



DRAFT DECISION
Essential Energy
Distribution determination

2019–24

Attachment 14 – Pass through
events

November 2018

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Note

This attachment forms part of the AER's draft decision on the distribution determination that will apply to Essential Energy for the 2019–24 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 mechanism

Attachment 14 – Pass through events

Attachment 15 – Alternative control services

Attachment 16 – Negotiated services framework and criteria

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Attachment 18 - Tariff structure statement

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Shortened forms

Shortened form	Extended form
AEMC	Australian Energy Market Commission
AER	Australian Energy Regulator
DNSP	Distribution network service provider
NER	National Electricity Rules

14 Pass through events

During the regulatory control period a DNSP 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 a service provider 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 networks.¹

The 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 Essential Energy (Essential) for the 2019–24 regulatory control period.

14.1 Draft decision

Our draft decision pursuant to clause 6.12.1(14) of the NER is as follows:

- We accept four of the seven proposed categories of nominated pass through (terrorism, natural disaster, insurance cap and insurer credit risk event)
- We do not accept three of the proposed nominated pass through events (war, major supplier credit risk and major cyber).

Our draft decision sets out amendments to the definitions of the terrorism, natural disaster, insurance cap and insurer credit risk events, to provide consistency between Essential and other network service providers. Our amended definitions are set out in Table 14-2.

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

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

³ NER, r. 6.6.1(a1)(5), r. 6A.7.3(a1)(5).

14.2 Essential Energy’s proposal

Essential's proposed nominated pass through events are set out in Table 14-1.⁴

Table 14-1 Essential Energy's proposed nominated pass through events

Pass through event	DNSP proposed definition
Insurance cap	<p>An insurance cap event occurs if:</p> <ul style="list-style-type: none"> • Essential Energy makes a claim or claims and receives the benefit of a payment or payments under a relevant insurance policy, • Essential Energy incurs costs beyond a relevant policy limit, and • the costs beyond the relevant policy limit materially increase the costs to Essential Energy in providing direct control services. <p>For this insurance cap event:</p> <ul style="list-style-type: none"> • the relevant policy limit is the greater of: <ul style="list-style-type: none"> ○ Essential Energy’s actual policy limit at the time of the event that gives, or would have given rise to a claim, and ○ 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 period in which the insurance policy is issued. • A relevant insurance policy is an insurance policy held during the 2019-24 regulatory period or a previous regulatory period in which Essential Energy was regulated. <p>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:</p> <ul style="list-style-type: none"> • the insurance premium proposal submitted by Essential Energy in its regulatory proposal; • the forecast operating expenditure allowance approved in the AER’s final decision; and • the reasons for that decision.
Insurer's credit risk	<p>The insolvency of a nominated insurer of Essential Energy, as a result of which Essential Energy:</p> <ul style="list-style-type: none"> • incurs materially higher or lower costs for insurance premiums than those allowed for in its Distribution Determination; or • in respect of a claim for a risk that would have been insured by Essential Energy’s insurers, is subject to materially higher or lower claim limit or a materially higher or lower deductible than would have applied under that policy.
Natural disaster	<ul style="list-style-type: none"> • Any natural disaster including but not limited to major fire, flood, earthquake, or Government declared state of emergency, beyond the reasonable control of Essential Energy that occurs during the 2019-24 regulatory period and materially increases the costs to Essential Energy in providing direct control services; provided the event was not

⁴ Essential Energy, Attachment 9.4 - Pass through events proposal, April 2018, pp. 8 ff.

