

Attachment 4.13

Ausgrid's nominated pass through events (PUBLIC)

May 2014



Ausgrid's nominated pass through events

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Contents

1	INTRODUCTION.....	1
2	BACKGROUND.....	1
	2.1 What are pass throughs and why are they necessary?.....	1
	2.2 When are pass throughs appropriate?.....	2
3	RELEVANT REGULATORY REQUIREMENTS	2
4	COST PASS THROUGHS APPROACH.....	3
	4.1 Identifying the need for additional nominated pass through events.....	3
	4.2 Approach risk management	3
	4.3 Assessing the appropriate regulatory treatment of risks.....	4
	4.4 External review of regulatory treatment of risks.....	5
	4.5 Consideration of cost impacts to consumers	6
	4.6 Decision to nominate additional pass through events.....	6
5	INSURANCE CAP EVENT.....	7
	5.1 Rationale	7
	5.2 Proposed definition.....	7
	5.3 Nominated pass through considerations.....	8
6	NATURAL DISASTER EVENT.....	9
	6.1 Rationale	9
	6.2 Proposed definition.....	10
	6.3 Nominated pass through considerations.....	11
7	TERRORISM EVENT	12
	7.1 Rationale	12
	7.2 Proposed definition.....	13
	7.3 Nominated pass through considerations.....	13
8	INSURER'S CREDIT RISK	14
	8.1 Rationale	14
	8.2 Proposed definition.....	14
	8.3 Nominated pass through considerations.....	15
9	APPLICATION OF PASS THROUGH PROVISIONS TO ALTERNATIVE CONTROL SERVICES.....	15
	APPENDIX 1 – SUMMARY OF AUSGRID'S APPROACH TO RISK MANAGEMENT.....	17
	APPENDIX 2 – ALIGNMENT BETWEEN INSURANCE COVER AND HAZARDOUS EVENTS.....	20
	REFERENCE DOCUMENTS	
	CHAPTER 5 (ID00216) - AUSGRID'S BOARD POLICY: RISK MANAGEMENT	
	CHAPTER 5 (ID12627) - AUSGRID'S RISK MANAGEMENT PLAN	
	ATTACHMENT 4.12 - EY REVIEW OF REGULATORY TREATMENT OF RISKS	
	ATTACHMENT 5.08 - AUSGRID'S NETWORK MANAGEMENT PLAN	

1 Introduction

This document sets out in detail Ausgrid's proposed nominated pass through events for the 2015-19 regulatory control period. Ausgrid's decision to nominate certain events as pass through events has been based on our assessment of a number of factors, such as:

- our ability to prevent or mitigate the risk;
- the availability of insurance (external and self insurance);
- the magnitude of the risk if it were to occur; and
- relevant provisions in the National Electricity Rules (Rules) and National Electricity Law (NEL).

Ausgrid has assessed the key risks it faces, as a network service provider operating in New South Wales, against the above criteria. Following our assessment we have identified a number of risks which we consider should be managed via nominated pass through events, rather than an allowance under our distribution determination.

The events we are proposing to be approved by the Australian Energy Regulator (AER) as nominated pass through events for our 2015-19 regulatory control period include:

- a insurance cap event;
- a natural disaster event;
- terrorism event; and
- an insurer's credit risk event.

Ausgrid considers that managing our exposure to certain risks via the pass through provisions represents the most prudent and efficient means for addressing risks which are beyond our control to prevent/mitigate; cannot be effectively insured; have a low probability of occurrence; and are likely to have significant cost impacts.

The remainder of this document discusses Ausgrid's proposed nominated pass through events in more detail. Specifically, this document sets out our approach towards determining the need for additional pass through events; the regulatory requirements for nominated cost pass throughs; Ausgrid's proposed definitions for each nominated pass through event; and how each nominated pass through event meets the nominated pass through event considerations (PTE considerations) enshrined in Chapter 10 of the Rules.

Document outline

Section 2 – provides background information on pass throughs and why they are necessary

Section 3 – outlines the relevant Rule requirements

Section 4 – outlines Ausgrid's approach to cost pass through

Section 5 – outlines proposed insurance cap event

Section 6 – outlines proposed natural disaster event

Section 7 – outlines proposed terrorism event

Section 8 – outlines proposed insurer's credit risk event

Section 9 – outlines the application of pass through

2 Background

2.1 What are pass throughs and why are they necessary?

The regulatory framework recognises that a distribution network service provider (DNSP) cannot reasonably be expected to forecast costs for all foreseen and unforeseen events over the regulatory control period. The regulatory framework addresses this issue by including a cost pass through mechanism, which allows DNSPs to seek the AER's approval to recover (or pass through) the costs (or savings) of defined, unpredictable, high cost event(s) for which the distribution determination does not provide a regulatory allowance.

The regulatory framework contains such a mechanism as it is not appropriate to include allowances for these events in a DNSP's regulatory determination due to the difficulties in quantifying an accurate allowance for such an event. The

corollary of this is that it would be contrary to the revenue and pricing principles¹ and the National Electricity Objective² to not provide a means for DNSPs to recover the costs from such an event, as the financial impacts could be a catastrophic and place the DNSP in financial distress.

2.2 When are pass throughs appropriate?

The use of pass through event is restricted by the Rules and the AER's determination. Under the rules they are limited to defined events such as a tax change event; service standard event; regulatory change event; and a retailer insolvency event.³ However, DNSP's are also able to propose additional pass through events as part of their regulatory proposal.⁴ This is because DNSPs may face risks that fall outside of the defined events in the Rules (due to their unique operating circumstances and network characteristics), which are uncontrollable and may have a material impact on the costs of providing direct control services.

Whilst DNSPs have the ability to nominate additional pass through events, this does not necessarily mean that they will be approved by the AER; nor does it mean that pass throughs should be used in place of prudent risk mitigation measures. DNSP's must satisfy the AER that its proposed event meets the Pass Through Event Considerations (PTE considerations) in the Rules in order for the AER to approve the event as a pass through for the regulatory control period.

The PTE considerations enshrined in the Rules reflect that additional cost pass throughs should only be approved under limited circumstances. Specifically, they should only be approved in circumstances where risks or events have a low probability of occurrence (or are uncertain), have the potential to have a high cost impact and are beyond a network service provider's reasonable control. Further, they should only be approved in circumstances where commercial insurance and self insurance are not available on a reasonable basis or in situations where the DNSP is unable to mitigate or avoid the event without creating unacceptable risks.⁵

Consequently, the PTE considerations help to ensure that nominated cost pass throughs are only approved under appropriate circumstances, so as not to undermine incentives in the regulatory framework for DNSP's to undertake efficient and prudent risk management.

3 Relevant regulatory requirements

The pass through mechanism in Chapter 6 of the Rules is designed to allow a DNSP to recover the costs that it incurs in the provision of standard control services that are material and beyond its control.

Clause 6.5.10 of the Rules provides that a DNSP's building block proposal may include a proposal as to events that should be defined as *pass through events* during its regulatory control period. These events are in addition to the pass through events prescribed in the Rules which apply to all DNSPs.⁶

In proposing nominated pass through events DNSP's must have regard to the following PTE considerations:

- 1) 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);
- 2) whether the nature or type of event can be clearly identified at the time the determination is made for the service provider;
- 3) 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;
- 4) whether the relevant service provider could insure against the event, having regard to:
 - (a) the availability (including the extent of availability in terms of liability limits) of insurance against the event on reasonable commercial terms; or
 - (b) 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
- 5) any other matter the *AER* considers relevant and which the *AER* has notified *Network Service Providers* is a nominated pass through event consideration.

¹ Refer to s 7(A)(2)(a) and (b) of the National Electricity Law (NEL), which provides that DNSPs should be given a reasonable opportunity to be able to recover at least the efficient costs the operator incurs with providing direct control services and complying with regulatory obligations or requirements.

² Refer to s 7 of the NEL.

³ Refer to clause 6.6.1(a1) and Chapter 10 of the National Electricity Rules (NER).

⁴ Refer to clause 6.5.10 of the NER.

⁵ AEMC 2012, Cost pass through arrangements for Network Service Providers, Rule Determination, 2 August 2012, p 8.

⁶ Clause 6.6.1(a1) to (4), NER.

The AER must take these considerations into account when deciding whether to accept or reject Ausgrid's nominated pass through events. In addition, the AER should also have regard to the National Electricity Objective (NEO) and the revenue and pricing principles in the NEL.

