

Determination

2022 North Coast Flooding Cost pass through Essential Energy

March 2023

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Contents

Overview	1
1 Introduction	3
1.1 Who we are and our role in this process	3
1.2 Essential Energy's application	3
2 Determination	4
3 Relevant regulatory requirements and assessment approach	5
3.1 Timing matters	5
4 Reasons for determination	6
4.1 Occurrence of a natural disaster	6
4.2 Positive change event	7
4.3 Timing of Essential Energy's application	8
4.4 Assessment of the pass through amount	9
4.5 Timing of cost pass through recovery	13
5 NER requirements and stakeholder submissions	14
Glossary	18

Overview

On 21 December 2022, Essential Energy submitted a cost pass through application seeking to recover actual and forecast costs as a result of the flooding event that occurred from 22 February and into early March 2022 on the North Coast of New South Wales. Essential Energy stated that the flooding event caused extensive damage to its electricity distribution network, resulting in major outages which impacted 69,603 customers.¹

Essential Energy is seeking to recover \$25.1 million (\$nominal) in incremental costs (capital and operating expenditure) that were not allowed for in Essential Energy's distribution determination for the 2019-24 regulatory control period.² This equates to Essential Energy proposing a cost pass through amount of \$3.8 million (\$nominal, smoothed) in incremental revenue, to be recovered in 2023-24, the final year of its current 2019-24 regulatory control period.

Under the National Electricity Rules (NER), Essential Energy is able seek the approval of the Australian Energy Regulator (AER), to pass through to network users a positive pass through amount in respect of certain events (referred to in the NER as positive change events).³ A cost pass through application must address specified matters.⁴

If the AER determines that a positive change event has occurred in respect of a cost pass through application, the AER is required to determine (within a specified timeframe):

- the approved pass through amount, and
- how much of that amount should be passed through to distribution network users in the regulatory year, and each regulatory year after that, in which the positive change event occurred,

taking into account the matters referred to in clause 6.6.1(j) of the NER.⁵

On 19 January 2023, we published Essential Energy's application on our website and invited stakeholder submissions. We did not receive any stakeholder submissions.

This determination sets out our assessment of Essential Energy's application and addresses the requirements for cost pass throughs set out in clause 6.6.1 of the NER.

We are satisfied that the 2022 North Coast Flooding event meets the definition of a natural disaster pass through event. Based on our consideration of the factors set out in clause 6.6.1(j) of the NER, we determine to allow the pass through of the costs relating to the 2022 North

¹ Essential Energy, *Essential Energy Cost pass through application – 2022 North Coast Flooding*, December 2022. p 3.

² Essential Energy, *Attachment C – Detailed cost information.xlsx*, December 2022.

³ NER, cl. 6.6.1(a). A positive change event is: (a) a pass through event, other than a retailer insolvency event, which entails the Distribution Network Service Provider incurring materially higher costs in providing direct control services than it would have incurred but for that event but does not include a contingent project or an associated trigger event; or (b) a retailer insolvency event. A pass through event is those events specified in clause 6.6.1(a1).

⁴ NER, cl. 6.6.1(c).

⁵ NER, cl. 6.6.1(d).

Coast Flooding cost pass through application. However, we have adjusted Essential Energy's proposed cost pass through amount to reflect only the actual and likely increase in costs that Essential Energy will incur within the current regulatory period solely as a consequence of the flooding event. This adjustment decreased the cost pass through amount by \$1.6 million (\$nominal, smoothed), from \$3.8 million (\$nominal, smoothed) to \$2.2 million (\$nominal, smoothed). Our adjustments are discussed in greater detail in section 4.4 of this report.

We are satisfied that the materiality threshold to constitute a positive change event has been met and that the costs incurred by Essential Energy as a direct result of the 2022 North Coast Flooding and included in this determination were prudent and efficient.

Our determination is to approve a positive pass through amount of \$2.2 million (\$nominal, smoothed) to be recovered in 2023-24, the final year of Essential Energy's 2019–24 regulatory control period through the X-factor set in the PTRM.

We estimate that the approved cost pass through amount will add approximately \$2 to the average residential customer's bills and \$4 to the average small business' bills in 2023–24.

1 Introduction

This section sets out the AER's role in assessing cost pass through applications from electricity distribution network service providers (DNSPs), and information on Essential Energy's application.

1.1 Who we are and our role in this process

The AER regulates Essential Energy's revenues through five-year distribution revenue determinations. Essential Energy's current revenue determination for the 2019–24 regulatory control period runs from 1 July 2019 to 30 June 2024.