Pass through event	DNSP proposed definition
	<p>a consequence of a negligent act or omission of the service provider.</p> <ul style="list-style-type: none"> The term 'major' in the above paragraph means an event that is serious and significant. It does not mean material as that term is defined in the Rules (that is 1 per cent of the DNSP's annual revenue requirement for that regulatory year). <p>Note: In assessing a natural disaster event pass through application, the AER will have regard to:</p> <ul style="list-style-type: none"> whether Essential Energy has insurance against the event; the level of insurance that an efficient and prudent DNSP would obtain in respect of the event; and maintaining assets at a level expected of the industry.
Terrorism	<p>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 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 which materially increases the costs to Essential Energy in providing direct control services.</p>
Major supplier credit risk	<p>A major supplier credit risk event occurs if a major supplier to Essential Energy becomes insolvent and, as a result, goods or services procured by Essential Energy are subject to material additional or higher costs than those which applied under the contract with the insolvent supplier.</p> <p>Note: In assessing a major supplier credit risk event pass through application, the AER will have regard to, amongst other things, Essential Energy's attempts to mitigate costs and prevent the event from occurring by reviewing and considering the supplier's track record, size, credit rating (if applicable) and reputation.</p>
Major cyber	<p>Major cyber event means any significant interruption to technology systems and assets occurring during the 2019-24 regulatory control period that materially increases the costs to Essential Energy in providing direct control services.</p> <p>Note: In assessing a major cyber event pass through application, the AER will have regard to, amongst other things:</p> <ul style="list-style-type: none"> Essential Energy's efforts to prevent the event from occurring and mitigate its consequences; the prevention and mitigation actions that an efficient and prudent DNSP would have implemented; whether Essential Energy has insurance against the event; and the level of insurance that an efficient and prudent DNSP would obtain in respect of the event.
War	<p>A nation state (whether acting alone or on behalf of or in connection with another nation state) declares war, attacks, invades or occupies another nation state, increasing the costs to Essential Energy in providing direct control services.</p> <p>In assessing a war event pass through application, the AER will have regard to, amongst other things:</p> <ul style="list-style-type: none"> whether Essential Energy has insurance against the event; the level of insurance that an efficient and prudent DNSP would obtain in respect of the event; and

- whether a declaration has been made by a relevant government authority that an act of war has occurred or a state of war exists.

14.3 AER's 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.

Our assessment approach is guided by the National Electricity Objective (NEO) and the Revenue and Pricing Principles. These provide, in part, that the service provider should have a reasonable opportunity to recover at least the efficient costs of providing services and complying with regulatory obligations.⁵ They also reflect the importance of incentives to promote economic efficiency,⁶ and balance the risks of under and over investment.⁷

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 AEMC when considering pass through event rule changes.⁸

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:⁹

- 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;

⁵ NEL, s. 7A(2).

⁶ NEL, s. 7A(3).

⁷ NEL, s. 7A(6).

⁸ NEL, s. 7; AEMC 2012, Cost pass through arrangements for Network Service Providers, Rule Determination, 2 August 2012, p. 6.

⁹ NER, Chapter 10, definition of nominated pass through event considerations.

- 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. That is, a cost pass through event is the least efficient option for managing the risk of unforeseen events.¹⁰

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 ascertaining the most efficient allocation of risks between a service provider and end customers.¹¹

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.¹² 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.¹³

¹⁰ AEMC 2012, Cost pass through arrangements for Network Service Providers, Rule Determination, 2 August 2012, p. 19.

¹¹ AEMC 2012, Cost pass through arrangements for Network Service Providers, Rule Determination, 2 August 2012, p. 20.

¹² AEMC 2012, Cost pass through arrangements for Network Service Providers, Rule Determination, 2 August 2012, p. 8.

¹³ AEMC 2012, Cost pass through arrangements for Network Service Providers, Rule Determination, 2 August 2012, p. 8.

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.¹⁴

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 opex and capex and rate of return included in our revenue determination. These interrelationships require 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 that event avoidance, mitigation, commercial insurance and self-insurance under approved forecasts of prudent and efficient opex and capex are either unavailable or inappropriate.¹⁵

In general, in respect of smaller projects a service provider should be using up its existing expenditure allowance, or reprioritising or substituting its projects, to avoid seeking cost recovery through the pass through mechanisms.¹⁶ This is reflected in the materiality threshold that applies to cost pass throughs applications.¹⁷

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

¹⁴ AEMC 2012, Cost pass through arrangements for Network Service Providers, Rule Determination, 2 August 2012, p. 18.

¹⁵ AEMC 2012, Cost pass through arrangements for Network Service Providers, Rule Determination, 2 August 2012, pp. 19–20.

¹⁶ AEMC 2012, Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services, Final Position Paper, 29 November 2012, p. 186.

¹⁷ NER, Chapter 10: Glossary, definition of 'materially'.

purpose of calculating efficiency carryover amounts under the Efficiency Benefit Sharing Scheme and Capital Expenditure Sharing Scheme.¹⁸

Where capex has already been recovered by way of a cost pass through in a regulatory period it cannot be recovered again in the roll-forward of the regulatory asset base for the next regulatory period..¹⁹

14.5 Reasons for draft decision

14.5.1 Insurance cap, insurer credit risk, natural disaster and terrorism events

The proposed insurance cap, insurer credit risk, natural disaster and terrorism events are supported by the nominated pass through event considerations set out in the NER:

- 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
- 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.

