



**PRELIMINARY DECISION**  
**AusNet Services distribution**  
**determination**  
**2016 to 2020**

**Attachment 15 – Pass through**  
**events**

October 2015

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## Note

This attachment forms part of the AER's preliminary decision on AusNet Services' revenue proposal 2016–20. It should be read with all other parts of the preliminary decision.

The preliminary 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

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Attachment 17 - Negotiated services framework and criteria

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## Shortened forms

Shortened form	Extended form
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
AMI	Advanced metering infrastructure
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

Shortened form	Extended form
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 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 not built into our distribution determination. The NER includes the following prescribed pass through events:

- a regulatory change event
- a service standard event
- a tax change event
- a retailer insolvency event.<sup>1</sup>

In addition to the above (prescribed) events, an event may be specified in a determination for a regulatory control period (nominated pass through event).<sup>2</sup>

AusNet Services proposed four nominated pass through event in addition to the events prescribed by the NER.<sup>3</sup>

This attachment sets out our preliminary decision on the additional pass through events for AusNet Services during the 2016–20 regulatory control period.

### 15.1 Preliminary decision

We accept the natural disaster event and terrorism event proposed by AusNet Services. We have corrected a reference to the regulatory control period in AusNet Services' proposed insurance cap event, but otherwise accept that event also.

We do not accept AusNet Services' proposed Power of Choice event.

In its proposal AusNet Services has incorrectly assumed that the retailer insolvency event prescribed under the NER applies in Victoria. Subject to submissions, we will consider a nominated pass through event for retailer insolvency if included in AusNet Services' revised proposal, consistent with our preliminary decisions for other Victorian distributors. Should it choose to pursue this option, we direct AusNet Services' attention to the nominated retailer insolvency event approved in those preliminary decisions.

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<sup>1</sup> Note, this is only a prescribed event in jurisdictions where the National Energy Customer Framework has commenced, and therefore does not apply in Victoria.

<sup>2</sup> NER, cl. 6.6.1(a1).

<sup>3</sup> AusNet Electricity Services Pty Ltd, *Electricity Distribution Price Review 2016-2020*, April 2015, p. 257.

## 15.2 AusNet Services' proposal

AusNet Services' proposed nominated pass through events are set out in Table 15-1.

**Table 15-1 AusNet Services' proposed pass through events**

Proposed event	AusNet Services' proposed definition
Insurance cap event	<p>"An insurance cap event occurs if:</p> <ol style="list-style-type: none"> <li>1. AusNet Services makes a claim or claims and receives the benefit of a payment or payments under a relevant insurance policy,</li> <li>2. AusNet Services incurs costs beyond the relevant policy limit, and</li> <li>3. the costs beyond the relevant policy limit materially increase the costs to AusNet Services in providing direct control services.</li> </ol> <p>For this insurance cap event:</p> <ol style="list-style-type: none"> <li>4. the relevant policy limit is the greater of: <ol style="list-style-type: none"> <li>a. AusNet Services actual policy limit at the time of the event that gives, or would have given rise to a claim, and</li> <li>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.</li> </ol> </li> <li>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 AusNet Services was regulated.</li> </ol> <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> <ol style="list-style-type: none"> <li>i. the relevant insurance policy for the event, and</li> <li>ii. the level of insurance that an efficient and prudent NSP would obtain in respect of the event." </li></ol>
Natural disaster event	<p>"A natural disaster event occurs if:</p> <p>Any major fire, flood, earthquake or other natural disaster occurs during the 2016-20 regulatory control period and materially increases the costs to AusNet Services 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 DNSP'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"> <li>i. whether AusNet Services has insurance against the event,</li> <li>ii. the level of insurance that an efficient and prudent NSP would obtain in respect of the event, and</li> <li>iii. whether a relevant government authority has made a declaration that a natural disaster has occurred." </li></ol>
Terrorism event	<p>"A terrorism event occurs if:</p> <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</p>