4 Cost pass throughs approach

4.1 Identifying the need for additional nominated pass through events

In reaching the decision to nominate cost pass through events to apply during the 2015-19 control period, Ausgrid undertook a thorough risk assessment of its operations using the bow-tie risk analysis methodology. The results of this analysis were cross-checked against Ausgrid's historical risk register to ensure that key risks were captured and assessed on a consistent basis.⁷

From this process, Ausgrid identified a number of residual risks which could not be fully mitigated or prevented, despite having in place prudent risk controls and appropriate levels of commercial insurance. Further analysis on the nature of the residual risks was undertaken to determine the most appropriate and efficient means for allocating the risk. In most cases it was determined that Ausgrid was the most appropriate party to bear the residual risks, particularly below insurance deductibles, as these costs were relatively stable and considered to be 'business as usual' costs. However, where it was found that the residual risks were likely to have a material impact or low probability of occurrence, Ausgrid undertook further analysis to determine whether it was appropriate to self insure against the risk or whether the risk was more appropriately addressed via a cost pass through. In reaching the decision that it was appropriate for certain risks to be addressed via a cost pass through, Ausgrid had regard to the PTE considerations and the likely cost impacts to customers from adopting this approach.

Lastly, Ausgrid in conjunction with Endeavour Energy and Essential Energy, engaged Ernst and Young (EY) to advise on the appropriateness and prudence of our risk management approach.⁸

Further details on the process that we undertook to arrive at our decision to nominate additional pass through events are outlined in further detail below.

4.2 Approach risk management

Ausgrid's approach to risk management is based on its Board Policy on Risk Management, which is aimed at sustaining a positive culture of risk management based on proactive and systematic identification and management of risk to support the delivery of safe, reliable and efficient energy services to Ausgrid's customers.⁹

Ausgrid's Risk Management Policy, is implemented through its Risk Management Framework and Risk Management Plan.¹⁰ Our Risk Management Framework sets out the foundation documents and organizational arrangements for designing, implementing, monitoring, reviewing and continually improving risk management throughout the business.¹¹

Ausgrid's Risk Management Framework utilises the bow-tie risk methodology to assess its key risks. The bow-tie methodology considers plausible worst case hazardous events and identifies both the preventative controls to reduce the likelihood of the risk occurring and mitigation controls to reduce the consequence of the event. Diagram 1 illustrates the bow-tie risk methodology and can be found on the following page.

In addition, Ausgrid maintains comprehensive insurance arrangements which are regularly reviewed to align with the bow-tie methodology. Advice is also obtained from external risk and insurance brokers/consultants (currently Aon and Marsh) and Ausgrid's internal insurance specialists to establish the appropriate levels of coverage, implement appropriate insurance market negotiation strategies and to efficiently and effectively manage claims.

Refer to Appendix 1 for a summary of Ausgrid's key risks and control measures for preventing and mitigating the risk.

⁷ Further details on Ausgrid's approach towards managing risk can be found in section 3.2, with a table summarizing our approach contained in Appendix 1.

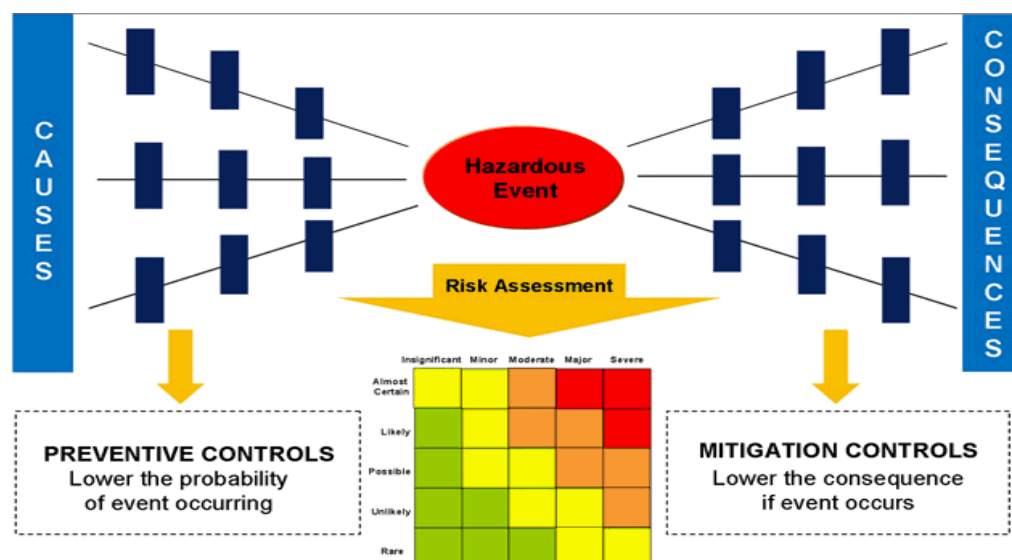
⁸ Refer to Attachment 4.12 – EY, *Review of regulatory treatment of risk: Ausgrid, Endeavour Energy, Essential Energy*, April 2014.

⁹ Refer to [Chapter 5 supporting documents \(ID00216\)](#) - Ausgrid Board Policy: Risk Management, Document ABP005, 28 August 2013.

¹⁰ Refer to [Chapter 5 supporting documents \(ID12627\)](#) - Ausgrid's 2013/14 Risk Management Plan, November 2013.

¹¹ Ausgrid's Risk Management Framework outlines a: Risk Management Policy, Risk Management Strategy, Risk Matrix, Risk Assessment Methodology, Corporate Risk Management Plan Development, Risk Management Reporting Requirements.

Diagram 1: Bow-tie risk methodology



4.3 Assessing the appropriate regulatory treatment of risks

In preparing for our 2015-19 distribution determination, we assessed our approach for managing risks from a regulatory perspective in order to ensure that risks are appropriately provisioned for and allocated to the party most appropriate for bearing the risk.

All risks faced by a DNSP are covered by one of the following:

- 1) forecast operating expenditure (opex) – this includes external insurance;
- 2) forecast capital expenditure (capex);
- 3) rate of return;
- 4) self insurance;
- 5) pass-through; and
- 6) not covered/retained by the business (cost impact of the risks is not significant).

In determining which mechanism should be used for efficiently managing a risk, Ausgrid had regard to the nature of the risk and whether an allowance has already been made through its forecast operating expenditure (opex); forecast capital expenditure (capex); or rate of return.

Whilst Ausgrid has in place prudent and effective measures to address most of the risks it faces, we have identified some risks which are beyond our control to prevent and have a low probability of occurrence or are unpredictable. Consequently, Ausgrid undertook further analysis to determine whether it was appropriate to manage our exposure to risks of this nature via a self insurance allowance or nominated pass through event.

'Self insurance' in the regulatory context refers to the setting aside of funds as compensation for potential losses in the future, and is distinct from other interpretations of the term which refer to the general practice of retaining potential financial risks and absorbing any potential future losses internally. Consequently, where it is not possible to obtain effective external insurance for a risk, a DNSP may consider whether it is appropriate for it to self insure the risk.

In determining whether it would be appropriate to self insure for certain risks during its 2015-19 regulatory control period, Ausgrid had regard to whether it was able to 'effectively' self insure for the risk. That is, whether Ausgrid would have the capacity to effectively pool enough risk to cover the severity of the likely impact should the risk occur.¹² Other considerations that we also had regard to included:

- i. whether the risk is practically quantifiable and does not merely relate to the loss of value;¹³

¹² For example, the risk of damages from a significant earthquake that is likely to occur less than 1 in 1,000 years. In theory, this risk can be self insured by saving an annual premium to pay for the earthquake when it occurs. However, if the event occurred prior to 1,000 years (i.e. in year 20) the business would have an insufficient pool of funds to cover the costs of the event.

¹³ The probability of the event occurring is relevant for quantifying the likely impact of the event (i.e. loss times probability) as it will determine the self insurance allowance that the AER will likely approve. The AER has stated that the financial impact of the event must be able to be recorded in the building block revenue components (i.e. opex or capex) hence the mere loss of value from the event occurring would not be allowed as self insurance allowance.

- ii. whether the risk is negatively asymmetric;¹⁴
- iii. AER information requirements;¹⁵ and
- iv. administrative and reporting requirements.¹⁶

Having regard to the above self insurance considerations, Ausgrid determined that it was only appropriate to self insure for risks associated with workers compensation, which it has done by including a forecasted allowance as part of its base year opex. In terms of addressing residual risks which were not addressed by opex, capex or the rate of return, we identified that the cost impacts from such events were either likely to be catastrophic or insignificant. Where the cost impacts were deemed to be small, such as below insurance deductibles, Ausgrid determined that it was the most appropriate party to bear the costs associated with this event, and as a result absorbs the cost impacts associated with the risk materializing. However, where the likely cost impact from the risk was determined to have a significant cost impact the risk was further assessed against the PTE considerations contained in Chapter 10 of the Rules.

Consequently, in reaching the decision to manage our exposure to certain risks via the nominated pass through provisions, Ausgrid has exhausted all other practicable means for addressing the risk under the regulatory framework. The events that we are proposing to apply as nominated pass through events during our 2015-19 regulatory control period are risks that:

- are uncontrollable, in the sense that they cannot reasonably or practicably be mitigated or prevented;
- have a low probability of occurrence and are unpredictable;
- cannot be effectively insured, in the sense that external insurance is unavailable on commercial terms or Ausgrid would not have sufficient capacity to pool enough risk to cover the severity of the likely impact should the event occur;
- are not already accounted for in Ausgrid's regulatory proposal;
- are likely to have a significant cost impact; and
- falls outside of the defined pass through events in the Rules.

