



PRELIMINARY DECISION
Energex determination 2015–16
to 2019–20

Attachment 15 – Pass through
events

April 2015

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Note

This attachment forms part of the AER's preliminary decision on Energex's 2015–20 distribution determination. 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

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 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
- 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 preliminary decision on the additional pass through events that will apply to Energex for the 2015–20 regulatory control period.

15.1 Preliminary decision

We do not accept the following nominated pass through events as drafted by Energex, but have proposed the following alternative definitions:

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

We do not accept the smart meter event that Energex proposed.

15.2 Energex's proposal

Energex's proposed nominated pass through events and definitions are set out in Table 15.1.

¹ NER, clause 6.5.10.

Table 15.1 Energex's proposed pass through events

Proposed event	Proposed definition
Insurance cap event	<p>An insurance cap event means an event whereby Energex:</p> <ul style="list-style-type: none"> • makes a claim and receives a payment under a relevant insurance policy, and • incurs costs beyond the relevant policy limit, and • the costs beyond the relevant policy limit materially increase the costs to Energex of providing direct control services. <p>For this insurance cap event the relevant policy limit is the greater of:</p> <ul style="list-style-type: none"> • Energex's actual policy limit at the time of the event that gives, or would have given, rise to the claim, or • the policy limit that is explicitly or implicitly commensurate with the allowance for insurance premiums that is included in the forecast opex allowance approved in the AER's final decision for the regulatory control period in which the insurance policy is issued. • A relevant insurance policy is an insurance policy held during the 2015-20 regulatory control period or a previous regulatory control period in which Energex was regulated. <p>Note:</p> <p>For the avoidance of doubt, in assessing an insurance cap event cost pass through application under rule 6.6.1, the AER will have regard to:</p> <ul style="list-style-type: none"> • the insurance premium proposal submitted by Energex in its revenue proposal • the forecast opex allowance approved in the AER's final decision; and • the reasons for that decision.
Insurer credit risk event	<p>The insolvency of a nominated insurer of Energex, as a result of which Energex:</p> <ul style="list-style-type: none"> • would incur materially higher or lower costs for insurance premiums than those allowed for in the distribution determination <p>or</p> <ul style="list-style-type: none"> • in respect of a claim for a risk that would have been insured by that nominated insurer, would be subject to a materially higher or lower claim limit or a materially higher or lower deductible than would have applied under its policy with that nominated insurer.
Terrorism event	<p>'Providing a terrorism reinsurance scheme under the Terrorism Insurance Act 2003 (Cth) is no longer in force, 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 Energex of providing direct control services'.</p>
Natural disaster event	<p>'A natural disaster is any event of force of nature caused by environmental factors that has catastrophic consequences which materially increases costs to Energex of providing direct control services and which is beyond the control of Energex. Natural disasters include, but are not limited to, bushfires, earthquakes, floods, landslides, mudslides, tornadoes, tsunamis and tropical cyclones'.</p>
Smart meter event	<p>'An obligation externally imposed on Energex, other than a regulatory change or service standard event as prescribed in clause 6.6.1.(a1), to install smart meters for some or all of its customers which materially increases the cost of providing direct</p>

Source: Energex, *Regulatory proposal July 2015 to June 2020*, pp. 228–237.

15.3 AER’s assessment approach

We must decide which of Energex’s proposed nominated pass through events will apply for the 2015–20 regulatory control period. Pass through events transfer financial risks from the 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.²

Our approach has been guided by the National Electricity Objective (NEO) and the Revenue and Pricing Principles. It provides the distributor with a reasonable opportunity to recover at least the efficient costs the operator incurs,³ while also providing effective incentives to promote economic efficiency.⁴ It promotes a balance between the economic costs and risks for promoting efficient investment.⁵

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

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

² NER, cl. 6.6.1(d),(g) and (j).

³ NEL, s.7A(2).

⁴ NEL, s.7A(3).

⁵ NEL, s.7A(6).

(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.⁶

These considerations involve an assessment of the incentives on 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 risky 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 risk. Generally, the party who is in the best position to manage the risk should bear the risk. 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 that the service can continue to be provided if the event happens. The uninsurable risk may be outside the control of the distributor and have a low probability of occurring, but it might also have a significant cost impact. 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, this may

⁶ NER, cl. 6.5.10(b); NER glossary, definition of 'nominated pass through event considerations'.

reduce the distributor's incentive to take prudent actions to prevent or mitigate the potential cost impact of the risk. Accordingly, while customers may need to accept 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 that 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 Energex 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 the AER to balance the incentives in the various parts of its decision.

15.4 Reasons for preliminary decision

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

- proposed alternative definitions for the insurance cap event, insurer credit risk event, terrorism event and the natural disaster event.
- not accepted the smart meter event.