We are responsible for assessing cost pass through applications.⁶ Under the NER, a distribution business may apply to us seeking the recovery of additional costs incurred during a regulatory control period, if predefined events occur as specified in either the NER or in its respective revenue determination.⁷

1.2 Essential Energy's application

On 21 December 2022, Essential Energy submitted a cost pass through application seeking to recover the costs it has incurred, and expects to incur, as a result of the 2022 North Coast Flooding in New South Wales.⁸

Essential Energy submitted that the 2022 North Coast Flooding caused extensive damage to its network. In late February and early March the magnitude of the flooding greatly exceeded anything previously recorded in the area resulting in the Lismore Central Business District and other regional centres being submerged. Essential Energy had substations, depots and whole sections of the network immersed or water damaged, resulting in major outages across the north coast, impacting 69,603 customers.⁹

Essential Energy stated that it has or will incur \$25.1 million (\$nominal) in additional costs as a result of the 2022 North Coast Flooding, apportioned as shown in table 1 below.

Table 1: Essential Energy – additional costs related to the 2022 North Coast Flood (\$million, nominal)

	2019-20	2020-21	2021-22	2022-23	2023-24	Total
Capex	-	-	13.0	1.6	8.4	22.9
Opex	-	-	1.7	0.5	-	2.2
Total	-	-	14.7	2.0	8.4	25.1

Source: Essential Energy, *Attachment C – Detailed cost information.xlsx*, December 2022 Essential Energy, *Cost pass through application for 2022 North Coast Flooding*, December 2022, p.12.; AER analysis.

Numbers may not add up to total due to rounding. Differences of '0.0' and '-0.0' represent small variances and '-' represents no variance.

The revenue impact of the proposed pass through amount is \$3.8 million (\$nominal, smoothed) in the 2023–24 regulatory year.

⁶ NER, cl. 6.6.1(d).

⁷ NER, cl. 6.6.1(a).

⁸ Essential Energy, *Cost pass through application – 2022 North Coast Flooding* - December 2022. p 3.

⁹ Essential Energy, *Cost pass through application – 2022 North Coast Flooding* - December 2022. p 4.

2 Determination

Based on our consideration of all the matters set out in this decision, we consider that Essential Energy's application, as submitted on 21 December 2022, establishes that a pass through event has occurred in respect of the 2022 North Coast Flooding, being a natural disaster pass through event as specified in Essential Energy's 2019–24 revenue determination. Our assessment against the requirements of a positive change event is summarised in section 5 (Table 5).

We are satisfied that the 2022 North Coast Flooding event constitutes a positive change event as defined under the NER. In particular, we are satisfied that Essential Energy incurred a material increase in the costs of providing direct control services in the 2021–22 regulatory year as a result of this pass through event.

Our determination is to approve a positive pass through amount of \$2.2 million (\$nominal, smoothed), to be recovered in 2023-24, the final year of Essential Energy's 2019–24 regulatory control period through the X-factor set in the PTRM.

Sections 4 and 5 set out our assessment of Essential Energy's cost pass through application and the positive pass through amount.

3 Relevant regulatory requirements and assessment approach

The pass through mechanism recognises that an efficient revenue allowance cannot account for certain matters that are uncertain and outside the control of the business and which cannot be prevented or mitigated by prudent operational risk management. A cost pass through enables a network service provider to recover the costs of defined unpredictable, high-cost events not factored into our five-year revenue determination for the business.

Clause 6.6.1(a1) of the NER defines a pass through event as one of the following prescribed pass through events for all distribution network service providers: a regulatory change event; a service standard event; a tax change event; a retailer insolvency event, and any other event specified in a distribution determination as a pass through event for the determination (a nominated pass through event).

The first step in our assessment is to determine whether a pass through event has occurred and examine timing matters, e.g. whether an application is submitted within the timeframe set out in the NER. Once we have determined that a pass through event has occurred, we are to determine whether it is a positive (or negative) change event.

The NER defines a positive change event for a DNSP as:

“a pass through event...which entails the DNSP incurring materially¹⁰ higher costs in providing direct control services than it would have incurred but for that event...”¹¹

We undertake this assessment with reference to the NER and the revenue determination applicable to Essential Energy when the 2022 North Coast Flooding occurred, which is Essential Energy’s distribution determination for the 2019–24 regulatory control period.

As part of this process, we examine whether Essential Energy’s application has addressed matters specified in clause 6.6.1(c) of the NER (see section 5 below (Table 4 and Table 5)). We also determine the materiality of the proposed pass through amount.

If the AER determines that a positive change event has occurred, the AER must determine:

- the approved pass through amount, and
- the amount that should be passed through to distribution network users in the regulatory year, and each regulatory year after that, in which the positive change event occurred, taking into account the factors referred to in clause 6.6.1(j) of the NER.

