



FINAL DECISION
Ergon Energy determination
2015–16 to 2019–20

Attachment 15 – Pass through
events

October 2015

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Note

This attachment forms part of the AER's final decision on Ergon Energy's 2015–20 distribution determination. It should be read with all other parts of the final decision.

The final decision includes the following documents:

Overview

Attachment 1 – Annual revenue requirement

Attachment 2 – Regulatory asset base

Attachment 3 – Rate of return

Attachment 4 – Value of imputation credits

Attachment 5 – Regulatory depreciation

Attachment 6 – Capital expenditure

Attachment 7 – Operating expenditure

Attachment 8 – Corporate income tax

Attachment 9 – Efficiency benefit sharing scheme

Attachment 10 – Capital expenditure sharing scheme

Attachment 11 – Service target performance incentive scheme

Attachment 12 – Demand management incentive scheme

Attachment 13 – Classification of services

Attachment 14 – Control mechanism

Attachment 15 – Pass through events

Attachment 16 – Alternative control services

Attachment 17 – Negotiated services framework and criteria

Attachment 18 – Connection policy

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Shortened forms

| Shortened form | Extended form |
|----------------------------------|--|
| AEMC | Australian Energy Market Commission |
| AEMO | Australian Energy Market Operator |
| AER | Australian Energy Regulator |
| augex | augmentation expenditure |
| capex | capital expenditure |
| CCP | Consumer Challenge Panel |
| CESS | capital expenditure sharing scheme |
| CPI | consumer price index |
| DRP | debt risk premium |
| DMIA | demand management innovation allowance |
| DMIS | demand management incentive scheme |
| distributor | distribution network service provider |
| DUoS | distribution use of system |
| EBSS | efficiency benefit sharing scheme |
| ERP | equity risk premium |
| Expenditure Assessment Guideline | Expenditure Forecast Assessment Guideline for electricity distribution |
| F&A | framework and approach |
| MRP | market risk premium |
| NEL | national electricity law |
| NEM | national electricity market |
| NEO | national electricity objective |
| NER | national electricity rules |
| NSP | network service provider |
| opex | operating expenditure |
| PPI | partial performance indicators |

| Shortened form | Extended form |
|----------------|---|
| PTRM | post-tax revenue model |
| RAB | regulatory asset base |
| RBA | Reserve Bank of Australia |
| repex | replacement expenditure |
| RFM | roll forward model |
| RIN | regulatory information notice |
| RPP | revenue and pricing principles |
| SAIDI | system average interruption duration index |
| SAIFI | system average interruption frequency index |
| SLCAPM | Sharpe-Lintner capital asset pricing model |
| STPIS | service target performance incentive scheme |
| WACC | weighted average cost of capital |

15 Pass through events

The pass through mechanism of the National Electricity Rules (NER) recognises a distributor can be exposed to risks beyond its control, which may have a material impact on its costs. A cost pass through enables a distributor to recover (or pass through) the costs of defined unpredictable, high cost events that are not built into our distribution determination. The NER includes the following prescribed pass through events for all distributors:

- a regulatory change event
- a service standard event
- a tax change event
- a retailer insolvency event
- in addition to those defined events, an event specified in a determination for a regulatory control period (nominated pass through event).¹

This attachment sets out our final decision on the additional pass through events that will apply to Ergon Energy for the 2015–20 regulatory control period.

15.1 Final decision

Our final decision is the following nominated pass through events will apply to Ergon Energy for the 2015–20 regulatory control period:

- insurance cap event
- natural disaster event
- insurer's credit risk event.

These events have the definitions listed in table 15.1 below.

¹ NER, cl. 6.5.10.