15.4.1 Insurance cap event

The insurance cap event would allow Energex to recover material costs incurred which exceed its insurance claim limit.⁷ We accept that an insurance cap event can be consistent with the nominated pass through considerations, if appropriately defined. We do not accept Energex's proposed definition of the insurance cap event. We have amended its proposed definition to reflect matters that we will have regard to in assessing an event.

Energex is funded through its opex allowance to obtain an appropriate level of insurance for these types of risks. Subject to the comments below, we accept that an insurance cap event would protect it from high cost impact events which would be uneconomic to insure against. We consider consumers can benefit from the inclusion

⁷ Energex, *Regulatory proposal 2015–2020*, p. 233.

of such an event 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 expect that Energex will obtain efficient levels of insurance cover commensurate with its business risk as reflected in its opex allowance. We also note the following:

- the extent to which Energex is able to reasonably prevent costs being incurred which exceed its insurance cap, or take steps to mitigate incurring costs above the cap, is limited
- the coverage of insurance should be capped at a level beyond which it is unable or uneconomic to insure, having regard to the cost of premiums and the likelihood of the event.

However, we consider Energex's proposed definition of an insurance cap event is not sufficiently clear to satisfy the nominated pass through event considerations. We have therefore amended the proposed definition to make the operation of this event more transparent, by incorporating factors that we will have regard to when assessing a pass through application under this event.

If a pass through event of this kind were to occur, in assessing Energex's application to pass through costs, we will consider the efficiency of Energex's 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.⁸ This gives Energex an incentive to mitigate the risks associated with the event. This may include acquiring an appropriate level of insurance and implementing other practical risk minimisation strategies in its operations.⁹

As set out below, in our proposed definition for Energex we have:

- included the term, 'relevant insurance policy', at paragraph 5(i) to use consistent terminology throughout our definition.
- removed the reference to the 'forecast opex allowance approved in the AER's final decision' and replaced it instead with 'the level of insurance that an efficient and prudent distributor would obtain in respect of the event'. We consider that clause 6.6.1(j) of the NER would require us to consider the opex allowance and how Energex has sought to mitigate the risks of the event occurring.

⁸ NER, cl. 6.6.1(j)(3).

⁹ We note that we have not explicitly excluded insurance cap events that arise due to a finding of negligence. Negligence suggests the NSP may have some control over the event or some opportunity to limit the magnitude of the event. This may be a factor that we would have regard to in assessing such a pass through application. However, we do not consider it would be appropriate to exclude all events where the suggestion of negligence on behalf of the business has been raised. We further note that unlawful conduct and gross negligence would not be covered by an insurer and that acts or omissions resulting from such unlawful conduct or gross negligence would be relevant considerations when assessing a pass through event application, having regard to the relevant factors set out in the NER.

- removed the term, 'the reasons for that decision' in the final dot point as it duplicates clause 6.6.1(j)(3) of the NER.

.Accordingly, we have proposed a new definition as set out below.¹⁰

An insurance cap event occurs if:

1. Energex makes a claim or claims and receives the benefit of a payment or payments under a relevant insurance policy,
2. Energex incurs costs beyond the relevant policy limit, and
3. the costs beyond the relevant policy limit materially increase the costs to Energex in providing direct control services

For this insurance cap event:

4. the relevant policy limit is the greater of:
 - a. Energex'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 Energex was regulated.

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:

- 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.

15.4.2 Insurer credit risk event

The insurer credit risk event is intended to provide for circumstances in which an insurance claim is successful, but Energex is unable to recover outstanding insurance claims as a result of the insolvency of an insurance provider.

¹⁰ We note that we have not explicitly excluded insurance cap events that arise due to a finding of negligence. Negligence suggests the NSP may have some control over the event or some opportunity to limit the magnitude of the event. This may be a factor that we would have regard to in assessing such a pass through application. However, we do not consider it would be appropriate to exclude all events where the suggestion of negligence on behalf of the business has been raised. We further note that unlawful conduct and gross negligence would not be covered by an insurer and that acts or omissions resulting from such unlawful conduct or gross negligence would be relevant considerations when assessing a pass through event application, having regard to the relevant factors set out in the NER.

We accept that an insurer credit risk event can be consistent with the nominated pass through considerations, if appropriately defined. We do not accept the proposed definition of an insurer credit risk event because we do not consider that it provides sufficient clarity around when we would accept an event.¹¹ We also do not accept the element of the definition which would allow the distributor to recover the costs associated with variations to the insurance premium. To this end, we have amended Energex's proposed definition of this pass through event to reflect matters that we will have regard to in assessing an event.

A distributor may suffer a significant loss as a consequence of an insurer becoming insolvent and thereby unable to satisfy all insurance claims. Distributors 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 distributors 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.