Given the nature of these risks, we consider cost pass throughs to be the most appropriate and cost efficient means for managing these types of risks. We do not consider that self insurance would be an appropriate means for managing risks of this nature as quantifying a self insurance allowance would be either subjective (due to the nature of the risk and a wide range of possible values), or could potentially expose the network service provider to catastrophic financial consequences if the risks were to eventuate. Ausgrid notes that its approach to cost pass throughs consistent with the AER's position in relation to these types of events and with the revenue pricing principles in the National Electricity Law (NEL), and preserves incentives under the Rules framework.¹⁷

4.4 External review of regulatory treatment of risks

The NSW DNSPs (Ausgrid, Endeavour Energy, Essential Energy) engaged EY to provide advice on the appropriate regulatory treatment of key risks. Specifically, EY was asked to review a list of key business risks and advise on: 1) whether the current risks management approach (including insurance arrangements) adopted by Ausgrid is appropriate and efficient for each of the risks identified; and 2) advise on the appropriate regulatory treatment of each risk based on Ausgrid's current and/or proposed risk management approach.¹⁸

Key findings from EY's report include:

- Ausgrid's proposed approach towards self insurance and cost pass through is appropriate from a commercial risk management and regulatory treatment perspective;
- Ausgrid's insurance arrangements encompass a robust and thorough renewal and review process;
- self insuring worker's compensation is appropriate for Ausgrid because it is cost effective; and
- the nominated pass through events proposed by Ausgrid are appropriate because they capture the risks which are beyond the control of the NSW DNSPs to prevent or mitigate. They also cannot be effectively or efficiently

¹⁴ According to the AER, events could have upside and downside risks. Expressed in a different way this refers to whether an event is characterised by symmetrical or asymmetrical risks. Asymmetric risks can be distinguished from symmetric risks, in the sense that if an asymmetric risk occurred it would only increase a DNSPs' costs whereas symmetrical risks are not always characterised by an increase in costs.

¹⁵ The AER requested the very detailed information on 'self insurance' in the regulatory information notice (RIN) it issued to the Victorian DNSPs to substantiate their self insurance claims. Information required by the AER included details of all amounts and values used to calculate the proposed insurance; an explanation of the methodology; Board resolutions to self insure; actuary reports verifying the self insurance premiums; annual accounts recording the cost of self insurance as an operating expense.

¹⁶ Electing to self insure for a risk means that the business must establish formal measures for pooling and managing the risk, and will also need to report the ongoing management of its self insurance via the RIN, which as noted above is onerous.

¹⁷ AER, Final Decision: ElectraNet Transmission Determination 2013-14 to 2017-18, 30 April 2013, pp 190-191; AER, Victorian electricity distribution network service providers Distribution determination 2011-2015, Draft Decision June 2010, pp 711-713. See also section 7A(2)(a) and (b) of the NEL.

¹⁸ A copy of EY's Report: Review of regulatory treatment of risk, April 2014, has been provided in Attachment 4.12 of our proposal.

insured due to the likely significant cost impacts and appear to satisfy the nominated PTE considerations in the Rules.

4.5 Consideration of cost impacts to consumers

In determining whether to nominate cost pass through events as part of our regulatory proposal, Ausgrid has had regard to the likely cost impacts to customers from adopting this approach. We note that there are no immediate costs to customers from an event being approved by the AER as a nominated cost pass through. In addition, there are no cost impacts to customers if the event does not occur during the regulatory control period.

Costs associated with nominated pass through events (and more broadly cost pass throughs) are *only* recovered from customers if the event occurs; even then, there is still no guarantee that the DNSP will be allowed to pass through the costs associated with the event as the AER must approve the any application to pass through the cost of the event to customers.

Cost pass through events (whether prescribed in the Rules or nominated) merely operate as a gateway for network service providers to access the pass through approval process under clause 6.6.1 of the Rules. There are a number of requirements that a DNSP must first satisfy in order for the costs associated from a pass through event to be recovered.

The AER is not required to approve a cost pass through merely because the event has occurred. A DNSP must first make an application to the AER demonstrating that a pass through event has occurred and that: 1) the event falls within a prescribed or nominated pass through category; 2) materially increases (decreases) the costs of providing standard control services; and 3) sets out the amount that the network service provider proposes should be recovered.¹⁹

If the network service provider is unable to demonstrate requirements 1) and 2), then the pass through event will not be approved. Costs are not recovered from customers and the network service provider must absorb the costs from the event.

In addition, just because an event is accepted as an approved pass through does not mean that the AER will approve the amount the DNSP is proposing. In determining the amount to be passed through, the AER must take into account a number of factors. In the case of a positive change event, the AER must apply an efficiency test to the proposed amount. In particular, it must consider the efficiency of the network service provider's decisions and actions in relation to the event, including whether the provider has failed to take any action that could reasonably be taken to reduce the magnitude of the eligible pass through amount and whether the provider had taken or omitted to take any actions which increased the magnitude of the amount.²⁰

Consequently, there are no immediate impacts to customers from the AER approving Ausgrid's nominated pass through events. Approval of these events merely enables Ausgrid to access the pass through approval process under the Rules, which in turn provides a mechanism for further analysis and determination by the AER. The approval process provisions enable the AER to apply the same level of scrutiny and assessment to a pass through application as it would to a regulatory proposal, thus ensuring only the efficient costs from the event are recovered.

4.6 Decision to nominate additional pass through events

Ausgrid adopts prudent risk and asset management measures to ensure the safety, reliability and security of electricity supply to all of its customers. As noted above, we are compensated for undertaking risk prevention/mitigation activities under the regulatory framework through allowances under forecast capex, forecast opex (including external insurance and self insurance), and the rate of return on assets. However, these mechanisms do not provide a return for all the risks that we face as a network service provider.

Ausgrid has undertaken a thorough risk assessment of its operations using the bow-tie risk analysis methodology and has identified a number of risks for which either cannot be mitigated or would be uneconomical for us to militate against.²¹ These risks are generally beyond our control to prevent. For example, natural disaster related events such as major floods, fires, earth quakes and storms; and acts of terrorism.

In addition, these types of risks are also highly unpredictable and generally have a low probability of occurrence. The uncertain and highly unpredictable nature of these risks makes it difficult for Ausgrid to forecast the severity and frequency of these risks accurately for the forthcoming regulatory control period.

Consequently, Ausgrid has not made provisions for these types of risks in other elements of our regulatory proposal, as it could give rise to undesirable outcomes. For instance:

¹⁹ Materiality in this context is defined as 1% of the network service provider's annual revenue requirement. Refer to definition of materiality in Chapter 10 of the NER.

²⁰ Clause 6.6.1(j), NER.

²¹ The cost of taking out an external insurance or adopting certain risk mitigating measures may be inefficient given the low probability of the risk occurring and substantial cost that would be imposed on customers.

- 1) The risk might not eventuate or the severity of the impact could be significantly less than estimated – this could result in Ausgrid being overcompensated for the risk it bears during the regulatory control period. This is undesirable as it would result in customers paying a higher price than necessary for their electricity supply.
- 2) The risk eventuates and Ausgrid underestimates the severity of the cost impact or the AER rejects or significantly reduces the proposed expenditure for mitigating the risk – depending on the magnitude of the cost impacts, Ausgrid could be placed in a situation where it has insufficient cash flows to meet its obligations as a DNSP and could become financially distressed.

To avoid these outcomes we have sought to manage our exposure to high impact, low probability events that are beyond our control by proposing them as nominated cost pass through events rather than receiving a regulatory allowance under our distribution determination. We believe that this is the most efficient way for managing these risks and consider that this approach delivers the best outcome for customers.

The events we are proposing be approved as part of our regulatory determination, which are to apply as nominated pass through events during the 2015-19 regulatory control period are a:

- Insurance cap event – this is discussed in further detail in section 5;
- Natural Disaster event – this is discussed in further detail in section 6;
- Terrorism event – this is discussed in further detail in section 7; and
- Insurer's credit risk event – this is discussed in further detail in section 8.

In proposing these events we have had regard to the PTE considerations in Chapter 10 of the Rules. We consider that each event meets the necessary requirements to be approved as a nominated cost pass through event.

5 Insurance cap event

5.1 Rationale

Ausgrid considers that the most efficient and appropriate means of managing our exposure to the risk of incurring liabilities above our insurance limits/caps is via the cost pass through mechanism. Under our previous determination this risk would have been addressed via the general nominated pass through event. However, as the AER's policy position on the appropriateness of general nominated pass through events has changed, Ausgrid considers that it is appropriate to nominate an insurance cap event in order to manage our exposure to such risks. This is because the probability of such an occurrence is extremely low, commercial and self insurance are not available on reasonable grounds and the cost impacts form such an event would be catastrophic.