Table 15.1 Accepted event definitions

| Event | Accepted definition |
|-----------------------------|--|
| Insurance cap event | <p>An insurance cap event occurs if:</p> <ol style="list-style-type: none"> 1. Ergon Energy makes a claim or claims and receives the benefit of a payment or payments under a relevant insurance policy, 2. Ergon Energy incurs costs beyond the relevant policy limit, and 3. 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> <ol style="list-style-type: none"> 4. the relevant policy limit is the greater of: <ol style="list-style-type: none"> a. Ergon Energy's actual policy limit at the time of the event that gives, or would have given rise to a claim, and b. 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 distribution determination for the regulatory control period in which the insurance policy is issued. 5. A relevant insurance policy is an insurance policy held during the 2015-20 regulatory control period or a previous regulatory control period in which Ergon 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) of the NER the AER will have regard to:</p> <ol style="list-style-type: none"> i. the relevant insurance policy for the event, and ii. the level of insurance that an efficient and prudent NSP would obtain in respect of the event. |
| Natural disaster event | <p>A natural disaster event occurs if:</p> <p>Any major fire, flood, earthquake or other natural disaster occurs during the 2015-20 regulatory control period and materially 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>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 distributor's annual revenue requirement for that regulatory year).</p> <p>Note: In assessing a natural disaster event pass through application, the AER will have regard to, amongst other things:</p> <ol style="list-style-type: none"> i. whether Ergon Energy has insurance against the event, ii. the level of insurance that an efficient and prudent NSP would obtain in respect of the event, and iii. whether a relevant government authority has made a declaration that a natural disaster has occurred. |
| Insurer's credit risk event | <p>An insurer's credit risk event occurs if:</p> <p>A nominated 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:</p> <ol style="list-style-type: none"> i. 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 |

Event

Accepted definition

ii. incurs additional costs associated with funding an insurance claim, which would otherwise have been covered by the insolvent insurer.

Note: In assessing an insurer's credit risk event pass through application, the AER will have regard to, amongst other things,

- 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.

15.2 Ergon Energy's revised proposal

In our preliminary decision we did not accept all nominated pass through events initially proposed by Ergon Energy. Instead we substituted our own definitions of insurance cap event and natural disaster event which we considered satisfied the requirements of the NER. We renamed the proposed insurance event to an insurer's credit risk event for consistency with other determinations made at this time and substituted our own definition. We did not accept Ergon Energy's initial proposal for a retail separation event or isolated network separation event because these events are likely to be covered by another category of pass through event.²

In its revised proposal, Ergon Energy adopted some elements of the preliminary decision but challenged others. In particular, Ergon Energy:

- agreed with the definitional change for the insurance cap event
- agreed with the definitional change for the insurance event (now named the insurer's credit risk event)
- challenged our removal of 'cyclone' in the definition of natural disaster event
- did not accept our decision to reject its proposed retail separation event or isolated network separation event
- proposed a new 'merger event'.

These are discussed further in section 15.4 below.

15.3 AER's assessment approach

Our approach to assessing cost pass through events was described in detail in attachment 15 of our preliminary decision for Ergon Energy.³

Our approach has been guided by the NEO and the RPP. It provides the network service provider (NSP) with a reasonable opportunity to recover at least the efficient

² AER, *Preliminary decision, Ergon Energy, Attachment 15*, April 2015, p.10.

³ AER, *Preliminary decision, Ergon Energy, Attachment 15*, April 2015, pp. 8–10.

costs⁴ the operator incurs⁵, while also providing effective incentives to promote economic efficiency.⁶ It promotes a balance between the economic costs and risks for promoting efficient investment.⁷

The NER includes the following nominated pass through event considerations which we must have regard to when assessing nominated pass through events:⁸

The nominated pass through event considerations are:

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

We have maintained the same approach in this final decision.

⁴ Under cl. 6.6.1(d), (g) and (j) of the NER, we are to make a decision on the costs of providing direct control services as a result of a pass through event occurring. Direct control services includes alternative control services and standard control services.

⁵ NEL, s.7A(2).

⁶ NEL, s.7A(3).

⁷ NEL, s.7A(6).

⁸ NER, cl. 6.5.10(b); NER glossary, definition of 'nominated pass through event considerations'.

15.3.1 Interrelationships

As we discussed in our preliminary decision, the nominated pass through events are interrelated with other parts of this decision, in particular with Ergon Energy's proposed opex and capex allowances and the rate of return. These interrelationships require that we balance our decision to accept nominated pass through events with the need to maintain appropriate incentives in other parts of our decision.

15.4 Reasons for final decision

This section sets out our reasons for the final decision on each pass through event.

15.4.1 Pass throughs and alternative control services

We approve Ergon Energy's proposal that nominated pass through events refer to 'direct control services'. This means that Ergon Energy may apply to pass through an increase (or decrease) in costs incurred in providing both standard and alternative control services. This is consistent with the prescribed pass through event definitions set out in the NER, which also reference direct control services.