3.1 Timing matters

To seek the approval of the AER to pass through a positive pass through amount, clause 6.6.1(c) of the NER requires a DNSP to submit a written statement specifying a range of details relating to the event within 90 business days of the positive change event occurring.

The NER requires us to make a determination within the timeframe specified in clause 6.6.1(e), that is, within 40 business days from the later of the date the AER received the cost pass through application and the date it received any additional information required through a notice issued under clause 6.6.1(e1) of the NER.

¹⁰ Materially higher costs means the costs incurred or likely to be incurred in any regulatory year of a regulatory control period, as a result of that event, exceed 1% of the maximum allowed revenue for that year.

¹¹ NER, chapter 10.

4 Reasons for determination

The sections below set out the reasons for our determination.

4.1 Occurrence of a natural disaster

This determination relates to a nominated pass through event, being a natural disaster event as specified in Essential Energy's 2019-24 revenue determination.

A natural disaster event is defined in Essential Energy's 2019-24 revenue determination:¹²

- *“Any natural disaster including but not limited to major fire, flood, earthquake, or Government declared state of emergency, beyond the reasonable control of Essential Energy that occurs during the 2019-24 regulatory period and materially increases the costs to Essential Energy in providing direct control services; provided the event was not a consequence of a negligent act or omission 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:

- *whether Essential Energy has insurance against the event;*
- *the level of insurance that an efficient and prudent DNSP would obtain in respect of the event; and*
- *maintaining assets at a level expected of the industry.*

4.1.1 Natural disaster event

We consider the 2022 North Coast Flooding satisfies the definition of a natural disaster pass through event as specified in Essential Energy's determination. In particular, the 2022 North Coast Flooding was:

- a flood (an event specified in the definition as being a natural disaster),
- responded to by State and Federal Governments as a natural disaster;¹³
- unexpected; and
- caused severe damage to property.

For example, the Australian Government made disaster relief payments to assist New South Wales residents to recover from the damage caused by the flooding that occurred from 22 February to early March (the subject of Essential Energy's application).

¹² AER, Draft decision *Essential Energy distribution determination - Attachment 14 - Pass through events* – November 2018, pp. 6-7.

¹³ New South Wales Government, <https://www.nsw.gov.au/disaster-recovery/natural-disaster-declarations>, viewed 03 February 2023.

The 2022 North Coast Flooding increased the costs to Essential Energy in providing direct control services and the event was not a consequence of an act or omission of Essential Energy – it was outside of Essential Energy’s control, and it was unforeseeable.

4.1.1.1 Effect of the event could not be prevented or mitigated

The magnitude of flooding saw peak levels reach 14.4 metres, exceeding the margin for modelling of a 1 in 100 year event by two metres and that of a 1 in 500 year event by one metre.¹⁴ We consider the decisions and actions of Essential Energy in response to the event were efficient and that the 2022 North Coast Flooding event could not have been prevented or mitigated through prudent operational risk management.

Essential Energy stated, given the greater likelihood of extreme weather events and natural hazards in the future it is adjusting its network planning practices so that its ongoing investments will build and maintain a reliable and safe network for the change which may lie ahead. This includes Essential Energy’s decision to relocate the primary zone substation servicing Lismore and the South Lismore Depot to higher ground.

Essential Energy has also stated that it is completing a detailed climate risk assessment of the network which involves modelling the effect of climate change on flood patterns, bushfires and windstorms on multiple Representative Concentration Pathway scenarios over the coming decades to improve its network resilience.¹⁵

We accept that Essential Energy’s network risk management and planning practices were appropriate and that Essential Energy did not reasonably do anything or omit to do anything that had the potential to increase the pass through amount.

4.2 Positive change event

If we are satisfied that a pass through event has occurred, we must determine whether the pass through event qualifies as a “positive change event”. That is, whether Essential Energy incurred materially higher costs in providing direct control services than it would have incurred but for the pass through event.

The NER defines “materially” as:

“For the purposes of the application of clause 6.6.1, an event results in a DNSP incurring materially higher or materially lower costs if the change in costs (as opposed to the revenue impact) that the DNSP has incurred and is likely to incur in any regulatory year of a regulatory control period, as a result of that event, exceeds 1% of the annual revenue requirement for the DNSP for that regulatory year.”

As is evidenced in Table 2 below, we consider the required additional costs incurred by Essential Energy in providing direct control services as a result of the 2022 North Coast Flooding event meet the materiality threshold for the 2021–22 regulatory year.¹⁶

¹⁴ Essential Energy, *Cost pass through application – 2022 North Coast Flooding* - December 2022. p 4.

¹⁵ Essential Energy, *Cost pass through application – 2022 North Coast Flooding* - December 2022. p 4.