Further, accepting an 'insurance cap event' as a nominated pass through event would also be consistent with the:

- Nominated PTE considerations,²²
- Policy intent for nominated cost pass through events – that is that a NSP should not be placed in a position where it is unable to mitigate or avoid the event without creating unacceptable risk,²³ and
- Revenue and pricing principles in the NEL – specifically, that a regulated NSP should be provided with an opportunity to recover at least the efficient costs it has incurred in providing direct control services or complying with a regulatory obligation or requirement.²⁴

5.2 Proposed definition

Ausgrid proposes an 'insurance cap event' as a pass through event for the 2015-19 regulatory control period, defined as follows:

An insurance cap event occurs if:

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

For this insurance cap event:

²² Chapter 10 of the NER, refer to definition of nominated cost pass through considerations.

²³ AEMC 2012, Cost pass through arrangements for Network Service Providers, Rule Determination, 2 August 2012, p 8.

²⁴ Refer to s 7(A)(2)(a) and (b) of the NEL.

4. *the relevant policy limit is the greater of:*
 - a. *Ausgrid's actual policy limit at the time of the event that gives, or would have given rise to a claim, and*
 - b. *the policy limit that is explicitly or implicitly commensurate with the allowance for insurance premiums that is included in the forecast operating expenditure allowance approved in the AER's final decision for the regulatory control period in which the insurance policy is issued.*
5. *A relevant insurance policy is an insurance policy held during the 2015-19 regulatory control period or a previous regulatory control period in which Ausgrid was regulated.*

Note for the avoidance of doubt, in assessing an insurance cap event cost pass through application under rule 6.6.1(j), the AER will have regard to:

- i. *the insurance premium proposal submitted by Ausgrid in its regulatory proposal;*
- ii. *the forecast operating expenditure allowance approved in the AER's final decision; and*
- iii. *the reasons for that decision.*

Ausgrid considers that the inclusion of this pass through event would provide a prudent and efficient means for addressing the risks associated with costs arising from third party liability claims, in excess of insured limits, as well as risks in excess of commercial limits.

Our proposed definition for this event is the same as the definition used by the AER in its recent determination of ElectraNet and SP AusNet's cost pass through proposals.²⁵ In addition, we note that similar insurance cap events for the Victorian DNSPs,²⁶ Aurora in Tasmania²⁷, and Powerlink in Queensland²⁸ have been previously accepted by the AER.

5.3 Nominated pass through considerations

In support of this pass through event, Ausgrid notes that:

- The event is not covered by a category of pass through event specified in clause 6.6.1(a1)(1) to (4) of the Rules;
- The nature and type of the event can be clearly identified at the time the AER makes its determination for Ausgrid, as evidenced by the proposed definition and the fact that the AER has previously accepted this event for the Victorian DNSPs, Aurora, Powerlink, ElectraNet and SP AusNet's determinations.
- The extent to which Ausgrid can reasonably prevent a claim occurring which exceeds its insurance cap, or can mitigate the cost impact of such an event, is limited. We note that the AER has previously concluded that an insurance cap event satisfies this consideration in its determinations for the Victorian DNSPs, Aurora, Powerlink and ElectraNet.
- Ausgrid has obtained efficient levels of insurance cover to commensurate with our assessment of our business risk.²⁹ However, the coverage of such insurance is typically capped, with levels of cover above the cap typically requiring higher premiums. Ausgrid has not sought to take out higher levels of insurance to mitigate our exposure to such an event, as we believe that such a response would be inefficient and also disproportionate given the low probability of us incurring liabilities above our insurance cap. Including an insurance cap event as a pass through event represents a more appropriate means for managing Ausgrid's risk exposure to such an event given the:
 - i. Complexity associated with developing credible self insured risk quantifications for very low probability events, such as those that are above existing liability limits/caps; and
 - ii. Catastrophic nature of such an event – the cost impacts to Ausgrid from such an event are estimated to represent anywhere between 2.5 per cent to 43 per cent of our annual revenue requirement.³⁰

Ausgrid has proposed an 'insurance cap event' as we consider this to be the most prudent and efficient means of mitigating our exposure to risks of this nature.

We do not consider any changes to the forecast insurance premiums in our regulatory proposal would be required, where the AER approves the inclusion of an insurance cap event. As noted above, Ausgrid has sought to obtain efficient levels of insurance that commensurate with our risk exposure. We have done this by undertaking a prudent and thorough

²⁵ AER, *Final Decision, ElectraNet Transmission determination 2013 to 2017-18*, April 2013, p 187-195. See also AER, *Final Decision – SP AusNet Transmission Determination 2014-15 to 2016-17*, 30 January 2014, p 56.

²⁶ AER, *Victorian electricity distribution network service providers distribution determination 2011-2015, Final Decision*, October 2010, p 197.

²⁷ AER, *Final distribution determination: Aurora Energy Pty Ltd 2012-13 to 2016-17*, April 2012, p 183.

²⁸ AER, *Decision, Powerlink nominated pass through events: Application to amend Powerlink's 2012-17 transmission determination*, March 2013, p 5.

²⁹ Refer to Appendix 2- Extract from Ausgrid's 2013/14 Risk Management Plan, November 2013, pp 126-128.

³⁰ Calculations are based upon Ausgrid's annual revenue requirement being \$2 billion. See Ausgrid's 2013/14 Risk Management Plan, November 2013, pp 126-128 for the applicable policy limits.

assessment of our business risk and aligning our exposure to such risks with appropriate levels of insurance cover.³¹ Each year we review the limits of our insurance policies in conjunction with our broker taking into account updated underwriting information and discussions with our operating divisions.³² Similarly liability insurance limits are reviewed annually including utilising externally provided bushfire probability and maximum probable loss analysis. As part of this review process, consideration is given to whether it is appropriate to purchase additional coverage in light of the nature of the risk, probability of occurrence and cost of purchasing additional levels of coverage.

Further, clause 4(b) of our proposed definition of an 'insurance cap event' is specifically aimed at ensuring that incentives for undertaking appropriate levels of insurance cover are maintained. Clause 4(b) provides that in assessing any pass through application for an 'insurance cap event' the AER is to take into account the allowance for insurance premiums included in Ausgrid's approved operating expenditure allowance. Subsequently, if Ausgrid did not maintain a level of coverage to commensurate with those premiums, the AER would be able to consider whether Ausgrid had, in reducing its insurance cover, '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 or omission has increased the magnitude of the amount.'³³

Consequently, the approval of an insurance cap event would not undermine the incentives for Ausgrid to take out appropriate levels of insurance cover.

As noted above, Ausgrid has not included a self insurance allowance for liabilities incurred above relevant insurance policy limits. Historically, Ausgrid has never had a loss above an insurance cap. In addition, ongoing risk management improvements following the restructure of the NSW DNSPs has in our view made the risk of such an event occurring even less likely. Therefore, given the difficulties in calculating a reliable self insurance amount and the likely severity of the cost impacts, Ausgrid does not consider that we would be in a position to effectively self insure against our exposure to such an event.

6 Natural disaster event

6.1 Rationale

Ausgrid considers the approval of a 'natural disaster event' cost pass through is necessary, as it captures a key category of uncertain, potential high cost impact events outside our reasonable control. Natural disaster events include bushfires and other extreme weather events such as earthquakes and cyclones. Such events typically result in DNSPs incurring substantial costs, including those arising from property damage to Ausgrid's assets.

Previously, natural disaster related risks were managed via a general nominated pass through. However, as general nominated pass through events are no longer considered appropriate by the AER, Ausgrid considers that a 'natural disaster event' be included as a pass through event, during its 2015-19 regulatory determination. We consider that this represents the most efficient means for managing risks of this nature in our forthcoming regulatory control period; and in addition, is consistent with the PTE considerations and pricing principles in the NEL.

Whilst Ausgrid notes that there maybe some overlap between a 'natural disaster event' and an 'insurance cap event' it is anticipated that both events will be necessary, as the costs associated from third party claims are unlikely to be captured by a 'natural disaster event.' This is because the costs impacts from third party claims are often delayed and tend to only crystallise months after the event,³⁴ whereas the pass through provisions are triggered by the occurrence of the defined event rather than the manifestation of the cost impacts.

Costs associated with third party claims are therefore unlikely to be captured by a natural disaster pass through event as it is unlikely that they will crystallise within the 90 business day period for making a pass through application.³⁵ Whilst the eligible pass through amount does encapsulate both the incurred and likely to be incurred costs from an event,³⁶ it is doubtful that Ausgrid would be in a position to provide a credible estimate for such claims given the difficulties involved in estimating claims on a prospective basis.³⁷

³¹ Refer to Appendix 2 - Extract from Ausgrid's 2013/14 Risk Management Plan, November 2013, pp 126-128. (Note that the self insured retention amounts, insured limits and mitigating insurance are confidential).

³² For example updated reinstatement values of our assets for Industrial Special Risks (ISR) insurance.

³³ Clause 6.6.1(j)(3), NER.

³⁴ Third party claims are often not made until months after the event. For example, in relation to bush fire damage, if houses or property are destroyed it may take several months before an estimation of the damage is received for affected party to make a claim.

