



FINAL DECISION
Essential Energy distribution
determination
2015–16 to 2018–19

Attachment 15 – Pass through
events

April 2015

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Note

This attachment forms part of the AER's final decision on Essential Energy's revenue proposal 2015–19. It should be read with 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 methodology

Attachment 19 - Analysis of Financial Viability

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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
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 that 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
- any other event specified in a determination as a pass through event (nominated pass through event).¹

This attachment sets out our final decision on the additional pass through events that will apply to Essential Energy for the 2015–19 regulatory control period.

15.1 Final decision

Our final decision is that the following nominated pass through events will apply to Essential Energy for the 2015–19 regulatory control period:

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

These events have the definitions listed in Table 15.1 below.

Table 15.1 Accepted event definitions

Event	Definition
Insurance cap event	An insurance cap event occurs if: <ol style="list-style-type: none">1. Essential Energy makes a claim or claims and receives the benefit of a payment or payments under a relevant insurance policy,2. Essential Energy incurs costs beyond the relevant policy limit, and

¹ NER, clause 6.5.10.

3. the costs beyond the relevant policy limit materially increase the costs to Essential Energy in providing direct control services.

For this insurance cap event:

4. the relevant policy limit is the greater of:
- a. Essential 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 final decision for the regulatory control period in which the insurance policy is issued.
5. A relevant insurance policy is an insurance policy held during the 2015–19 regulatory control period or a previous regulatory control period in which Essential Energy was regulated.

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:

- 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.

Insurer's credit risk event

An insurer's credit risk event occurs if:

A nominated insurer of Essential 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, Essential Energy:

- 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.

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

- 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 event

A natural disaster event occurs if:

Any major fire, flood, earthquake or other natural disaster occurs during the 2015–19 regulatory control period and materially 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.

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).

Note: In assessing a natural disaster event pass through application, the AER will have regard to, amongst other things:

- i. whether Essential Energy has insurance against the event,
- ii. the level of insurance that an efficient and prudent NSP would obtain in respect of the event,
- iii. whether a relevant government authority has made a declaration that a natural disaster has occurred.

Terrorism event

A terrorism event occurs if:

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.

Note: In assessing a terrorism event pass through application, the AER will have regard to, amongst other things:

- i. whether Essential 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 declaration has been made by a relevant government authority that a terrorism event has occurred.

Source: AER analysis.

15.2 Essential Energy's revised proposal

In our draft decision we did not accept all of the nominated pass through events proposed by Essential Energy. Instead we substituted our own definitions of insurance cap event, terrorism event and natural disaster event which we considered satisfied the requirements of the NER. We did not accept Essential Energy's proposal for an insurer's credit risk event or an aviation hazards event.²

In its revised proposal, Essential Energy adopted some elements of the draft decision but challenged others. In particular, Essential Energy:³

- challenged our inclusion, in the definitions of the insurance cap, terrorism and natural disaster events, of information on how we would apply those definitions.
- did not accept our draft decision to reject its proposed insurer's credit risk event, and responded to our concerns that this event was not consistent with the NER.
- did not accept our draft decision to reject its proposed aviation hazards 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 draft decision for Essential Energy.⁴

Our approach has been guided by the NEO and the RPP. It provides the NSP with a reasonable opportunity to recover at least the efficient costs⁵ the operator incurs⁶, while also providing effective incentives to promote economic efficiency.⁷ It promotes a balance between the economic costs and risks for promoting efficient investment.⁸

We have maintained the same approach in this final decision.

15.4 Reasons for final decision

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

We discuss the arguments in Essential Energy's revised proposal and how we have addressed them in this final decision. In addition, we received submissions on pass through events from the following stakeholders:

² AER, *Draft decision, Essential Energy, Attachment 15*, p. 7.

³ Essential Energy, *Revised regulatory proposal*, attachment 5.7, pp. 3–4.

⁴ AER, *Draft decision, Essential Energy, Attachment 15*, pp. 9–10.

⁵ Under clauses 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 include alternative control services and standard control services.

⁶ NEL, s. 7A(2).

⁷ NEL, s. 7A(3).

⁸ NEL, s. 7A(6).