¹⁶ The materiality has been assessed on AER’s determination of approved additional costs required.

Table 2 AER – Materiality assessment of the 2022 North Coast Flooding event (\$million, nominal)

	2019-20	2020-21	2021-22	2022-23	2023-24	Total
Approved cost pass through opex	-	-	0.6	0.3	-	0.9
Approved cost pass through capex	-	-	11.9	0.9	-	12.9
Approved totex	-	-	12.5	1.2	-	13.8
AER approved unsmoothed revenues as per 2022-23 RoD updated PTRM	950.0	1012.2	1030.5	1048.6	1053.1	5094.5
Materiality	-	-	1.2%	0.1%	-	0.3%

Source: Essential Energy, *Information request IR#02 Essential Energy response – Attachment C Detailed cost spreadsheet*, February 2023; AER analysis.

Numbers may not add up to total due to rounding. Differences of '0.0' and '-0.0' represent small variances and '-' represents no variance.

4.3 Timing of Essential Energy's application

Clause 6.6.1(c) of the NER requires a DNSP to submit a pass through application to us within 90 business days of the positive change event occurring.

We consider the 2022 North Coast Flooding event to have commenced on 22 February 2022 and continued through to early March 2022. Essential Energy requested on 28 March 2022 an extension to submit the 2022 North Coast Flooding cost pass through application by 31 December 2022.¹⁷ Clause 6.6.1 (k) of the NER requires the AER to extend the fixed time limit if it is satisfied that the difficulty of assessing or quantifying the effect of the pass through justifies the extension. Based on the information provided by Essential Energy in its request, the AER was satisfied that the proposed extension was required.¹⁸

We received Essential Energy's cost pass through application on 21 December 2022.

Following our initial assessment of Essential Energy's application, we issued an information notice to Essential Energy (on 31 January 2023) under clause 6.6.1(e1) of the NER, requesting further information on the scope of works and associated costs.¹⁹

We received Essential Energy's response to our information notice on 8 February 2023. Accordingly, we are required to make this determination by 5 April 2023.

¹⁷ Essential Energy, *Application for cost pass through extensions – North Coast Floods*, 28 March 2022

¹⁸ AER, *Letter to Essential Energy – Request for extension of time to submit cost pass through application*, 14 April 2022.

¹⁹ AER, *IR – AER Letter to Essential Energy – Notice under clause 6.6.1(e1) of the NER*, 31 January 2023.

4.4 Assessment of the pass through amount

In assessing a pass through application, the NER requires us to take into account a range of relevant factors,²⁰ including the need to ensure that Essential Energy only recovers any actual or likely increment in costs, to the extent that such an increment is solely as a consequence of the pass through event,²¹ and that Essential Energy does not recover costs that have or will be factored into Essential Energy's annual revenue requirement.²²

We approach this assessment by ensuring, amongst other factors, that:

- the pass through amount reflects only those costs incurred as a result of the 2022 North Coast Flooding natural disaster event, and not costs incurred as a result of other positive change events, business-as-usual costs, or costs of increasing the scope of network services provided by Essential Energy
- the costs incurred are prudent and efficient costs required to rectify the damage caused by the flood event;
- the pass through amount reflects only the incremental cost of the 2022 North Coast Flooding, taking into account deductions for actual and expected cost savings that will occur as a result of works undertaken to address the flood. For example, the replacement of older assets damaged by the floods with new assets may result in lower future inspection and maintenance costs, which should be deducted from the costs to be passed through.

We are satisfied that Essential Energy's estimates of the increase in capex and opex costs due to the 2022 North Coast Flooding, accounting for the identified avoided costs, are reasonable. However, we have adjusted Essential Energy's proposed cost pass through amount to:

- exclude property costs likely to form part of an insurance claim
- reflect only the costs we are satisfied that Essential Energy has incurred or is likely to incur within the current regulatory period as a consequence of the flooding event.

Our reasons for this are discussed below.

Our determination on the approved incremental revenue for the 2022 North Coast Flooding event is set out below in Table 3.

²⁰ NER, cl. 6.6.1(j).

²¹ NER, cl. 6.6.1(j)(5).

²² NER, cl. 6.6.1(j)(7).

Table 3 AER – approved incremental revenue for the 2022 North Coast Flooding (\$million, nominal)

	2019-20	2020-21	2021-22	2022-23	2023-24	Total
Return on capital	-	-	-	0.6	0.7	1.3
Return of capital (regulatory depreciation)	-	-	-	-0.0	-0.0	-0.0
Operating expenditure	-	-	0.6	0.3	-	0.9
Net tax allowance	-	-	-0.0	-0.0	-0.0	-0.1
Incremental annual revenue requirement (unsmoothed)	-	-	0.6	0.8	0.6	2.1
Incremental annual expected revenue (smoothed)	-	-	-	-	2.2	2.2

Source: AER's analysis

Note: '0.0' and '-0.0' represent small nonzero number and '-' represents zero. The smoothed and unsmoothed revenues are equal in NPV terms. The difference between the nominal smoothed and unsmoothed total revenues is explained by the time value of money.