Proposed event	AusNet Services' proposed definition
	<p>government and/or put the public, or any section of the public, in fear) and which materially increases the costs to AusNet Services in providing direct control services.</p> <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"> <li>i. whether AusNet Services has insurance against the event,</li> <li>ii. the level of insurance that an efficient and prudent NSP would obtain in respect of the event,</li> <li>iii. whether a declaration has been made by a relevant government authority that a terrorism event has occurred, and" [sic].</li> </ul>
Power of Choice event	<p>"A Power of Choice event occurs if:</p> <ol style="list-style-type: none"> <li>1. The AEMC publishes notice of the making of a rule under sections 96A, 102 or 102A of the National Electricity Law; and</li> <li>2. The rule is: <ul style="list-style-type: none"> <li>(a) The National Electricity Amendment (Improving demand side participation information provided to AEMO by registered participants) Rule 2015 No. 4; or</li> <li>(b) The National Electricity Amendment (Distribution Network Pricing Arrangements) Rule 2014 No. 9; or</li> <li>(c) The National Electricity Amendment (Customer access to information about their energy consumption) Rule 2014 No. 7; or</li> <li>(d) The final rule made in determination of Rule change proposal ERC0169 Expanding competition in metering and related services; or</li> <li>(e) The final rule made in determination of the rule change request submitted by AEMO on 2 October 2014 which is identified by the AEMC as ERC0179 Embedded Networks; or</li> <li>(f) The final rule made in determination of the rule change request submitted by AEMO on 17 December 2014 which is identified by the AEMC as ERC0181 Embedded Networks; or</li> <li>(g) Any other final rule made in determination of a rule change proposal which reflects, in whole or in part, one or more of the recommendations made by the AEMC in Power of choice review – giving consumers options in the way they use electricity, Final Report dated 30 November 2012; and</li> </ul> </li> <li>3. At the date notice under paragraph 1 is given, implementing or complying with that rule and each rule in paragraph 2 made earlier in time, individually or in aggregate and in any combination, materially increases the cost of providing direct control services.</li> </ol> <p>If, at the time the Power of Choice event occurs:</p> <ol style="list-style-type: none"> <li>4. The AEMC has not published notice of the making of one or more of the rules in paragraph 2; and</li> <li>5. AusNet Services cannot provide evidence of the actual or likely increase in costs that it will or is likely to incur in providing direct control services as a result of the making of that rule or rules, AusNet Services may seek the approval of the AER later in the regulatory control period to pass through those amounts on the basis that the materiality threshold is met." </li></ol>

Source: AusNet Electricity Services Pty Ltd, *Electricity Distribution Price Review 2016-2020*, April 2015, pp. 263-272.

## 15.3 AER's assessment approach

We must decide which of AusNet Services' proposed nominated pass through events will apply for the 2016–20 regulatory control period. Pass through events transfer financial risks from distributors to consumers. If one of the nominated events occurs, the costs of the event that we assess as meeting the factors set out in the NER are passed through to consumers and network charges increase.<sup>4</sup>

Our approach has been guided by the National Electricity Objective (NEO) and the Revenue and Pricing Principles. These provide the distributor with a reasonable opportunity to recover at least the efficient costs incurred in providing services.<sup>5</sup> They also provide incentives to promote economic efficiency.<sup>6</sup> Together, they promote a balance between the economic costs and risk management to promote efficient investment.<sup>7</sup>

The NER include the following nominated pass through event considerations which we must have regard to when assessing nominated pass through events.<sup>8</sup>

*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.

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<sup>4</sup> NER, cl. 6.6.1(d),(g) and (j).

<sup>5</sup> NEL, s. 7A(2).

<sup>6</sup> NEL, s. 7A(3).

<sup>7</sup> NEL, s. 7A(6).

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

(e) any other matter the AER considers relevant and which the AER has notified *Network Service Providers* is a nominated pass through event consideration.<sup>9</sup>

These considerations involve an assessment of the incentives for distributors to manage their risks efficiently.

For systemic risks, distributors are compensated through the allowed rate of return. Distributors also face business-specific, or residual, risks. These activities are generally compensated through the opex and capex allowances. Beyond this, a distributor may manage other risks through a number of other strategies, including:

- prevention (avoiding the risk)
- mitigation (reducing the negative effect or probability 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. For example, if a cost is reasonably predictable a business should factor it into its proposed opex and capex. In addition, a distributor may invest in its networks to mitigate the impact of certain events occurring. Alternatively, if the probability of events occurring can be readily estimated then the event should be insurable.

Pass through events cover those limited circumstances for which the risks cannot be managed efficiently in these ways and for which the distributor should be able to recover its efficient costs.

A factor for us to consider, which is reflected in the pass through event considerations, is who is best placed to manage a given risk. Generally, the party in the best position to manage a risk should bear the risk of that event occurring. If the distributor, or customers, are fully exposed to a risk, this may lead to adverse outcomes.

For example, where it is not possible for a distributor to insure against a risk, a distributor may need to share that risk with customers to ensure the service may continue should the event occur. The uninsurable risk may be outside the control of the distributor and have a low probability of occurring, but a significant cost impact when it does occur. The most efficient and prudent solution to manage that type of risk may be to require customers to accept some of the burden of that risk, by allowing a pass through in the unlikely event that the risk eventuates.

On the other hand, if the distributor is able to pass through all the costs of such an event, its incentive to take prudent actions to prevent or mitigate the potential cost impact of the risk may be weakened. Accordingly, while customers may need to accept

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<sup>9</sup> NER, cl. 6.5.10(b); NER glossary, definition of 'nominated pass through event considerations'.

some of the burden of the risk, the distributor will need to share some of the risk too. That might be achieved, for example, by making a pass through conditional on the distributor demonstrating it has acted prudently and efficiently in managing the potential impact of the event.