³⁵ Clause 6.6.1(c), NER.

³⁶ Clause 6.6.1(c)(6)(i), NER.

³⁷ Costs arising from third party claims are difficult to estimate on a prospective basis, as each claim must be assessed on its merits. In addition, claims can vary substantially depending on a number of factors such as the nature of the damage cause, how quickly claims are able to be settled and whether claims become the subject of legal proceedings.

Consequently, it is expected that both pass through events are necessary in order to provide Ausgrid with an opportunity to recover its efficient costs from a natural disaster event, where such costs are material. It is anticipated that material capital consequences, such as property damage from the event will be recovered via a 'natural disaster event'; whereas third party claims, such as fire related claims arising from a bush fire caused or exacerbated by Ausgrid's assets, would be more appropriately recovered through an 'insurance cap event.'

Ausgrid notes that accepting both nominated pass through events is consistent with the approach adopted by the AER in its determinations for ElectraNet,³⁸ Aurora,³⁹ and SP AusNet.⁴⁰ In accepting Aurora's 'natural disaster event', the AER acknowledged that it is inevitable that some overlap exists between the 'natural disaster event' and 'insurance cap event'.⁴¹ However, the AER did not perceive this overlap to be an issue, as it is suitably placed to determine which event is most appropriate for making a cost claim and ensuring that any cost to be recovered from the event is not double counted.⁴²

Ultimately, whether a pass through application is made under one or both events will depend on the nature of the cost impacts flowing from the event. Just because an event is accepted as an approved pass through does not mean that the DNSP has the ability to automatically pass through the costs associated from the event. DNSP's are only eligible to recover the cost increases in providing direct control services incurred as a direct consequence from the event, and only if these costs are material.⁴³

Consequently, approval of a natural disaster and insurance cap event merely provides Ausgrid with an opportunity to access the pass through approval process under the Rules, which in turn provides a mechanism for further analysis and determination by the AER. We note that the approval process provisions enable the AER to apply the same level of scrutiny and assessment to a pass through application as it would to a regulatory proposal, thus ensuring only the efficient costs from the event are recovered.

In addition, accepting a 'natural disaster event' as a nominated pass through event would also be consistent with the:

- Nominated PTE considerations;⁴⁴
- Policy intent for nominated cost pass through events – that is that a NSP should not be placed in a position where it is unable to mitigate or avoid the event without creating unacceptable risk;⁴⁵ and
- Revenue and pricing principles in the NEL – specifically, that a regulated NSP should be provided with an opportunity to recover at least the efficient costs it has incurred in providing direct control services or complying with a regulatory obligation or requirement.⁴⁶

6.2 Proposed definition

Ausgrid proposes a 'natural disaster event' as a pass through event for the 2015-19 regulatory control period, defined as follows:

Any major fire, flood, earthquake or other natural disaster beyond the reasonable control of Ausgrid that occurs during the 2015-19 regulatory control period and materially increases the costs to Ausgrid in providing direct control services.

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 the:

- insurance premium proposal submitted by Ausgrid in its regulatory proposal;*
- forecast expenditure allowance approved in the AER's final decision; and*
- reasons for that decision.*

This additional pass through event clearly captures a key category of uncertain, potentially high cost events outside of Ausgrid's control. As evidenced by the recent Victorian Bushfires, natural disaster related events pose a key risk to network service providers and can result in substantial cost impacts to the business.

³⁸ AER, *Final Decision – ElectraNet Transmission Determination 2013-14 to 2017-18*, 30 April 2013, p 192-195.

³⁹ AER, *Draft Distribution Determination, Aurora Energy Pty Ltd 2012-13 to 2016-17*, November 2011, p 39.

⁴⁰ AER, *Final Decision – SP AusNet Transmission Determination 2014-15 to 2016-17*, 30 January 2014, p 55-56.

⁴¹ *Ibid*, p 39 and 287.

⁴² *Ibid*. See also clause 6.6.1(j), NER.

⁴³ Chapter 10, NER definition of 'materially.' Materiality is defined in the Rules as an amount that exceeds 1 % of the annual revenue requirement for the DNSP.

⁴⁴ Chapter 10 of the NER, refer to definition of nominated cost pass through considerations.

⁴⁵ AEMC 2012, *Cost pass through arrangements for Network Service Providers, Rule Determination*, 2 August 2012, p 8.

⁴⁶ Refer to s 7(A)(2)(a) and (b) of the NEL.

Ausgrid notes that a 'natural disaster event' has been previously approved by the AER for the Victorian DNSPs⁴⁷ and in the AER's recent determination for Aurora in Tasmania⁴⁸ and ElectraNet in South Australia.⁴⁹ We have based our definition of this event on the AER's recent definition or a 'natural disaster event' used in ElectraNet and SP AusNet's transmission determinations.⁵⁰

6.3 Nominated pass through considerations

Ausgrid considers that accepting a 'natural disaster event' is consistent with the nominated PTE considerations as:

- The proposed 'natural disaster event' is not covered by a category of pass through event specified in clause 6.6.1(a1)(1) to (4) of the Rules. Whilst we note that there may be some overlap between this event an 'insurance cap event' we note that the AER has made the following observation in relation to this:

*The AER recognises that there is some potential overlap with other allowances or events such as liability above the insurance cap. However, it will consider any specific cost claim under the most appropriate event and ensure it is not double counted.*⁵¹

- The nature and the type of event can be clearly identified at the time of this determination, as recognised by the AER in its earlier determinations.⁵²
- Whilst Ausgrid cannot prevent a natural disaster from occurring it does have in place a number of preventative measures in place in relation to potential natural disasters. These include:
 - Adoption of the bow tie risk methodology. Ausgrid assesses each of its risks according to the bow tie methodology. For a particular risk, such as bushfires, the bow tie approach captures the causes, defences against those causes, consequences of the event and mitigation factors. The improved understanding of bushfire risks that comes from using the bow tie approach underpins Ausgrid's asset and risk management activities and encompasses both prevention and mitigation.⁵³
 - Development and adherence to Ausgrid's bushfire risk management plan. Our key bushfire prevention and mitigation strategies include:⁵⁴
 - Identification of bushfire risks – Ausgrid identifies bushfire prone zones in collaboration with the NSW Rural Fire Service (RFS). Ausgrid's assets are subsequently classified on an area basis according to their level of bushfire risk.⁵⁵
 - Improving the standards for electricity assets – Ausgrid implements an audit regime to ensure compliance with internal and industry standards and codes. Ausgrid has recently identified aspects of our existing asset base that would have the potential to ignite bushfires. We have sought to mitigate this by fitting low voltage spreaders⁵⁶, and installation of high voltage substation/control point equipment.⁵⁷ In addition, Ausgrid seeks to use fire resistant material and low risk equipment for assets in high risk bushfire areas.⁵⁸
 - Prudent maintenance procedures aimed at mitigating bushfire risks. This includes routine above ground inspections carried out at intervals of between four and five years to detect defects and prioritise their repair or replacement. For areas designated as fire prone, our procedures require an annual pre-summer patrol⁵⁹ and defect rectification of overhead mains. Where necessary, these inspections are carried out from helicopters, fixed wing air craft and now unmanned aerial vehicles.

⁴⁷ AER, *Victorian electricity distribution network service providers distribution determination 2011-2015, Draft Decision*, June 2010, p 726-728.

⁴⁸ AER, *Final Distribution Determination, Aurora Energy Pty Ltd 2012-13 to 2016-17*, 30 April 2012, p 183-185.

⁴⁹ AER, *Final Decision – ElectraNet Transmission Determination 2013-14 to 2017-18*, 30 April 2013, p 187-198.

⁵⁰ Ibid, p 188. AER, *Final Decision – SP AusNet Transmission Determination 2014-15 to 2016-17*, 30 January 2014, p 55.

⁵¹ AER, *Draft Distribution Determination, Aurora Energy Pty Ltd 2012-13 to 2016-17*, November 2011, p 39.

⁵² For example, AER, *Victorian electricity distribution network service providers distribution determination 2011-2015, Draft Decision*, June 2010; AER, *Final Distribution Determination, Aurora Energy Pty Ltd 2012-13 to 2016-17*, 30 April 2012; AER, *Final Decision – ElectraNet Transmission Determination 2013-14 to 2017-18*, 30 April 2013.

⁵³ Refer to Chapter 5 support documents (ID12627) - Ausgrid's 2013/14 Risk Management Plan, November 2013.

⁵⁴ Refer to Attachment 5.08 Ausgrid's Network Management Plan, June 2012, Chapter 4 Bushfire Risk Management Plan.

⁵⁵ To identify bushfire prone areas Ausgrid uses bushfire prone land maps prepared by local councils and certified by the Commission of the NSW RFS. Ausgrid overlays these maps with our geospatial asset information to identify assets in bushfire prone areas.

⁵⁶ This mitigates potential deficiencies in existing low voltage bare overhead constructions in bushfire prone areas.

⁵⁷ This is aimed at minimising emission of hot particles that could initiate a bushfire. For example air break switches with arc containment.