4.4.1 Incremental revenue and pass through amount calculations

Essential Energy's application included \$25.1 million (\$nominal) of additional capital and operating costs (total expenditure or totex) required to address the flooding event. We assessed Essential Energy's proposed costs, and requested further information in regard to property expenditure items covered by insurance and forecast 2023-24 capex costs.²³ After reviewing Essential Energy's response²⁴, we have reduced the proposed additional costs by \$11.3 million (\$nominal) to ensure that only actual and likely costs are recovered to address the damage caused by the flood, as shown in Table 4 below. Our reasoning is explained below.

Table 4 AER – approved additional costs for the 2022 North Coast Flooding (\$million, nominal)

	2019-20	2020-21	2021-22	2022-23	2023-24	Total
Proposed cost pass through totex	-	-	14.7	2.0	8.4	25.1
Approved cost pass through totex	-	-	12.5	1.2	-	13.8
Difference	-	-	-2.2	-0.8	-8.4	-11.3

Source: AER's analysis

Note: '0.0' and '-0.0' represent small nonzero number and '-' represents zero. The smoothed and unsmoothed revenues are equal in NPV terms. The difference between the nominal smoothed and unsmoothed total revenues is explained by the time value of money.

²³ AER, *IR – AER Letter to Essential Energy – Notice under clause 6.6.1(e1) of the NER*, 31 January 2023; AER, *Essential Energy 2022 North Coast Flooding CPT Information Request #002*, 16 February 2023.

²⁴ Essential Energy, *IR#002 Essential Energy response – Confidential*, 23 February 2023.

Insurance – Property expenditure items

Essential Energy's application stated that insurance policies were held for the South Lismore Zone Substation, and the Murwillumbah and South Lismore Depots. Therefore, costs associated with damage rectification or replacement of these assets fall outside the scope of this application.²⁵ We requested Essential Energy to confirm that none of the proposed property expenditure item costs for these assets were also included in its insurance claims.

Essential Energy advised that, following a further detailed review of the property expenditure item costs submitted in its proposal, these items are likely to form part of its insurance claims.²⁶ Essential further stated that in addition to reviewing the property expenditure category, it has identified further costs which are potentially subject to insurance claims. Therefore, we have adjusted the proposed totex expenditure to remove all items likely to be included in Essential Energy's insurance claims in relation to the event.

Forecast 2023-24 Capex costs

Essential Energy proposed \$8.4 million (\$nominal) of forecast 2023-24 capex costs for works to strengthen network resilience in the likelihood of future flooding events. We requested Essential Energy to provide an economic cost-benefit analysis, demonstrating the proposed capex works planned to occur in 2023-24, was the most prudent and cost efficient long term solution to ensure the quality, reliability and security of delivering services. We also requested further evidentiary information that the total 2023-24 forecast capex costs would be incurred within this period.

Based on the information provided by Essential Energy, we are not satisfied that Essential Energy has submitted persuasive evidence which demonstrates that the forecast capex costs identified are likely to be incurred in 2023-24.

In the case of a positive change event, the approved pass through amount should only reflect the increase in costs in the provision of direct control services that, as a result of the positive change event, the distributor has incurred and is likely to incur. This ensures that the distributor only recovers within the regulatory control period the incremental costs it incurs solely as a consequence of that event.²⁷

We have not included Essential Energy's proposed 2023-24 capex forecast costs in our approved pass through amount as we are not satisfied that the costs are likely to be incurred in 2023-24. The forecast 2023-24 capex costs, in terms of both timing and quantum, are subject to a significant degree of uncertainty due to factors beyond Essential Energy's control. We consider our approved pass through amount provides for the prudent and efficient incremental expenditure likely to be incurred by Essential Energy in the current regulatory control period as a consequence of the flood event.

In regard to additional costs associated with strengthening Essential Energy's network resilience, we consider that it is reasonable in the circumstances for Essential Energy to

²⁵ Essential Energy, *Cost pass through application – 2022 North Coast Flooding* - December 2022. p 7.

²⁶ Essential Energy, Information Request *IR#002 Essential Energy response - Public*, 23 February 2023.