We consider all of these issues when assessing a nominated pass through event with the aim of achieving the right balance, in the long term interests of consumers, in accordance with the nominated pass through event considerations.

As a matter of good regulatory practice, an additional factor we take into account is consistency in our approach to assessing nominated pass through events across our determinations.

### **15.3.1 Interrelationships**

As we mentioned above, pass through events are not the only mechanism in this determination by which AusNet Services can manage its risks. The nominated pass through events are interrelated with other parts of this determination, in particular with the proposed opex and capex allowances and the rate of return. These interrelationships require us to balance the incentives in the various parts of our decision.

## **15.4 Reasons for preliminary decision**

In this section we set out the reasons for our preliminary decisions on each of AusNet Services' proposed pass through events. We have:

- accepted the natural disaster event and terrorism event proposed by AusNet Services. We have corrected a reference to the regulatory control period in AusNet Services' proposed insurance cap event, but otherwise accept that event also.
- not accepted the Power of Choice event.

### **15.4.1 Insurance cap event**

The insurance cap event would allow AusNet Services to recover material costs incurred which exceed its insurance cap. We note that AusNet Services:

- maintains a level of insurance cover which reflects the scale and size of its operations
- outlines its opex forecast includes self-insurance costs for losses falling below its deductible
- outlines its proposed self-insurance forecast excludes losses from liability that exceed the cap of its insurance policies

- depicts how the Black Saturday bushfires demonstrate the liability losses the company's liability insurance policy absorbs
- provides sound arguments for why an insurance cap event satisfies the nominated pass through event considerations.<sup>10</sup>

We accept the insurance cap event would protect AusNet Services from high cost impact events which would be uneconomical to insure against. We consider consumers can benefit from this because they are not required to fund excessive premiums where insurance, if available, would be uneconomic. Consumers then only bear the risk should an insurance cap event occur.

We note if a pass through event of this type were to occur, in assessing AusNet Services' application to pass through costs we will consider the efficiency of AusNet Services' decisions and actions. We would consider whether it failed to take reasonable action to reduce the magnitude of the amount being claimed and whether any act or omission it took in response to the event increased the magnitude of the amount claimed.<sup>11</sup> This gives AusNet Services an incentive to mitigate the risks associated with the event including through acquiring an appropriate level of insurance and implementing other practical risk minimisation strategies in its operations.

The structure and content of AusNet Services' proposed insurance cap event is consistent with our views and approach in recent determinations.<sup>12</sup> However, the reference to the 2015–19 regulatory control period should be corrected to 2016–20.

#### 15.4.2 Natural disaster event

This event would allow AusNet Services to pass through costs associated with natural disasters. We accept a natural disaster event can be consistent with the nominated pass through considerations, if appropriately defined.

We consider there may be some overlap between an insurance cap event and a natural disaster event, but accept the need to have both because the NSP may incur costs which an insurance policy would not ordinarily cover.

We note AusNet Services has a range of measures in place to manage the risks of natural disaster events, including:

- insurance coverage that provides some protection against property damage caused by natural disasters
- a proposed self-insurance allowance in its opex forecast to cover damage to poles and wires assets (which are not covered under the insurance policy).<sup>13</sup>

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<sup>10</sup> AusNet Electricity Services Pty Ltd, *Electricity Distribution Price Review 2016-2020*, April 2015, pp. 263–264.

<sup>11</sup> NER, cl. 6.6.1(j)(3).

<sup>12</sup> See e.g. AER, *Attachment 15 – Pass through events Energex determination 2015 -20*, pp. 10–11.

<sup>13</sup> AusNet Electricity Services Pty Ltd, *Electricity Distribution Price Review 2016-2020*, April 2015, p. 266.

We will have regard to whether AusNet Services has taken prudent and efficient steps to insure against the event, when assessing any pass through application.

We accept AusNet Services' proposed definition, which is consistent with our views and recent determinations.<sup>14</sup>

### 15.4.3 Terrorism event

This event would allow AusNet Services to pass through the costs of terrorism events. We accept a terrorism event can be consistent with the nominated pass through considerations, if appropriately defined.

A prudent and efficient NSP may be able to take actions which reduce the vulnerability of the network to terrorist attacks and would obtain insurance in respect of terrorism events. We note AusNet Services' insurance coverage provides some protection against losses caused by terrorism, however AusNet Services' ability to prevent or mitigate the cost impact of a terrorism event is limited.<sup>15</sup>

We consider there may be some overlap between an insurance cap event and the terrorism event, but accept the need to have both because AusNet Services may incur costs which an insurance policy would not ordinarily cover.