We therefore accept that an insurer credit risk event can be consistent with the nominated pass through considerations, if appropriately defined. We consulted with Energex and others on an appropriate definition for this event.¹² As a result of this consultation, we have clarified that we may allow distributors to pass through claims that would have been made immediately after the insurer became insolvent and before the distributor had a reasonable opportunity to acquire new insurance for those risks. This amendment maintains an incentive on distributors to acquire new insurance as soon as reasonably possible after an insurance provider becomes insolvent. We have also defined this pass through event to include the matters that we will have regard to in assessing an event.

In its definition for this event, Energex sought to pass through the costs associated with material 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 are best placed to bear rather than customers. We therefore do not consider it appropriate to allow this element of the nominated pass through event.

As set out below, we have proposed an alternative definition to incorporate factors that we will have regard to when assessing a claim for a pass through. We have also removed the element which would allow pass throughs for changes to insurance premiums. For consistency with other determinations made at this time we have referred to this event as the 'insurer's credit risk event'.

An insurer's credit risk event occurs if:

A nominated insurer of Energex 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, Energex:

¹¹ NER, glossary, definition of 'nominated pass through event considerations', paragraph (b).

¹² Information request and response 053, 26 March 2015.

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

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,

- Energex'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 Energex had reasonable opportunity to insure the risk with a different provider.

15.4.3 Terrorism event

This event allows Energex to pass through the costs of terrorism events. For the 2010–15 regulatory control period, this was a prescribed pass through event. A rule change removed the terrorism event from the prescribed list of pass through events. The decision whether to accept this event is now to be made by us as part of the determination process, considering the circumstances of each network business.

In relation to this event, we note:

- Energex has a range of measures in place to prevent acts of terrorism affecting its operations, or mitigate the impacts of an event should one occur.¹³ Energex has an ongoing program to mitigate the security risk to its network and non-network assets. Examples include reviews to identify critical infrastructure and to determine security risks.¹⁴ Energex also works in association with the Queensland Police Intelligence Counter Terrorism and Major Events Command Branch and the Australian Security Intelligence Organisation to respond to the threat of terrorist and issue-motivated group attacks on critical infrastructure.¹⁵
- The Australian Government terrorism reinsurance scheme, established under the *Terrorism Insurance Act 2003* (Cth), would be likely to cover Energex for losses arising from acts of terrorism, including cyber terrorism.¹⁶ The scheme was introduced by the Australian Government, recognising market failure by the insurance industry in this area. Energex notes that the scheme is to be reviewed every three years. Should the scheme be revoked when it is next reviewed in 2017, Energex could be left exposed to losses resulting from terrorism acts without necessarily being able to access external insurance on terms which are commercially acceptable.

¹³ NER, glossary, definition of 'nominated pass through event considerations', paragraph (c).

¹⁴ Energex, *Regulatory proposal*, p. 235.

¹⁵ Energex, *Regulatory proposal*, p. 235.

¹⁶ Energex, *Regulatory proposal*, p. 236.

- The commercial market for insurance in Australia is not strong (hence the introduction of the reinsurance scheme) and would be unlikely to be available on commercial terms should the reinsurance scheme be revoked.¹⁷ Energex does have commercial insurance which, while not specific to a terrorism event, may be triggered if a terrorism event occurred.¹⁸ However, this may not cover all the costs associated with a terrorism event.
- Energex has the option of self-insuring but the relative infrequency and potentially high costs of terrorism events create significant challenges for self-insurance for this type of risk.¹⁹ Further, there is limited data on which to calculate a credible self-insurance premium.²⁰ Taking out further insurance would likely be inefficient and result in an unnecessary cost increase to customers.

These events are largely beyond the control of Energex but potentially could have a high cost impact. As noted above, we consider that Energex has taken prudent actions to mitigate the risks of these events occurring and the likely costs to the network if they do occur. Based on our assessment approach these events should therefore be included as nominated pass through events.

We consider that there may be some overlap between an insurance cap event, including the terrorism reinsurance scheme under the *Terrorism Insurance Act 2003* (Cth), and the terrorism event. We accept there is a case for inclusion of both events where Energex may incur costs resulting from a terrorism event which an insurance policy would not ordinarily cover.

However, we do not accept the proposed definition of a terrorism event is sufficiently clear to satisfy the nominated pass through considerations. We also consider that a terrorism event should be more clearly defined so that the event can be clearly identified and assessed.²¹ We have amended the proposed definition to incorporate factors that we will have regard to when assessing a claim for a pass through. We note that Energex's opex allowance includes funding for insurance and self-insurance yet it may have an incentive to keep that allowance (and not insure the risk) while managing this risk through the pass through mechanism. We consider that this disincentive to insure against terrorism can be reduced by clarifying the pass through event definition. These amendments to the pass through event definition will also assist in clarifying the interaction between the insurance cap and terrorism events.