²⁷ NER, cl. 6.6.1(j)(5).

consider longer term solutions that minimise future additional cost pass through amounts resulting from flooding events. However, we have not made a determination on the prudence or efficiency of such costs in the context of this cost pass through determination. We note that Essential Energy's regulatory determination process for the 2024–29 regulatory control period is currently underway. We consider that process provides the appropriate context in which to consider the need, timing and cost of such investments which, if justified, are likely to occur within the next regulatory control period. That will help to ensure that any expenditure incurred is based on the option that likely achieves the greatest net benefit of the feasible options considered, and that consumers have been fully informed of different resilience expenditure options.²⁸

4.4.2 Costs reflect only 2022 North Coast Flooding-related costs and not business-as-usual costs

We are satisfied that the costs included in our approved pass through amount are costs incurred as a consequence of the 2022 North Coast Flooding, and do not include business-as-usual costs. These costs have been demonstrated to be incremental costs and separate to the business-as-usual costs of operating the distribution network.

Essential Energy described the process it used for isolating the 2022 North Coast Flooding-related costs it incurred from its business-as-usual costs by establishing discrete project codes related directly to the flooding. This ensured the direct expenses attributable to the floods were identifiable. Essential Energy also engaged Deloitte consultants to undertake a quality assurance review to ensure the incremental costs included in the application were accurate and related directly to the North Coast Flooding event.

In calculating the eligible pass through amount, Essential Energy included only the incremental costs for those activities that were incurred solely as a result of the positive change event. To be clear, Essential Energy excluded the following costs from its claim:

- administrative and office based costs
- corporate and network overheads from all cost categories
- costs associated with rectification or replacement of damaged or destroyed insured assets.

We have reviewed Essential Energy's cost calculations and are satisfied Essential Energy's application reflected only the costs incurred as a result of the 2022 North Coast Flooding.

4.4.3 The level of 2022 North Coast Flooding-related costs reflects the prudent and efficient costs to maintain service levels

We are satisfied that the level of costs Essential Energy has incurred as a result of the 2022 North Coast Flooding event reflects efficient costs. We have examined the scope of actions and works Essential Energy undertook in response to the 2022 North Coast Flooding event, and consider them to be reasonable and in line with good industry practice.

²⁸ AER, *Network resilience - A note on key issues*, April 2022, pp. 11-13.

4.4.4 Cost reflects adjustments for savings to business-as-usual costs resulting from the 2022 North Coast Flood expenditure

We are satisfied that Essential Energy's pass through amount reflects deductions for savings to business-as-usual costs resulting from its flood expenditure. Essential Energy proposed an expenditure decrement of \$0.01 million (\$nominal) from the total costs for tasks that were existing prior to the flooding event, which we consider reasonably captures the likely savings.

4.4.5 Submissions from stakeholders

We received no submissions from stakeholders.

4.5 Timing of cost pass through recovery

Essential Energy has proposed to recover the incremental revenue arising from its cost pass through application in 2023-24, the final year of its current 2019-24 regulatory control period. We agree with this proposed approach.

5 NER requirements and stakeholder submissions

For a cost pass through to be determined, there must be a positive change event that results in an eligible pass through amount. Essential Energy can then submit a pass through application, that must address certain matters specified in the NER.²⁹ We make a determination on Essential Energy's cost pass through application and determine the approved pass through amount and the regulatory years in which that pass through amount is to be recovered.³⁰

For the reasons set out in Table 5 below, we are satisfied that a positive change event has occurred, and that Essential Energy's application relating to the 2022 North Coast Flooding specifies the necessary matters required by the NER. Additionally, after consideration of the factors set out in Table 5 below, we are satisfied the appropriate pass through amount is \$2.2 million (\$nominal), to be recovered in 2023-24, the final year of Essential Energy's 2019–24 regulatory control period.

Table 5: Requirements for determining a positive change event has occurred

Requirement of the NER	Our consideration
Is the pass through event a regulatory change event, service standard event, tax change event, or retailer insolvency event? ³¹	No.
Is the pass through event a contingent project or a trigger event associated with a contingent project? ³²	No.
Does the pass through relate to any other event specified in Essential Energy's 2019–24 distribution determination as a pass through event for that determination? ³³	Yes. We consider that the 2022 North Coast Flooding satisfies the natural disaster pass through event definition specified in Essential Energy's determination, which is defined as including cyclone, fire, flood, earthquake or other event, provided the event was not a consequence of the acts or omissions of the service provider. ³⁴
Was the pass through event a consequence of acts or omissions of Essential Energy?	No, there is no evidence that Essential Energy's acts or omissions caused the 2022 North Coast Flooding event.
Did the 2022 North Coast Flooding cost pass through event entail Essential Energy incurring materially higher costs in providing direct control services than it would have incurred but for the event? ³⁵	Yes. As discussed in section 4.2, we consider the additional costs incurred by Essential Energy in providing standard control services as a result of the 2022 North Coast Flooding meet the materiality threshold. Essential Energy's annual revenue requirement (unsmoothed) for the 2021–22 regulatory year during which the flood occurred was \$1,030.5 million (\$nominal), 1% of which is \$10.30 million (\$nominal). We consider that the efficient amount of opex and capex incurred as a result of the 2022 North Coast Flooding in 2021-22 (\$12.5 million, \$nominal) exceeds this amount, and therefore the increase

²⁹ NER, cl. 6.6.1(c).