15.4.2 Insurance cap and insurer's credit risk events

In our preliminary decision we rejected Ergon Energy's proposed definitions for insurance cap event and insurance event (now renamed insurer's credit risk event), and substituted alternative definitions we considered satisfied the requirements of the NER.

In its revised proposal Ergon Energy accepted the alternative definition for an 'insurance cap event' set out in our preliminary determination.

Ergon Energy also accepted our renaming of the 'insurance event' (now named the insurer's credit risk event) and accepted our amended definition.

Our approved definitions are set out in table 15.1.

15.4.3 Natural disaster event

In our preliminary decision we rejected Ergon Energy's proposed definition of natural disaster event, and substituted an alternative definition. In its revised proposal Ergon Energy accepted part of our definition but did not accept the removal of 'cyclone'.

We remain of the view 'cyclone' would fall within the category of 'other natural disaster' Ergon Energy has not provided any arguments as to why 'cyclone' does not fall within the category of 'other natural disaster'. We therefore do not accept the inclusion of the word 'cyclone' in the definition of natural disaster.

Our approved definition is set out in table 15.1.

15.4.4 Retail separation event and isolated network separation event

In our preliminary decision we did not approve the proposed retail separation event and isolated network event, because these events are likely to be covered by another category of pass through. In its revised proposal Ergon Energy did not agree with our position that a retail separation event and isolated network separation event are likely, 'at all times', to be covered by another category of pass through event.

In particular, Ergon Energy considers 'that the prescribed regulatory change event would not, in every case,' encompass an isolated network separation event or retail separation event.⁹ Ergon Energy gave the example that it 'would be possible for the Queensland Government to put a retail separation event into place via the passing of an administrative decision, such that any obligation or requirement arising from that decision would not meet the NEL definition of a regulatory obligation or requirement'.¹⁰ Ergon Energy referenced a previous AER decision where we stated:

The AER considers that privatisation is likely to occur as a result of an administrative decision of the NSW Government, which would not be covered by the definition of a regulatory change event.¹¹

In response to Ergon Energy's revised proposal, we note a regulatory change event is not the only alternative pass through event for the type of costs described by Ergon Energy. Were Ergon Energy's costs to materially change from retail or isolated network separation resulting from an administrative decision by the Queensland Government, we consider the event would likely meet the definition of a service standard event.

As set out in our preliminary decision, were Ergon Energy's costs to materially change as a result of an Act or an instrument issued or made under an Act, the event would likely meet the definition of a regulatory change event or service standard event. Therefore, Ergon Energy would be able to make a pass through application to the AER under one of the existing prescribed pass through events.¹²

We consider a retail separation event is not consistent with the nominated pass through event considerations set out by the NER, as the event will be covered by a category of pass through specified in clause 6.6.1(a1)(1) to (4) of the NER.

15.4.5 Merger event

In its revised proposal Ergon Energy proposed a 'merger event'. This nominated pass through event would allow Ergon Energy to recover any material costs incurred if a

⁹ Ergon Energy, *Revised regulatory proposal, 04.01.03 (Revised) Nominated cost pass through events*, July 2015, p.15–17.

¹⁰ Ergon Energy, *Submission to the AER on its Preliminary Determination – Pass through events*, July 2015, p. 6.

¹¹ AER, *Draft decision NSW Distribution Determination 2009–10 to 2013–14*, p.280.

¹² NER, cl. 6.5.10(b); NER glossary, definition of 'nominated pass through event considerations'.

merger of State owned electricity and distribution businesses occurs. Ergon Energy did not include this proposed pass through event in its original regulatory proposal.

Our decision is not to accept Ergon Energy's proposed merger event.

For the reasons listed in section 15.4.4 above, Ergon Energy does not believe a merger event 'is likely, at all times, to be covered by another category of pass through event'. However, reflecting on the arguments above in section 15.4.4, we are of the view this event would likely meet the definition of either a service standard event (if the merger resulted from an administrative decision of the Queensland Government) or a regulatory change event (if resulting from an Act or instrument under an Act).

We consider a merger event is not consistent with the nominated pass through event considerations set out by the NER, as the event will be covered by a category of pass through specified in clause 6.6.1(a1)(1) to (4) of the NER.¹³

¹³ NER, cl. 6.5.10(b); NER glossary, definition of 'nominated pass through event considerations'.