⁵⁸ For example we use fuses and charges that are designed to minimise the risk of our assets initiating a bushfire and use steel and concrete poles instead of treated timber to mitigate the risk of a our assets causing a bushfire to spread.

⁵⁹ Ausgrid uses patrols to identify any factors associated with overhead mains that could lead to the initiation of a bushfire such as inadequate tree clearances, impact damage, lightning damage, etc.

- Specific operational procedures for times of very high fire danger. Our staff and contractors are required to adopt special work procedures and precautions during the bushfire danger and total fire bans.⁶⁰ Notification of total fire ban days is via SMS from our Network Control Room. In addition, we change the protection settings on certain equipment during very high fire danger by switching the re-close function on nominated high voltage distribution and sub transmission feeders from automatic to manual.⁶¹
- Management of safe vegetation clearances. To help prevent the possibility of trees or bushland vegetation causing bushfires, we manage vegetation safety clearances on our network according to our Tree Safety Management Plan and Network Standards NS 179 Vegetation Safety Clearances. In bushfire prone areas the vegetation clearances are increased by at least a further 0.5 metres.
- Working with other agencies to ensure a coordinated approach to bushfire risk management. Ausgrid participates in Regional Bushfire Risk Management forums, industry debriefs following bushfires, works closely with the NSW RFS and provides 'hands on' assistance during bushfires.⁶²
 - o Where possible, Ausgrid seeks to locate its assets in geotechnical stable areas away from mines and flood prone areas to mitigate the risk of our assets being damaged by floods, earthquakes or unstable grounding. In addition, Ausgrid designs its major substations to withstand certain wind and earthquake loads, in accordance with AS/NS 117.0 – 2002 to mitigate any damage arising from floods, storms and earthquakes.
 - o In the event of a natural disaster event, Ausgrid has in place a Emergency Management Plan and Incident Management Process, Incident Management System and Risk Escalation Process which are designed to ensure that impacts from such events are minimised and managed in a coordinated and timely manner.

Ausgrid considers that its current level of commercial insurance cover in relation to natural disasters is appropriate and represents a prudent approach for mitigating the cost impact to Ausgrid from such an event.⁶³ It would be inappropriate for Ausgrid to take out higher levels of insurance cover for natural disaster events given the low probability of a major natural disaster event occurring. Adopting such an approach would also be inefficient as it would result in an unnecessary cost increase to customers and is a disproportionate response to the level of risk.

Ausgrid has not included a self insurance amount in its proposal for natural disaster events. In the event of a major natural disaster event occurring we do not consider that we would be in a position to effectively pool enough risk to cover the cost impacts from such an event.

7 Terrorism event

7.1 Rationale

Previously, this event was a prescribed pass through event in the Rules; however, following the Australian Energy Market Commission's (AEMC's) amendment to the Rules in 2012, this event was removed.⁶⁴ Consequently, while the transitional amendments in the Rules (clause 11.49.2) provides that the 'terrorism event' remains a pass through event for the remainder of the network service provider's current regulatory period and the transitional regulatory control period, this event will no longer apply for Ausgrid's 2015-19 regulatory period unless it is approved by the AER as a nominated pass through event.

Ausgrid proposes that a 'terrorism event' be included as a pass through event, as part of its regulatory determination for the 2015-19 regulatory control period, as this represents the most prudent and efficient means for managing a risk of this nature in its forthcoming regulatory control period.

Accepting a 'terrorism event' as a nominated pass through event would also be consistent with the:

- Nominated PTE considerations,⁶⁵

⁶⁰ Risk mitigation procedures are used during construction and maintenance activities to ensure that we do not start a bush fire as per the Distribution Guideline DG – 33 Hot Work During Total Fire Bans.

⁶¹ Our procedures for manual re-closing after faults are based on the requirements of ISSC 33 Guidelines for network configuration during bushfire risk days and section 7.3.6 of the ENA NENS 01-2001 National Electricity Safety Code.

⁶² For example Ausgrid assisted ActewAGL to restore power during the January 2003 bushfires in Canberra and offered assistance during the February 2009 Victorian bushfires.

⁶³ Refer to Appendix 2- Extract from Ausgrid's 2013/14 Risk Management Plan, November 2013, pp 126-128

⁶⁴ National Electricity Amendment (Cost pass through arrangements for Network Service Providers) Rule 2012 No.4.

⁶⁵ Chapter 10 of the NER, refer to definition of nominated cost pass through considerations.

- Policy intent for nominated cost pass through events – that is that a NSP should not be placed in a position where it is unable to mitigate or avoid the event without creating unacceptable risk,⁶⁶ and
- Revenue and pricing principles in the NEL – specifically, that a regulated NSP should be provided with an opportunity to recover at least the efficient costs it has incurred in providing direct control services or complying with a regulatory obligation or requirement.⁶⁷

7.2 Proposed definition

Ausgrid proposes a ‘terrorism event’ as a pass through event for the 2015-19 regulatory control period, defined as follows:

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 Ausgrid in providing direct control services.

Our proposed definition for this event is the same as the definition previously included in the Rules, amended only insofar as to make it applicable to Ausgrid directly, rather than all network service providers.

7.3 Nominated pass through considerations

- Ausgrid considers that including a ‘terrorism event’ (as defined above) represents the most prudent and efficient means for managing a risk of this nature in its forthcoming regulatory control period. In addition, we note that such an approach is also consistent with the nominated PTE considerations. Specifically:
- The proposed ‘terrorism event’ is not covered by a category of pass through event specified in clause 6.6.1(a1)(1) to (4) of the Rules;
- The nature and type of the event can be clearly identified at the time the AER makes its determination for Ausgrid, as evidenced by the proposed definition and the fact that the event was previously prescribed in the Rules.
- Ausgrid’s ability to reasonably prevent a terrorism event from occurring and/or substantially mitigate the cost impact from the event is limited. Whilst the occurrence of a terrorism event is largely beyond our control to prevent, we in have place a number of prudent measures to reduce the likelihood of such an event from occurring. These include:
 - Ausgrid has an ongoing program to meet its obligations in relation to infrastructure security. The activities that we undertake to ensure the security of our assets range from the application and inspection/maintenance of standards related to fences, locks and keys for tens of thousands of pieces of equipment, through to full monitored 24/7 electric security on selected key infrastructure.
 - Participation in joint security risk assessments of Ausgrid assets with the NSW Counter Terrorism Branch, Ministry of Policy and Emergency Services, which has resulted in 62 Ausgrid sites being classified as ‘critical infrastructure.’⁶⁸
 - For each of its critical infrastructure sites Ausgrid undertakes a combination of staff site visits and contracted security service provider visits once every 24 hours, to identify any breaches in the perimeter barrier of a site.⁶⁹
 - Ausgrid personnel also undertake monthly inspections of all of our major substations. These monthly inspections are intended to detect any breaches of the perimeter and/or any attempted intrusions.
 - Ausgrid inspects and risk assesses all physical perimeter security measures annually. This annual review is undertaken by specialist security experts and includes a reassessment of substation perimeter security for functionality and integrity.⁷⁰ Following this review, recommendations are made for repair, upgrade or modification as required.

⁶⁶ AEMC 2012, Cost pass through arrangements for Network Service Providers, Rule Determination, 2 August 2012, p 8.

⁶⁷ Refer to s 7(A)(2)(a) and (b) of the NEL.

⁶⁸ Critical infrastructure is defined in the National Guidelines for Protecting Critical Infrastructure from Terrorism (2011) as “those physical facilities, supply chains, information technologies and communication networks which, if destroyed, degraded or rendered unavailable for an extended period, would significantly impact on the social or economic well being of the nation, or affect Australia’s ability to conduct national defence and ensure national security.”

⁶⁹ The National Guidelines for Protecting Critical Infrastructure from Terrorism require owners/operators of critical infrastructure to be able to detect related incidents within a period of time based on their national threat level rating. Currently, Ausgrid’s national threat level rating is medium, which requires us to detect incidents within 24 hours.

⁷⁰ The methodology for undertaking the security risk assessment is based upon the principles outlined in AS/NZS IS31000:2009 Risk Management – Principles and Guidelines. In addition, the following documents are also used as reference guides for the annual audit: Ausgrid Protective Security Manual 2010; NSW Policy Counter Terrorism Plan; Australian Government Protective Security Manual; Network Engineering Guideline EP09 – Intruder resistant fencing guidelines and Depot and Boundary Fence Guidelines 2009.

- Ausgrid has recently begun trialling electronic perimeter security systems at selected critical infrastructure assets. The equipment installed includes video cameras, Public Address (PA) speakers, Infra Red movement sensors and electronic alarms.
- Ausgrid has commercial insurance cover which would likely be triggered by an act of terrorism. However, Ausgrid does not have specific cover for terrorism or cyber terrorism, as the market for such insurance is still developing. Consequently obtaining insurance cover for this type of risk on commercial grounds remains difficult.
- The potential magnitude of the cost impact of a terrorism event means that it is a risk that Ausgrid believes cannot be credibly self insured. The low probability of such an event also means that there is a lack of data on which to base a reliable calculation of a self insurance premium.