We accept AusNet Services' proposed definition, which is consistent with our views and definitions in recent determinations.<sup>16</sup>

### 15.4.4 Power of Choice event

The 'Power of Choice' event would allow AusNet Services to pass through costs associated with the Power of Choice energy market reforms. We do not accept the nominated pass through event because a Power of Choice event would be covered under the prescribed regulatory change and/or service standard events set out in the NER.

We have taken into account AusNet Services' arguments that:

- the implementation of the Power of Choice reforms will require changes to the NER which will have implications for the operation of the electricity market
- ICT system changes will be required to respond to metering contestability
- architectural changes to AusNet Services' AMI and non-AMI systems may be required to implement the 'multiple trading relationship' and 'embedded networks' rule changes
- there is uncertainty with respect to the timing and quantum of Power of Choice related cost impacts.<sup>17</sup>

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<sup>14</sup> See e.g. AER, *Attachment 15 – Pass through events Energex determination 2015 -20*, pp. 16–17.

<sup>15</sup> AusNet Electricity Services Pty Ltd, *Electricity Distribution Price Review 2016-2020*, April 2015, p. 267.

<sup>16</sup> See e.g. AER, *Attachment 15 – Pass through events Energex determination 2015 -20*, pp. 15–16.

When assessing a proposed nominated pass through event, the NER require us to consider 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). We agree with AusNet Services that changes to the NER to implement the Power of Choice reforms are likely to be covered by the prescribed regulatory change event set out in the NER.<sup>18</sup>

However, AusNet Services has submitted that the materiality threshold that applies to the regulatory change event “may prevent AusNet Services from passing through costs resulting from the Power of Choice review because of the separate, but interconnected, nature of the reforms.”<sup>19</sup> If each rule change under the Power of Choice review was considered as an individual change, AusNet Services is concerned the materiality threshold may not be met and it will be the responsibility of AusNet Services to meet the associated costs. AusNet Services has therefore proposed a separate pass through event that would allow it to combine the cost impact of multiple regulatory change events occurring over the regulatory control period, in order to meet the materiality threshold.

The NER include a prescribed pass through event for regulatory changes that substantially impact the manner in which services are provided. The NER also make clear a change in costs passed through under that event must be material. The risk a number of rule changes will be made over a regulatory control period, some of which may not result in a material change in costs, is not unique to the Power of Choice review. Nor is the prospect that a rule change made in one year will be related to a change or changes in another. We are not convinced an additional, nominated pass through event specific to the Power of Choice review is warranted simply because the materiality threshold that applies to the regulatory change event may preclude recovery of costs below that threshold.

For the reasons outlined above, we do not accept AusNet Services' proposed Power of Choice Event and consider the prescribed regulatory change event provides appropriate protection against the risks AusNet Services has identified.

#### **15.4.5 Retailer insolvency event**

In its proposal, AusNet Services has incorrectly identified the pass through events prescribed in the NER as including, for AusNet Services, a retailer insolvency event. The prescribed retailer insolvency event was among the amendments made to the NER as part of the National Energy Customer Framework (NECF), and only applies in jurisdictions where the NECF has commenced. It does not, therefore, apply in Victoria.

In our preliminary decisions for the other Victorian electricity distributors, we have approved a nominated, retailer insolvency event that affords Victorian distributors the same protection in the event of retailer failure as those in NECF jurisdictions. Subject

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<sup>17</sup> AusNet Electricity Services Pty Ltd, *Electricity Distribution Price Review 2016-2020*, April 2015, pp. 269–271.

<sup>18</sup> NER, cl. 6.5.10(a); NER glossary, definition of 'nominated pass through event considerations'.

<sup>19</sup> AusNet Electricity Services Pty Ltd, *Electricity Distribution Price Review 2016-2020*, April 2015, p. 270.

to submissions, we will consider a nominated pass through event for retailer insolvency, if included in AusNet Services' revised proposal. Should it choose to pursue this option, we direct AusNet Services' attention to the nominated retailer insolvency event approved in our preliminary decisions for other Victorian distributors:

Prior to the commencement of the National Energy Customer Framework in Victoria, retailer insolvency event has the meaning set out in the NER as in force from time to time.

Note: This retailer insolvency event will cease to apply as a nominated pass through event on commencement of the National Energy Customer Framework in Victoria.

#### **15.4.6 Application of pass through provisions to alternative control services**

We approve AusNet Services' proposal that nominated pass through events refer to 'direct control services'.<sup>20</sup> This means that AusNet Services 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.

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<sup>20</sup> AusNet Electricity Services Pty Ltd, *Electricity Distribution Price Review 2016-2020*, April 2015, p. 272.