurance that an efficient and prudent NSP would obtain in respect of the event, and

Pass through event	Ergon Energy's proposed definition
Terrorism	<ul style="list-style-type: none"> • whether a relevant government authority has made a declaration that a natural disaster has occurred. <p>Terrorism event means 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 connection with any organisation or government), which:</p> <ul style="list-style-type: none"> • 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 • increases the costs to Ergon Energy in providing direct control services. <p>Note: In assessing a terrorism event pass through application, the AER will have regard to, amongst other things:</p> <ul style="list-style-type: none"> • whether Ergon Energy has insurance against the event, • the level of insurance that an efficient and prudent NSP would obtain in respect of the event, and • whether a declaration has been made by a relevant government authority that an act of terrorism has occurred.

14.3 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.⁶

Our assessment approach is guided by the National Electricity Objective (NEO) and the Revenue and Pricing Principles (RPPs).⁷ The RPPs include that the service provider should have a reasonable opportunity to recover at least the efficient costs of providing services and complying with regulatory obligations.⁸ The NEO and the RPPs 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 Australian Energy Market Commission (AEMC) when considering pass through event rule changes.¹¹

⁶ NER, cl. 6.5.10(b), 6.6.1.

⁷ NEL, ss. 7 and 7A.

⁸ NEL, s. 7A(2).

⁹ NEL, s. 7A(3).

¹⁰ NEL, s. 7A(6).

¹¹ AEMC 2012, *Cost pass through arrangements for Network Service Providers, Rule Determination*, 2 August 2012, p. 6.

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

- 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);
- whether the nature or type of event can be clearly identified at the time the determination is made for the service provider;
- 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;
- whether the relevant service provider could insure against the event, having regard to:
 - the availability (including the extent of availability in terms of liability limits) of insurance against the event on reasonable commercial terms; or
 - whether the event can be self-insured on the basis that:
 - it is possible to calculate the self-insurance premium; and
 - 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
- any other matter the AER considers relevant and which the AER has notified Network Service Providers is a nominated pass through event consideration.

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.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

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

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

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

14.4 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 operating and capital expenditure (opex and capex) and rate of return included in our revenue determination. We must specify and take account of these interrelationships.¹⁸ This requires 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 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

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.

¹⁸ NEL, s. 16(1)(c).

that event avoidance, mitigation, commercial insurance and self-insurance under approved forecasts of prudent and efficient opex and capex are either unavailable or inappropriate.¹⁹

In general, in respect of unforeseen costs that are relatively minor, a service provider should manage them by using up its existing expenditure allowance, or reprioritising or substituting its projects, to avoid seeking cost recovery through the pass through mechanisms.²⁰ This is reflected in the materiality threshold that applies to cost pass through applications.²¹

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 Efficiency Benefit Sharing Scheme and Capital Expenditure Sharing Scheme.²²

Any capex that has already been recovered in a regulatory control period by way of a cost pass through cannot be recovered again in the roll-forward of the regulatory asset base for the next regulatory control period.²³

14.5 Reasons for draft decision

Ergon Energy's proposed nominated pass through events and their definitions are consistent with those we approved in the 2015–20 regulatory control period and in our recent decisions with respect to other network service providers.²⁴ We have made some minor amendments to these definitions to provide greater drafting consistency between Ergon Energy and other network service providers.

We consider Ergon Energy's proposed nominated pass through events meet the nominated pass through event considerations set out in the NER:²⁵

- 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

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

²⁰ AEMC 2012, *Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services, Final Position Paper*, 29 November 2012, p. 186.

²¹ NER, Chapter 10: Glossary, definition of 'materially'.

²² AER, *Efficiency Benefit Sharing Scheme for Electricity Network Service Providers*, November 2013, p. 7; AER, *Capital Expenditure Incentive Guideline for Electricity Network Service Providers*, November 2013, p. 6.

²³ NER, cl. S6.2.1(e)(1)(ii).

²⁴ E.g. AER, Draft Decision, *Ausgrid distribution determination 2019–24, Attachment 14 Pass Through Events*, November 2018, pp. 12–13; AER, Draft Decision, *Essential Energy distribution determination 2019–24, Attachment 14 Pass Through Events*, November 2018, pp. 11–13; AER, Draft Decision, *SA Power Networks distribution determination 2020–25, Attachment 14 Pass Through Events*, October 2019, pp. 12–15; AER, Draft Decision, *Energex distribution determination 2020–25, Attachment 14 Pass Through Events*, October 2019, pp. 11–13.