³⁰ NER, cl. 6.6.1 (d).

³¹ NER, cl. 6.6.1(a1)(1) through 6.6.1(a1)(4); and chapter 10.

³² See the definition of "positive change event" in chapter 10 of the NER.

³³ NER, cl. 6.6.1(a1)(5)

³⁴ AER, *Draft decision Essential Energy distribution determination - Attachment 14 - Pass through events* – November 2018, p. 10.

³⁵ That is, does it meet the definition of a "positive change event" as defined in chapter 10 of the Rules.

Requirement of the NER	Our consideration
	in costs incurred in providing direct control services as a result of the event exceed the materiality threshold.
What is the date on which the positive change event occurred?	For the purpose of complying with 6.6.1(c), Essential Energy indicated that the flooding occurred from 22nd February to early March 2022. We agree with Essential Energy as the New South Wales and Federal Governments recognise this date in providing assistance packages to affected individuals and communities. ³⁶
Did Essential Energy submit a written statement of its pass through application within 90 business days of the positive change event occurring? ³⁷	Yes. As discussed in section 4.3, Essential Energy was approved an extension to submit its cost pass through application by 31 December 2022. We consider that Essential Energy has submitted its written statement within the allowed timeframe.
Did Essential Energy specify details of the positive change event, including the date on which the event occurred, in its written statement? ³⁸	Yes. Essential Energy's written statement is available on our website. ³⁹
Did Essential Energy specify in its written statement the eligible pass through amount, the proposed positive pass through amount, and the amounts proposed to be recovered from customers in each regulatory year? ⁴⁰	Yes. Essential Energy proposed an eligible, positive pass through amount of \$3.8 million (\$nominal) to be recovered from consumers in 2023-24, the last year of the current regulatory control period 2019-24.
Did Essential Energy specify in its written statement evidence of the actual and likely increase in costs that occurred solely as a consequence of the positive change event? ⁴¹	Yes. Essential Energy's pass through application (that is, its written statement) set out the costs it incurred as a result of the 2022 North Coast Flooding, as well as how it calculated its proposed pass through amount. ⁴²
Was there a regulatory information instrument applicable to the pass through application? ⁴³	No.
Is the pass through amount, in whole or in part, in respect of expenditure for a restricted asset? ⁴⁴	No.

Source: AER's analysis

³⁶ New South Wales Government, <https://www.nsw.gov.au/disaster-recovery/natural-disaster-declarations>, viewed 03 February 2023.

³⁷ NER, cl. 6.6.1(c).

³⁸ NER, cl. 6.6.1(c)(1) and 6.6.1(c)(2).

³⁹ <https://www.aer.gov.au/networks-pipelines/determinations-access-arrangements/cost-pass-throughs/essential-energy-cost-pass-through-2022-flood-event>

⁴⁰ NER, cl. 6.6.1(c)(3), 6.6.1(c)(4), and 6.6.1(c)(5).

⁴¹ NER, cl. 6.6.1(c)(6).

⁴² Essential Energy, *Cost pass through application – 2022 North Coast Flooding* - December 2022. p 12; Essential Energy, *Attachment C – Detailed cost information.xls – Public*, December 2022.

⁴³ NER, 6.6.1(c)(7).

⁴⁴ NER, cl. 6.6.1(c1) and (d2).

Table 5: Factors that the AER is to consider under the NER when determining a positive pass through amount