- AusNet Services proposed further amendments to the definition of the insurance cap event (discussed in section 15.4.2 below).
- Jemena Limited proposed that we initiate a market consultation on pass through events. We note that such a review is beyond the scope of this final decision, but that our approach has been informed by the AEMC's recent consultation on pass through events.⁹

15.4.1 Interrelationships

As we discussed in the draft decision, the nominated pass through events are interrelated with other parts of this determination, in particular with Essential 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.

15.4.2 Insurance cap, natural disaster and terrorism events

In our draft decision we rejected Essential Energy's proposed definitions for insurance cap, terrorism and natural disaster events, and substituted alternative definitions that we considered satisfied the requirements of the NER. In its revised proposal Essential Energy accepted part of our definitions in the draft decision but proposed amended definitions.

In relation to all three of these events, Essential Energy argues that:

- the definitions of pass through events should not include factors that go to the assessment of a pass through application, because these are already set out in the NER.¹⁰ Essential Energy also considered that there was some overlap between the definitions of some of the elements of the nominated pass through event definitions and various provisions of the rules, in particular 6.6.1(j)(3), (5) and (7).
- including these factors would be inconsistent with the definitions of prescribed pass through events in the NER, which do not include this detail.¹¹

Similarly, in its submission, AusNet Services suggests the following refinements to the definitions in our draft decision, which it submits will achieve greater clarity and consistency with existing definitions and Rules:

- The reference in paragraph 5(i) of the AER's definition of an insurance cap event should be to a 'relevant insurance policy'¹²
- Paragraph 5(iii) should be deleted as it duplicates clause 6.6.1(j)(3) of the NER and potentially introduces confusion.¹³

⁹ Jemena, Submission, pp. 1–2.

¹⁰ NER, Clauses 6.6.1(c)(6); 6.6.1(j)(3),(5) and (7).

¹¹ Essential Energy, *Revised regulatory proposal*, attachment 5.7, pp. 9–10.

¹² AusNet Services, *Submission*, p. 9.

The NER do not include this additional information in defining the prescribed pass through events. However, we do not consider including this additional information in definitions of nominated events is inconsistent with, or contrary to, the NER.

The NER include, at a high level, matters that we are to have regard to in assessing pass through applications.¹⁴ To more clearly identify when a pass through event would be taken to have occurred, the alternative definitions in our draft decision included specific factors which we will have regard to. These provide greater certainty and transparency in the operation of nominated pass through events given the 'significant cost impact'¹⁵ that our decision on a pass through application can have on the NSP or its customers. This approach supports the nominated pass through event considerations in the NER, which specifically state that nominated pass through events should be clearly identified at the time the determination is made.¹⁶ In the case of the insurance cap event, the natural disaster event and the terrorism event, this includes whether the NSP has insurance against the event as well as the level of insurance that it has acquired.

We do accept that paragraph 5(iii) of our definition is not required in addition to clauses 6.6.1(j)(3),(5) and (7) of the NER. Specifically, in assessing a pass through application clause 6.6.1(j)(3) states we are to consider the efficiency of the NSP's decisions and actions in relation to the risk of the event.

We also agree that as 'relevant insurance policy' is defined within our definition of the insurance cap event, consistent use of that term throughout the definition is preferable. We have therefore amended the definition to use this term at paragraph 5(i).

Essential Energy also challenged aspects of our proposed definitions of the natural disaster and terrorism events. It argued that we should not include, in the definition of the natural disaster event and terrorism event that we would have regard to whether a 'declaration' has been made by a relevant government authority that such an event has occurred.

Whether a relevant government authority has made a relevant declaration in respect of these pass through events is a factor that we would have regard to in considering whether to approve such a pass through event. We consider that this adds clarity around the purpose of this nominated pass through event and when it is likely to be considered to have occurred. We therefore maintain this element of the definition.

Essential Energy also challenged the addition of the following consideration in our proposed definition of the natural disaster event:

Provided the fire, flood or other event was not a consequence of the acts or omissions of the service provider.

¹³ AusNet Services, *Submission*, pp. 9–10.

¹⁴ NER, clause 6.6.1(j).

¹⁵ AER, *Draft decision, Essential Energy, Attachment 15*, p. 10.

¹⁶ NER, Chapter 10 (Glossary), Definition of 'Nominated pass through event considerations', paragraph (b).

Our assessment approach for determining which nominated pass through events to include in our final decision includes consideration of who is best placed to bear the risks of events occurring. Adopting a definition which notes that we will not allow NSPs to pass through costs where the event has been caused by the NSP is consistent with the regulatory regime. We have sought to maintain the incentive properties of the regime by excluding events that businesses have control over. We therefore maintain this element of the definition.