Whether a relevant government authority has made a relevant declaration in respect of a terrorism event is also a factor that we would also 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 have included this element in our definition.

¹⁷ Australian Government, *Terrorism Insurance Act Review*, May 2012.

¹⁸ NER, glossary, definition of 'nominated pass through event considerations', paragraph (d)(1).

¹⁹ Energex, *Regulatory proposal*, October 2014, p. 236.

²⁰ NER, glossary, definition of 'nominated pass through event considerations', paragraph (d)(2).

²¹ NER, glossary, definition of 'nominated pass through event considerations', paragraph (b).

Accordingly, as set out below, we have proposed a new definition which includes the factors that we will have regard to in assessing a pass through application for a 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 Energex 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 Energex 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.

15.4.4 Natural disaster event

This event will allow Energex to pass through the costs associated with natural disasters. We accept that a natural disaster event can be consistent with the nominated pass through considerations, if appropriately defined. We do not accept the proposed definition. To this end, we have amended Energex's proposed definition of this pass through event to reflect matters that we will have regard to in assessing an event.

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

In relation to this event, we note:

- Energex has a range of measures in place to mitigate the impacts of an event, should one occur.^{22 23}
- Energex is unable to take out external insurance for natural disasters on reasonable terms or this would likely be inefficient and result in an unnecessary cost increase to customers.^{24 25}

²² NER, glossary, definition of 'nominated pass through event considerations', paragraph (c).

²³ Energex, *Regulatory proposal*, October 2014, pp. 229–231.

²⁴ NER, glossary, definition of 'nominated pass through event considerations', paragraph (d)(1).

²⁵ Energex, *Regulatory proposal*, October 2014, p. 229.

- Energex has not included a self-insurance amount in its opex proposal.^{26 27}

However, we do not accept Energex's proposed definition of the natural disaster event. Energex's opex allowance includes funding for insurance yet it may have an incentive to keep that allowance (and not insure the risk) while managing this risk through the pass through mechanism. We consider that this incentive can be balanced if the definition of the natural disaster event recognises that, in assessing a pass through application under this event, we will have regard to whether Energex has taken prudent and efficient steps to insure against the event.²⁸

We do not accept Energex's view that the term, 'major' is not necessary for Energex. Pass throughs should not be available for events which could be considered part of the ordinary risks that a distributor is exposed to. Under our assessment approach the distributor is best placed to bear the risks of these types of events. We therefore maintain our view that keeping the term, 'major' in the natural disaster event is appropriate.

Energex's definition also included references to 'environmental factors' and 'catastrophic consequences'. While we do not necessarily disagree with these definitions, they introduce ambiguous concepts that may not assist in determining whether a natural disaster event has occurred. We therefore have not included these in our proposed definition.

Whether a relevant government authority has made a relevant declaration in respect of a natural disaster event is also a factor that we would also 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 have included this element in our definition.

Accordingly, in our proposed definition for Energex set out below we have:

- amended the proposed definition to incorporate factors that we will have regard to when assessing a pass through application
- removed the references to 'environmental factors, and 'catastrophic consequences'
- included the word, 'major'.

A natural disaster event occurs if:

Any major fire, flood, earthquake or other natural disaster occurs during the 2015-20 regulatory control period and materially increases the costs to Energex 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

²⁶ NER, glossary, definition of 'nominated pass through event considerations', paragraph (d)(2).

²⁷ Energex, *Regulatory proposal*, October 2014, p. 229.

²⁸ NER, glossary, definition of 'nominated pass through event considerations', paragraph (d).

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).

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

- i. whether Energex 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.

15.4.5 Smart meter event

Energex stated that an obligation to install smart meters is more likely than in previous periods. It referred to the AEMC's current Expanding Competition in Metering and Related Services rule change process and the Power of Choice review. It also referred to the Queensland Government's policy to pursue smart meters subject to a favourable cost benefit analysis.²⁹

We do not accept the smart meter event as a pass through event in our preliminary decision because the event is likely to be covered by another category of pass through event.³⁰ Energex did not provide an explanation why the smart meter event would not already be covered by the regulatory change event. If the rule change materially changes Energex's costs, then Energex may be able to make a pass through application to the AER under one of the existing prescribed pass through events.

Energex noted that we did include a smart meter event in our 2010–15 distribution determination. Since then, the NER has been amended to include specific considerations which we must have regard to, the nominated pass through event considerations. As discussed above we do not consider that the proposed smart meter event is consistent with these considerations.

Accordingly, we do not consider there is a need to for an additional specific pass through event to cover the potential costs of this event, beyond those set out in the NER or approved in this determination.

²⁹ Energex, *Regulatory proposal*, October 2014, p. 237.

³⁰ NER, glossary, definition of 'nominated pass through event considerations', paragraph (a).