Relevant factors under cl. 6.6.1(j)	AER consideration
In making the pass through determination we must take into account the matters and proposals set out in Essential Energy's written statement. ⁴⁵	This decision sets out how we have taken into account the matters and proposals set out in Essential Energy's pass through application (written statement).
We must take into account the incremental increase in costs in providing direct control services resulting from the pass through event. ⁴⁶	In section 4.4 above we set out our assessment of the costs incurred by Essential Energy as a consequence of the 2022 North Coast Flooding. We have considered the costs that Essential Energy has incurred and is likely to incur as a result of the flooding event as well as the likely cost savings to Essential Energy's business-as-usual activities as a result of its expenditure related to the 2022 North Coast Flooding.
We must take into account the efficiency of Essential Energy's decisions and actions in relation to the risk of the event. ⁴⁷	<p>In making this determination, we must take into account the efficiency of Essential Energy's decisions and actions in relation to the risk of the positive change event, including whether Essential Energy has failed to take any action that could reasonably be taken to reduce the magnitude of the eligible pass through amount, or omitted to take any action where such action has increased the magnitude of the amount.</p> <p>We do not have evidence to consider that Essential Energy's decisions and actions in relation to the risk of the positive change events were inefficient. We believe Essential Energy has taken positive actions during the positive change event, including working collaboratively and assisting with authorities where necessary.</p> <p>There does not appear to be any action that Essential Energy has failed to take, that it could reasonably have taken, to reduce the magnitude of the flooding repair costs, or that it took or omitted to take which has increased the magnitude of these costs.</p> <p>Therefore, we do not consider that Essential Energy's actions increased the magnitude of the pass through amount.</p>
We must take into account the time cost of money. ⁴⁸	To account for the recovery of the pass through amount in 2023–24, we have used the nominal rate of return, as determined in Essential Energy's 2019–24 distribution determination reflecting the most recent return on debt update in the approved PTRM.
We must take into account the need to ensure that the pass through amount reflects only costs incurred solely as a consequence of the 2022 North Coast Flood. ⁴⁹	<p>We have investigated the costs proposed by Essential Energy in its proposal and response to our subsequent information requests.</p> <p>We are satisfied that the costs included in our approved pass through amount were solely incurred because of the 2022 North Coast Flooding.</p>
The AER will have regard to whether Essential Energy has insurance against the event, and whether it is the level of insurance that an	Essential Energy submitted that none of the costs in this application related to insured structures. In response to our information request, Essential Energy identified some costs which were likely to be the subject of insurance claims. We

⁴⁵ NER, cl. 6.6.1(j)(1).

⁴⁶ NER, cl. 6.6.1(j)(2).

⁴⁷ NER, cl. 6.6.1(j)(3).

⁴⁸ NER, cl. 6.6.1(j)(4).

⁴⁹ NER, cl. 6.6.1 (j)(5).

Relevant factors under cl. 6.6.1(j)	AER consideration
efficient and prudent network operator would obtain? ⁵⁰	<p>have excluded these costs from our approved cost pass through amount.</p> <p>Essential Energy also submitted that it did not have insurance covering poles and wires of its network, and the insurance was limited to structures such as substations and buildings. Essential Energy stated that not insuring poles and wires is consistent with other network businesses. It explained that obtaining this insurance product is difficult and expensive as few insurers are willing to provide this high risk product. The associated premiums would consequently result in consistently high network charges for customers.⁵¹</p> <p>We note that this approach to managing this risk is generally consistent with comparable peer NEM networks including those also impacted by other natural disasters (e.g., bushfires). As such, we are satisfied that it was prudent and efficient for Essential Energy to not obtain insurance cover for its poles and wires assets.</p>
We must take into account whether the costs of the pass through event have already been factored into the calculation of the Distribution Network Service Provider's annual revenue requirement for the regulatory control period in which the pass through event occurred or will be factored into the calculation of the Distribution Network Service Provider's annual revenue requirement for a subsequent regulatory control period ⁵²	<p>We do not consider the costs that Essential Energy is proposing to recover have been factored into Essential Energy's annual revenue requirement for the regulatory control period in which the pass through event occurred (e.g. 2019-24).</p> <p>We note that additional costs relating to investments to enhance the resilience of Essential Energy's network to future flooding events may be considered in the context of Essential Energy's regulatory determination for the 2024–29 regulatory control period.</p>
We must take into account the extent to which Essential Energy's costs have already been funded by previous pass through determinations. ⁵³	There is no evidence to suggest that costs included in Essential Energy's application have already been funded by previous pass through determinations.
We must take into account any other factors that we consider relevant. ⁵⁴	<p>The other factors we took into account in our assessment of Essential Energy's application are set out below.</p> <p>The AER must exercise its power in a manner that will or is likely to contribute to the achievement of the National Electricity Objective (NEO).</p>

Source: AER's analysis

⁵⁰ AER, *Draft decision Essential Energy distribution determination - Attachment 14 - Pass through events* – November 2018, pp. 6-7.

⁵¹ Essential Energy, *Cost pass through application – 2022 North Coast Flooding* - December 2022. p 7.

⁵² NER, cl. 6.6.1(j)(7).

⁵³ NER, cl. 6.6.1(j)(7A).

⁵⁴ NER, cl. 6.6.1(j)(8).

Glossary

Term	Definition
AER	Australian Energy Regulator
Capex	Capital Expenditure
NEL	National Electricity Law
NEM	National Electricity Market
NEO	National Electricity Objective
Opex	Operating Expenditure