Whilst Ausgrid does have some commercial insurance that would likely be triggered if a terrorism event occurred, this is likely to be insufficient in mitigating the cost impacts from such an event. Where a terrorism event occurred which enabled an existing commercial policy to be called upon, this would reduce the costs incurred directly by Ausgrid and therefore reduce the amount claimed under any cost pass through.

Ausgrid considers that its current insurance levels are appropriate in light of the nature of the risk and availability of insurance on commercial grounds. Whilst the recent Terrorism Insurance Act Review 2012⁷¹ found that some commercial market capacity for terrorism insurance is re-emerging both internationally and domestically, it found that insurance capacity remains insufficient to cover demand. Furthermore, there is insufficient capacity for individual risks in Australia, with the quantum of commercial market capacity likely to be significantly below the current \$13.4 billion scheme operated by the Australian Reinsurance Pool Corporation.

It would be inappropriate to manage the risk of a terrorism event via a self insurance allowance, as there is a lack of reliable data to calculate a credible self insurance premium for this event. Even if a self insurance premium could be calculated, Ausgrid has serious reservations as to whether we would be in a position to 'effectively' self insure for such an event given the likely magnitude of the cost impacts.

Should the AER disagree with our position and determine that a terrorism event should not be included as a nominated pass through event for our 2015-19 regulatory control period, Ausgrid would be placed in a position where it was exposed to terrorism related risks not covered by commercial insurance. In effect, this would mean that Ausgrid would be retaining or absorbing its exposure to such a risk. Under such circumstances, Ausgrid reserves the right to amend its proposed self insurance allowance to reflect a self insurance amount for terrorism. However, as noted above, the difficulty in calculating a reliable self insurance premium is a consideration which supports the acceptance of a terrorism event as a nominated pass through event.

8 Insurer's credit risk

8.1 Rationale

Ausgrid has in place a number of mitigation strategies to avoid being in a situation where one of its insurer's becomes insolvent. However, as demonstrated by the recent global financial crisis, whilst the likelihood of this risk materializing is very low it is not improbable. Consequently, to manage our exposure to any of our insurer's becoming insolvent, Ausgrid proposes an 'insurer's credit risk event' to apply during its 2015-19 regulatory control period.

Ausgrid notes that accepting an 'insurer's credit risk event' as a nominated pass through event would also be consistent with the:

- Nominated PTE considerations;⁷²
- Policy intent for nominated cost pass through events – that is that a NSP should not be placed in a position where it is unable to mitigate or avoid the event without creating unacceptable risk;⁷³ and
- Revenue and pricing principles in the NEL – specifically, that a regulated NSP should be provided with an opportunity to recover at least the efficient costs it has incurred in providing direct control services or complying with a regulatory obligation or requirement.⁷⁴

8.2 Proposed definition

Ausgrid proposes an 'insurer's credit risk event' as a pass through event for the 2015-19 regulatory control period, defined as follows:

⁷¹ Australian Government, Terrorism Insurance Act Review, May 2012.

⁷² Chapter 10 of the NEL, refer to definition of nominated cost pass through considerations.

⁷³ AEMC 2012, Cost pass through arrangements for Network Service Providers, Rule Determination, 2 August 2012, p 8.

⁷⁴ Refer to s 7(A)(2)(a) and (b) of the NEL.

The insolvency of a nominated insurer of Ausgrid, as a result of which Ausgrid:

- i. incurs materially higher or lower costs for insurance premiums than those allowed for in its Distribution Determination; or*
- ii. in respect of a claim for a risk that would have been insured by Ausgrid's insurer's, is subject to materially higher or lower claim limit or a materially higher or lower deductible than would have applied under that policy.*

Ausgrid notes that a similar pass through event was approved for the Victorian DNSP's and also Aurora.⁷⁵

8.3 Nominated pass through considerations

In relation to the nominated PTE considerations, Ausgrid notes the following:

- The event is not covered by a category of pass through event specified in clause 6.6.1(a1)(1) to (4) of the Rules.
- The nature and the type of event can be clearly identified at the time of this determination, as recognised by the AER in its earlier determinations.⁷⁶
- Ausgrid seeks to mitigate the risk of any of insurers becoming non-viable by regular monitoring and reporting by the broker of insurer Standard & Poor (S&P) rating movements. Our minimum acceptable insurer S&P rating is A-. Also multiple insurers are used on the Ausgrid's liability and Industrial Special Risks (ISR) insurance policies, therefore spreading the risks amongst several insurers and minimises our reliance on any one insurer.
- It is not economically viable for Ausgrid to insure (commercial and self insurance) against this event as the probability of this occurring is extremely low. Further, given the risk mitigation strategies outlined above, it is not viable to commercially insure this risk with another insurer.

Whilst the AER has previously noted that it may be possible for a DNSP to affect such an event, by selecting a cheap but unstable insurance company, it noted that as part of the criteria for approving actual pass through costs that it would take into account whether the DNSP could have done anything to mitigate the costs⁷⁷.

9 Application of pass through provisions to alternative control services

Ausgrid proposes that the pass through provisions for defined and nominated pass through events apply to alternative control services on the basis that the pass through provisions in the Rules apply to direct control services, which applies to both standard control services and alternative control services.⁷⁸

We note the application of this approach is consistent with the AER's decision in the NSW DNSPs 2009-14 distribution determination, ActewAGL's 2009-14 distribution determination, Queensland DNSPs 2010-2015 distribution determination and SA Power Networks (formerly ETSA Utilities).

Ausgrid supports the AER's view that it is appropriate to apply the pass through provisions of the Rules to alternative control services, as all direct control services are subject to the distribution determination.⁷⁹ We also support the AER's view that the Rules do not preclude the pass through provisions from applying to alternative control services for defined events and nominated events accepted by the AER.⁸⁰

Further, whilst the classification of services is essential in determining the extent of regulation, it is not a determining factor in deciding whether or not the pass through, as a mechanism to compensate for risks or allocating of the consequences of the risk, should be made available. Rather, it is the fact that the DNSP, as a provider of distribution services, faces risks, the cost impact of which (if the risk materializes) is most appropriately borne by customers. The risk faced by the DNSP in providing that service does not change or dissipate simply because the classification has changed. The DNSP is still facing the same risk, which if materialized would have an impact on the cost of providing that service(s).

⁷⁵ AER, *Victorian electricity distribution network service providers distribution determination 2011-2015, Final Decision*, October 2010; AER, *Final Distribution Determination*; AER, *Aurora Energy Pty Ltd 2012-13 to 2016-17*, 30 April 2012.

⁷⁶ *Ibid.*

⁷⁷ AER, *Draft Determination – Aurora Energy Pty Ltd 2012-13 to 2016-17*, November 2011, p 287.

⁷⁸ Refer to Chapter 10 of the NER – definitions of 'negative change event', 'positive change event', 'regulatory change event', 'tax change event', 'service standard event', and 'retailer insolvency event.' See also Ausgrid proposed definition for its proposed nominated pass through events for 'an insurance cap event,' 'natural disaster event', 'terrorism event' and 'insurer's credit risk event.'

⁷⁹ AER, *Draft Decision – South Australia: Draft distribution determination 2010-11 to 2014-15*, 25 November 2009, p 407. See also AER, *Draft Decision – Queensland: draft distribution determination 2010-11 to 2014-15*, 25 November 2009, p 347.

⁸⁰ AER, *Draft Decision – New South Wales: draft distribution determination 2009-10 to 2013-14*, 21 November 2008, p 286.

Consequently, as a provider of distribution services, Ausgrid faces risks that would impact on the cost of providing these distribution services. The cost consequence of some of these risks should (in accordance with the Rules with respect to defined pass through events or AER approved pass through events) be borne by the customer if the risk materialises and has a material impact on the DNSP's cost in providing direct control services. Under such circumstances, a DNSP should be able to recover these costs irrespective of how the services, which were impacted by the events/risk materializing, were classified by the AER for the purpose of determining the extent of regulation. This is consistent with section 7(A)(2)(a) and (b) of the NEL, which provides that DNSPs should be given a reasonable opportunity to be able to recover at least the efficient costs the operator incurs with providing direct control services and complying with regulatory obligations or requirements.