²⁵ NER, cl. 6.5.10(b); Chapter 10: Glossary, definition of 'nominated pass through event considerations'.

- 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 on reasonable commercial terms.

With regard to the latter point, while Ergon Energy could take steps to reduce its risk 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 Ergon Energy and its customers is appropriate and more likely to be in the long-term interests of consumers with respect to price.

Our approved definitions are set out in Table 14.2.

Table 14.2 AER pass through event definitions

Pass through event	Approved definition
Insurance cap	<p>An insurance cap event occurs if:</p> <ul style="list-style-type: none"> • Ergon Energy makes a claim or claims and receives the benefit of a payment or payments under a relevant insurance policy, • Ergon Energy incurs costs beyond the relevant policy limit, and • the costs beyond the relevant policy limit materially increase the costs to Ergon Energy in providing direct control services. <p>For this insurance cap event:</p> <ul style="list-style-type: none"> • A relevant insurance policy is an insurance policy held during the 2020-25 regulatory control period or a previous regulatory control period in which Ergon Energy was regulated • Ergon Energy will be deemed to have made a claim on a relevant insurance policy if the claim is made by a related party of Ergon Energy in relation to any aspect of the network or Ergon Energy's business. <p>Note: In assessing an insurance cap event cost pass through application under rule 6.6.1(j), the AER will have regard to, amongst other things:</p> <ul style="list-style-type: none"> • the relevant insurance policy for the event, and • the level of insurance that an efficient and prudent NSP would obtain in respect of the event.
Insurer credit risk	<p>An insurer credit risk event occurs if:</p> <ul style="list-style-type: none"> • An insurer of Ergon Energy becomes insolvent, and as a result, in respect of an existing or potential claim for a risk that was insured by the insolvent insurer, Ergon Energy: <ul style="list-style-type: none"> ○ is subject to a higher or lower claim limit or a higher or lower deductible than would have otherwise applied under the insolvent insurer's policy; or ○ incurs additional costs associated with funding an insurance claim, which would otherwise have been covered by the insolvent insurer. <p>Note: In assessing an insurer credit risk event pass through application, the AER will have regard to, amongst other things:</p> <ul style="list-style-type: none"> • Ergon Energy's attempts to mitigate and prevent the event from occurring by reviewing and considering the insurers track record, size, credit rating and reputation, and • in the event that a claim would have been made after the insurer

Pass through event	Approved definition
Natural disaster	<p data-bbox="691 248 1358 300">became insolvent, whether Ergon Energy had reasonable opportunity to insure the risk with a different insurer.</p> <p data-bbox="643 331 1358 465">Natural disaster event means any natural disaster including but not limited to cyclone, fire, flood or earthquake that occurs during the 2020–25 regulatory control period that increases the costs to Ergon Energy in providing direct control services, provided the fire, flood or other event was not a consequence of the acts or omissions of the service provider.</p> <p data-bbox="643 488 1334 539">Note: In assessing a natural disaster event pass through application, the AER will have regard to, amongst other things:</p> <ul data-bbox="643 562 1366 734" style="list-style-type: none"> <li data-bbox="643 562 1222 589">• whether Ergon Energy has insurance against the event, <li data-bbox="643 607 1366 658">• the level of insurance that an efficient and prudent NSP would obtain in respect of the event, and <li data-bbox="643 676 1366 734">• whether a relevant government authority has made a declaration that a natural disaster has occurred.
Terrorism	<p data-bbox="643 763 1358 875">Terrorism event means 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 connection with any organisation or government), which:</p> <ul data-bbox="643 898 1350 1077" style="list-style-type: none"> <li data-bbox="643 898 1350 1010">• 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 <li data-bbox="643 1021 1286 1077">• increases the costs to Ergon Energy in providing direct control services. <p data-bbox="643 1099 1358 1151">Note: In assessing a terrorism event pass through application, the AER will have regard to, amongst other things:</p> <ul data-bbox="643 1173 1366 1346" style="list-style-type: none"> <li data-bbox="643 1173 1222 1200">• whether Ergon Energy has insurance against the event, <li data-bbox="643 1218 1366 1270">• the level of insurance that an efficient and prudent NSP would obtain in respect of the event, and <li data-bbox="643 1288 1302 1346">• whether a declaration has been made by a relevant government authority that a terrorism event has occurred.