With regard to the latter point, Essential could take some steps to reduce its exposure to these events, but 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 Essential and its customers is appropriate and more likely to be in the long-term interests of consumers with respect to price.

Essential's proposed definitions for the pass through events are for the most part consistent with those in our recent decisions.²⁰ We have made some additional amendments to provide greater consistency between Essential and other network service providers. Our amended definitions are set out in Table 14-2.

Table 14-2 AER pass through event definitions

Pass through event	AER definition
Insurance cap	<p>An insurance cap event occurs if:</p> <ul style="list-style-type: none"> • Essential Energy makes a claim or claims and receives the benefit of a payment or payments under a relevant insurance policy,

¹⁸ AER, Efficiency Benefit Sharing Scheme for Electricity Network Service Providers, November 2013, p. 9; AER, Capital Expenditure Incentive Guideline for Electricity Network Service Providers, November 2013, p. 18.

¹⁹ NER, cl. S6.2.1(e)(1)(ii).

²⁰ E.g. AER, Draft Decision, ElectraNet Transmission Determination 2018 to 2023, Attachment 13 Pass Through Events, October 2017, pp. 13-6, 13-7; AER, Draft Decision, TransGrid Transmission Determination 2018 to 2023, Attachment 13 Pass Through Events, October 2017, pp. 13-6, 13-7.

Pass through event	AER definition
	<ul style="list-style-type: none"> Essential Energy incurs costs beyond the relevant policy limit, and The costs beyond the relevant policy limit materially increase the costs to Essential 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 2019-24 regulatory control period or a previous regulatory control period in which Essential Energy was regulated Essential Energy will be deemed to have made a claim on a relevant insurance policy if the claim is made by a related party of Essential Energy in relation to any aspect of the network or Essential Energy's business. <p>Note for the avoidance of doubt, in assessing an insurance cap event cost pass through application under rule 6.6.1(i), the AER will have regard to:</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's credit risk	<p>An insurer's credit risk event occurs if:</p> <p>An insurer of Essential 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, Essential Energy:</p> <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 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"> Essential 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 Essential 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 cyclone, fire, flood or earthquake that occurs during the 2019-24 regulatory control period that increases the costs to Essential 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 Essential Energy has insurance against the event, The level of insurance that an efficient and prudent NSP would obtain in respect of the event, Whether a relevant government authority has made a declaration that a natural disaster has occurred.
Terrorism	<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>

Pass through event	AER definition
	<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 Essential 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 Essential 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 a terrorism event has occurred

14.5.2 War, major supplier credit risk, and major cyber events

Our draft decision is that the other events proposed by Essential—war, major supplier credit risk, and major cyber events—are not supported by the nominated pass through event considerations.

The definition of the proposed war event (see Table 4–1, above) is extremely broad. It is not clear what kind of costs it is intended to cover, or what the driver of the change in costs would be. In contrast to natural disaster and terrorism events, acts of war besides a physical invasion of Australia would appear unlikely to directly impact on Essential’s physical assets. It would be difficult to prove a nexus between the triggering war, attack, invasion or occupation of a nation state and the change in costs claimed, such that we could be satisfied that “such costs occur solely as a consequence of the positive change event”.²¹ Our draft decision is therefore that the proposed war event does not satisfy the consideration that it can be clearly identified at the time the determination is made.²² That same uncertainty leads us to conclude that Essential has not shown that a prudent service provider could not substantially mitigate the cost impact of such an event, or could not insure (or self insure) against the event.²³

The adverse circumstance contemplated by the major supplier credit risk and major cyber events is an increase in the DNSP’s costs caused by the insolvency of an existing supplier or an interruption to technology systems outside the scope of the existing terrorism event (which we have previously confirmed would include cyber-terrorism). We consider these are standard business risks which the DNSP should manage. Inclusion of a pass through option would reduce incentives to do so. Our draft decision is not to approve these proposed events. We are not satisfied that Essential

²¹ NER, cl. 6.6.1 (c)(6)(ii)

²² See definition of Nominated Pass Through Considerations: NER, Chapter 10.

²³ See definition of Nominated Pass Through Considerations: NER, Chapter 10.

has shown that a prudent service provider could not reasonably prevent an event of that nature or type from occurring or substantially mitigate the cost impact of such an event, or could not insure (or self insure) against the event.²⁴

²⁴ See definition of Nominated Pass Through Considerations: NER, Chapter 10.