Appendix 1 – Summary of Ausgrid’s approach to risk management

Risk	Description	Risk Management Approach	Treatment of residual risk
Asbestos	Liability for claims related to the impact of asbestos (both retrospectively and prospectively) on employees and third parties	<p>There are two components to the risk, (1) the risk of exposure to customers and the community and 2) the risk of exposure to workers and contractors</p> <p>Insurance</p> <ul style="list-style-type: none"> - 1) is dealt with via the NSW DNSPs Group Liability Insurance Scheme (GLIS) cover up to \$50m with a deductible of \$100k. Ausgrid also has cover up to \$20m with a deductible of \$50k (or \$5k for a member of the public) - 2) is dealt with through Ausgrid's self insurance for workers compensation <p>Risk controls</p> <ul style="list-style-type: none"> - Asbestos awareness training - Asbestos safety management plan - Risk management policy and plan 	Residual risks above insurance cap amounts to be managed via the 'insurance cap event'
Gradual pollution	Unintentional pollution of the surrounding environment from underground fuel tank leakage, transformer oil, contamination from treated poles etc	<p>Risk controls</p> <ul style="list-style-type: none"> - Environmental policy - Risk management policy and plan 	Risk is retained by the business
Electric and magnetic fields (EMF)	Adverse health impacts caused by EMF and regulatory changes impacting the undertaking of "live line" work	<p>Insurance – GLIS</p> <p>Risk controls</p> <ul style="list-style-type: none"> - Environmental policy - Monitoring of global research and developments 	Residual risks for above insurance cap amounts to be managed via the 'insurance cap event'
Business continuity	Future incidents/events that could significantly impact on the business' ability to continue business as usual	<p>Insurance</p> <ul style="list-style-type: none"> - Limited group cover through Industrial Special Risks(ISR), and property insurance (additional up to \$50m however this does not include loss of revenue rather it covers the extra cost of relocating the business) <p>Risk controls</p> <ul style="list-style-type: none"> - emergency evacuations plans - incident management plans - facility incident response plan - business continuity plan 	Residual risk is retained by the business

Risk	Description	Risk Management Approach	Treatment of residual risk
Theft of assets	Risk of theft from employees and external parties	Insurance - covered by the group ISR/property policy Risk controls <ul style="list-style-type: none"> - CCTV - Secure premises and security patrols 	Residual risks above insurance cap amounts to be managed via the 'insurance cap event'
Fraud	Theft, false accounting, bribery and corruption, deception and collusion	Insurance <ul style="list-style-type: none"> - This risk is covered by the NSW DNSPs crime policy with a limit of \$10m and a deductible of \$100k Risk controls <ul style="list-style-type: none"> - Inventory, bank and computer controls - Limited cash on premises - Audits and information security policy - Fraud management policy 	Residual risks above insurance cap amounts to be managed via the 'insurance cap event'
Bomb threat/hoax, terrorism, Earthquakes, bushfire, non-terrorist impact of planes and helicopters and substations		Insurance <ul style="list-style-type: none"> - These risks are broadly covered by GLIS. Terrorism, earthquakes, and property also being covered under the NSW DNSP group property cover Risk controls <ul style="list-style-type: none"> - Emergency evacuation plans - Incident management plans - Business continuity plans - Security arrangements - Bushfire risk management plan - Strategic asset management plan 	Risk for non-terrorist planes to be managed via an 'insurance cap event' Residual risks from bushfires, earthquakes and other natural disasters are to be managed via a 'natural disaster event' and 'insurance cap event' (depending on what is deemed to be appropriate by the AER). Residual risk from bomb threats and hoaxes are to be retained by the business Exposure to terrorism events are to be managed via a 'terrorism' event.
Insurer's credit risk	Potential for insurer to default on promise to pay claims as well as the loss of premium paid upfront	Insurance – none Risk controls <ul style="list-style-type: none"> - Use of multiple insurer's where possible - Only accept insurers with S&P rating of A- or higher 	Exposure to be managed via an 'insurer's credit risks event' Residual risk of insurer's default without becoming insolvent is to be retained by the business

Risk	Description	Risk Management Approach	Treatment of residual risk
		<ul style="list-style-type: none"> - Regular reporting on credit worthiness from brokers 	
Counter party credit risk	Probability of retailer defaulting on payment obligations	<p>Insurance – None</p> <p>Risk controls</p> <ul style="list-style-type: none"> - Existence of a credit manager role - Risk management policy - Counter party credit reviews - Security deposit f deemed appropriate 	Exposure managed via retailer insolvency pass through event
General public liability	Injuries or losses suffered by the general public as a result of Ausgrid's negligence	<p>Insurance – GLIS</p> <p>Risk controls</p> <ul style="list-style-type: none"> - Network management framework - Public electrical safety awareness plan 	Residual risks for above insurance cap amounts to be managed via the 'insurance cap event'
Poles and lines	Exogenous incident causes damage to distribution network	<p>Insurance – None</p> <p>Risk controls</p> <ul style="list-style-type: none"> - Recovery actions against third parties - Vegetation controls - Regular inspections - Asset management plan (Strategic Asset Management Plan) 	Residual risk absorbed by the Ausgrid
Power quality	Electricity supplied falls outside of statutory limits or perceived "good electricity practice"	<p>Insurance – GLIS covers defective supply and failure to supply</p> <p>Risk controls</p> <ul style="list-style-type: none"> - Maintenance of network - NECF/contractual arrangements 	Residual risks above insurance cap amounts to be managed via the 'insurance cap event'
Workers compensation	Substantial increase in workers compensation claims as a result of a cause outside of the control of the business	<p>Insurance – self insure</p> <p>Risk controls</p> <ul style="list-style-type: none"> - Safety strategic plan - Excess of loss for Ausgrid 	Premiums covered via a regulatory allowance for self insurance

Appendix 2 – Alignment between insurance cover and hazardous events

The maintenance of comprehensive insurance policies is an effective treatment action that transfers the financial risk associated with a hazardous event to the insurer. Ausgrid holds insurances that, in full or in part, limit the financial impact of each of our 45 operational hazardous events. **Table A1** below details the insurance cover held to minimise the financial impact of the operational risks. Note the table includes any self insured retention (SIR) amount and the limit/sum insured of the insurance policy concerned. That is, SIR in this context refers to the cost impact that Ausgrid absorbs or retains in the event of a risk materializing. The insurance policy limits have been arrived at by appropriate procedures including in conjunction with Ausgrid's insurance brokers.

Table A1: Alignment between insurance cover and hazardous events

BR No.	Hazardous Event	Residual Risk Rating	SIR Limit	Insured Limit	Mitigating Insurance
1.1	Uncontrolled discharge or contact with electricity	High			
1.2	Exposure to hazardous materials	Medium			
1.3	Fall from height	High			
1.4	Motor vehicle accident	High			
1.5	Unintended contact with plant	High			
1.6	Struck by falling/moving object	High			
1.7	Incident while undertaking lifting operations	High			
1.8	Incident while undertaking excavation work	High			
1.9	Incident while working near or around traffic	High			
1.10	Exposure to mental stress/traumatic event	High			
1.11	Exposure to hazardous manual tasks	High			

BR No.	Hazardous Event	Residual Risk Rating	SIR Limit	Insured Limit	Mitigating Insurance
1.12	Uncontrolled release of a pressurised substance	Medium			
1.13	Slips, Trips and Falls (excluding fall from height)	Medium			
1.14	Exposure to environmental elements (heat & cold)	Medium			
1.15	Exposure to non-ionising radiation	Medium			
1.16	Incident while working at depth or in a confined space	High			
1.17	Striking object with part of the body	Medium			
1.18	Exposure to sound or sound pressure	Medium			
1.19	Exposure to a biological hazard including flora/fauna	Medium			
2.1	Performance of the Network is inadequate to meet customers' supply expectations	High			
2.2	The Network has insufficient capacity/capability to meet the demands placed on it	Medium			
2.3	A major fire caused by the Network or Network activity	Medium			
2.4	Loss of Upstream supply	Medium			

BR No.	Hazardous Event	Residual Risk Rating	SIR Limit	Insured Limit	Mitigating Insurance
3.1	Loss of, or damage to, a physical organizational asset	High			
3.2	Claim for loss of, or damage to, a Third Party (excluding bushfire)	Medium			
3.3	Unbudgeted shortfall in finance due to unfavourable changes in revenue and/or costs	Medium			
3.4	Financial loss due to Retailer non-payment	Low			
3.5	Material adverse movement relating to significant foreign exchange exposure	Low			
3.6	Untimely TSA delivery and transition	Low			
4.1	Disputes leading to litigation and/or arbitration	Medium			
4.2	Non-compliance with legislation or license conditions	Medium			
4.3	Corrupt conduct by an employee, consultant or contractor	Medium			
5.1	Misalignment between Community expectations and management decisions	Medium			
5.2	Ineffective management response to an incident/crisis	Medium			
5.3	Failure to embed National Energy Customer Framework requirements	Medium			
6.1	Polluting the environment	Medium			
6.2	Unauthorised development or damage to flora, fauna or heritage	Medium			

BR No.	Hazardous Event	Residual Risk Rating	SIR Limit	Insured Limit	Mitigating Insurance
6.3	Inappropriate management of waste and contaminated materials	Medium			
6.4	Emissions causing nuisance to the community	Medium			
7.1	Poor cultural alignment following new Operating Model implementation	Medium			
7.2	Loss of key knowledge and/or experience	Medium			
8.1	Failure to develop a robust Strategy	Medium			
8.2	Failure to deliver Strategy	Medium			
9.1	Loss of ICT & OT service	High			
9.2	Breach of data integrity and/or security	Medium			