We have also considered the use of the terms, 'material' and 'materially', in our pass through definitions. The use of these terms is not inconsistent with the definition of the term in the NER. The definitions of the prescribed pass through events also use these terms. We have therefore maintained the use of these terms in our pass through definitions.

Our final decision therefore includes insurance cap, terrorism and natural disaster events, but makes the following amendments to the definitions:

- Removes references which replicate clause 6.6.1(j)(3) of the NER
- Consistent use of the term, 'relevant insurance policy'.

15.4.3 Insurer's credit risk event

The insurer's credit risk event is intended to provide for circumstances in which an insurance claim is successful, but Essential Energy is unable to recover against its insurance policy as a result of the insolvency of an insurance provider. In our draft decision, we rejected this event and stated that Essential Energy may be able to prevent this event occurring by purchasing insurance from reputable providers who have the capacity to satisfy any claims.¹⁷ We further stated, 'NSPs can assess the viability of an insurer by reviewing its track record, size credit rating and reputation.'¹⁸ We also had regard to the incentives on Essential Energy to acquire insurance prudently.

In its revised regulatory proposal, Essential Energy argued that:

- the collapse of HIH Insurance was not foreseen by the market and that in the weeks prior to its collapse HIH still had an investment-grade rating¹⁹
- it only obtains insurance from an insurer with a minimum A- credit rating, and it monitors S&P ratings movements²⁰
- it insures its risks with multiple insurers to diversify the risks.²¹

¹⁷ AER, *Draft decision, Essential Energy, Attachment 15*, p. 14.

¹⁸ AER, *Draft decision, Essential Energy, Attachment 15*, p. 14.

¹⁹ Essential Energy, *Revised regulatory proposal, Attachment 5.7*, p. 5.

²⁰ Essential Energy, *Revised regulatory proposal, Attachment 5.7*, p. 5, Attachment 4.13, Essential Energy's nominated pass through events (public), p. 15.

²¹ Essential Energy, *Attachment 4.13, Essential Energy's nominated pass through events (public)*, p. 15.

We have considered the example of HIH and how a similar event would impact NSPs. If a similar event were to occur in the 2015–19 regulatory control period, an NSP that had adopted the risk management measures contemplated in our draft decision could nonetheless incur significant costs. The NSP may therefore still potentially suffer a significant loss as a consequence of an insurer becoming insolvent and thereby unable to satisfy all insurance claims. NSPs are also limited in the extent to which they can avoid such losses, short of taking out multiple insurance policies to cover the same risks. We accept that the options available to NSPs to manage these risks are limited and, given the rarity of such events, may in fact result in greater expenditure on insurance than is prudent or efficient.

Essential Energy has also responded to our concerns around the incentives a pass through option may create to reduce insurance costs by shifting this risk entirely to customers. In its revised proposal it has demonstrated a robust and prudent approach to assessing risk and obtaining insurance.²² Essential Energy's explanation of its approach to insurance demonstrates that the regulatory regime already provides incentives to take prudent actions in relation to insurance, which are not weakened by accepting this proposed pass through event. We also note clause 6.6.1(j)(3) of the NER acts as an appropriate balance to any incentive an insurer's credit risk event may create to transfer the risk of insurer failure entirely to customers.

We therefore accept that an insurer's credit risk event can be consistent with the nominated pass through considerations, if appropriately defined. We have added to Essential Energy's proposed definition of this pass through event the matters that we will have regard to in assessing an event.

In its definition for this event, Essential Energy also sought to pass through the costs associated with significant changes to insurance premiums as a result of an insurer becoming insolvent. Insurance premiums are a typical business expense. They are subject to ordinary market factors of the economy. We consider this is a risk that businesses, and not their customers, are best placed to bear. We therefore do not consider it appropriate to allow this element of the nominated pass through event.

We consulted with Essential Energy and others on an appropriate definition for this event.²³ As a result of this consultation, we have clarified that we may allow NSPs to pass through claims that would have been made immediately after the insurer became insolvent and before the NSP had a reasonable opportunity to acquire new insurance for those risks. This amendment maintains an incentive on NSPs to acquire new insurance as soon as reasonably possible after an insurance provider becomes insolvent.

²² Essential Energy, *Revised regulatory proposal, Attachment 5.7*, p. 5.

²³ Information request and response 056, 27 March 2015.

15.4.4 Aviation hazards event

Essential Energy did not accept our draft decision to reject its proposed aviation hazards pass through event. Our understanding of this event is it would allow Essential Energy to pass through the costs of taking actions to mitigate the risks of aviation hazards if the NSW Government does not provide Essential Energy with protection from certain liabilities. Our reasons for not accepting this event in the draft decision included²⁴ that the event may be covered by another pass through event,²⁵ and insurance would be available.²⁶

Essential Energy accepted, in part, the AER's view that insurance is available but commented on the purpose of the proposed pass through event:

Although Essential Energy acknowledges its current insurance program potentially offers some protection against this liability, its pass through application relates to the potentially significant investment required to undertake a strategy and feasibility study that identifies actions necessary to mitigate the risks of aviation hazards and the cost of taking such action.²⁷

In this statement, Essential Energy appears to be suggesting that the reason for nominating the pass through is not about its liability should an incident occur, but about the costs of managing its exposure to such liability. We maintain our view then that insurance or self-insurance is available for the liabilities to which Essential Energy is exposed.

The cost pass through application process at clause 6.6.1(c) of the NER sets out the process for an NSP seeking approval from the AER to pass through costs attributable to the occurrence of a pass through event. At the time of making a cost pass through application, the NSP must submit evidence that the 'costs occur solely as a consequence of the positive change event'.²⁸ We consider this is relevant to the consideration of whether we should accept a nominated pass through event in our decision because if the application to pass through costs cannot succeed then the event should not be included in our decision. For the reasons set out below, we consider that the trigger, as proposed, does not of itself impose an obligation on Essential Energy which requires it to incur additional costs. That is, the costs do not arise *solely* as a consequence of the proposed event:

- The study to which the proposed event relates pertains to an existing risk, rather than a new requirement. Judgments against Essential Energy in the New South

²⁴ AER, *Draft decision, Essential Energy, Attachment 15*, pp. 14–15.

²⁵ NER, Chapter 10 (Glossary), Definition of 'Nominated pass through event considerations', paragraph (a).

²⁶ NER, Chapter 10 (Glossary), Definition of 'Nominated pass through event considerations', paragraph (d).

²⁷ Essential Energy, *Revised regulatory proposal, Attachment 5.7*, p. 7.

²⁸ NER, clause 6.6.1(c).

Wales Supreme Court and Court of Appeal²⁹ have identified an existing duty of care.

- Essential Energy's approach to managing this risk has been to take out insurance against its liability should incidents arise.³⁰ Its proposed pass through event would cover the cost of a study of additional mitigation measures to reduce the frequency of such incidents and its exposure to them. This study is a risk management strategy that is available to Essential Energy now in response to its existing risk.
- Essential Energy's preference is for the relevant government authority to absolve it of its liability under this existing duty of care to the extent that it requires more of Essential Energy than compliance with the relevant Australian Standard. If it does this, Essential Energy seems to suggest that the need for the study is reduced or falls away. However, the liability is pre-existing: a decision of the relevant authority not to do this does not give rise to a new risk that Essential Energy must manage. That is, there is no positive change.

We therefore consider that the pass through event proposed would not result in Essential Energy incurring costs that arise *solely* from the events specified. Rather, in addition to the event as proposed, Essential Energy would need to make a decision to change its approach to managing the risks of the event. Therefore, the pass through assessment provisions would not allow Essential Energy to make a successful pass through application.

These issues further support the view expressed in the draft decision that rather than the NSW Government absolving Essential Energy of this liability it may seek to impose, if considered appropriate, an obligation on Essential Energy to undertake the studies and actions contemplated by Essential Energy in its revised regulatory proposal.³¹ Under this scenario, provided the materiality threshold is satisfied, then Essential Energy would most likely be able to make a pass through application to the AER under an existing pass through event, potentially the regulatory change event.

We maintain our view from the draft decision not to accept this as a nominated pass through event.

²⁹ *Sheather v Country Energy* [2007] NSWCA 179; *South West Helicopters and anor v Essential Energy* [2014] NSWSC 1758.

³⁰ Essential Energy, *Revised regulatory proposal, Attachment 5.7*, p. 7.

³¹ AER, *Draft decision, Essential Energy, Attachment 15*, p. 14.