



REVENUE PROPOSAL 2019 - 2023

Attachment 13

Pass Through Events

28 March 2017

Company Information

ElectraNet Pty Ltd (ElectraNet) is the principal electricity transmission network service provider (TNSP) in South Australia.

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Note

This attachment forms part of our Revenue Proposal for the 2018-19 to 2022-23 regulatory control period. It should be read in conjunction with the other parts of the Revenue Proposal.

Our Revenue Proposal comprises the overview and attachments listed below, and the supporting documents that are listed in Attachment 15:

Revenue Proposal Overview

Attachment 1 – Maximum allowed revenue

Attachment 2 – Regulatory asset base

Attachment 3 – Rate of return

Attachment 4 – Value of imputation credits

Attachment 5 – Regulatory depreciation

Attachment 6 – Capital expenditure

Attachment 7 – Operating expenditure

Attachment 8 – Corporate income tax

Attachment 9 – Efficiency benefit sharing scheme

Attachment 10 – Capital expenditure sharing scheme

Attachment 11 – Service target performance incentive scheme

Attachment 12 – Pricing methodology

Attachment 13 – Pass through events (this document)

Attachment 14 – Negotiated services

Attachment 15 – List of supporting documents

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13. Pass Through Events

13.1 Key points

- The current provisions relating to pass through events are an important aspect of the regulatory framework as they provide an efficient risk management framework for unlikely, but potentially costly events.
- We are nominating the following pass through events in accordance with clause 6A.7.3 of the Rules:
 - Insurance cap event;
 - Terrorism event;
 - Natural disaster event; and
 - Insurer credit risk event.
- Our proposed drafting for each of these events is consistent with the AER's most recent draft transmission determinations for AusNet Transmission Group and Powerlink.

13.2 Introduction

The cost pass through provisions set out in clauses 6A.6.9 and 6A.7.3 of the Rules enable us to recover (or pass back to customers) materially higher (or lower) costs in providing prescribed transmission services if a 'pass through event' occurs.

The current Rules provisions reflect changes that were introduced by the Australian Energy Market Commission (AEMC) in August 2012. The aim of these amendments was to enable network businesses to recover their efficient costs in the advent of an unexpected event, while ensuring that the prices for consumers are no more than necessary to provide an appropriate level of service.

To achieve this objective, the AEMC decided to:

- provide transmission businesses with the ability to nominate additional pass through events as part of their revenue proposals;
- include a set of 'nominated cost pass through event considerations' in the Rules that the AER must consider when deciding whether to accept the pass through event nominated by the transmission business; and
- remove the terrorism event as a prescribed pass through event.

Clause 6A.7.3(a1) therefore provides for the following pass through events:

- A regulatory change event;
- A service standard event;
- A tax change event;
- An insurance event; and

- Any other event nominated as a pass through event in a transmission determination.

In accordance with the Rules requirements, this attachment sets out our proposals for the following nominated pass through events:

- Insurance cap event;
- Terrorism event;
- Natural disaster event; and
- Insurer credit risk event.

The basis for nominating these events, and the proposed definitions, are set out in the remaining sections of this attachment. For each nominated pass through event, we explain the rationale for its inclusion and the risk mitigation measures we take to minimise the likelihood of its occurrence and its cost impact.

13.3 Insurance cap event

13.3.1 Definition

We nominate an Insurance Cap Event as a pass through event for the regulatory period 2018-19 to 2022-23. Our proposed definition of this event is as follows:

An Insurance Cap Event occurs if:

1. ElectraNet makes a claim or claims and receives the benefit of a payment or payments under a relevant insurance policy;
2. ElectraNet incurs costs beyond the policy limit of the relevant insurance policy at the time of the event that gives rise to the relevant claim; and
3. The costs beyond the relevant policy limit increase the costs to ElectraNet of providing prescribed transmission services.

For this Insurance Cap Event:

- a) A relevant insurance policy is an insurance policy held during the 2018-19 to 2022-23 regulatory control period or a previous regulatory control period in which ElectraNet was regulated, and
- b) ElectraNet will be deemed to have made a claim on a relevant insurance policy if the claim is made by a related body corporate of ElectraNet in relation to any aspects of ElectraNet's prescribed transmission services.

Note: In making a determination on an Insurance Cap Event, the AER will have regard to, amongst other things:

- i. the insurance policy for the event,
- ii. the level of insurance that an efficient and prudent NSP would obtain in respect of the event, and
- iii. any assessment by the AER of ElectraNet's insurance document in respect of its transmission determination for the relevant period.

13.3.2 Rationale

This pass through event is proposed on the basis that it is not always efficient for TNSPs to fully insure against high impact, low probability events. This is because commercial insurance for these events may be unavailable, or may be available at a prohibitively high cost.

It is also unlikely to be efficient to receive an additional annual self-insurance allowance to be placed in a reserve as the reserve may need to be maintained, theoretically, for a significant period of time. There is also the possibility that an extreme event may occur well before the reserve has reached the level required to meet the cost of an event.

The AER has previously determined that an insured event where costs are incurred beyond the insurance cap would largely be triggered by circumstances beyond the NSP's control, could not be forecast and would likely incur costs of a high magnitude. The AER considered that a combination of self-insurance (for costs above the insurance cap but below a specified threshold) and pass throughs should compensate for such an event.

The event definition set out in Section 13.3.1 above is consistent with that contained in the AER's recent draft decision for Powerlink.

13.3.3 Risk mitigation

We understand the complementary nature of commercial insurance coverage, self-insurance and pass through events, ensuring that we have an optimal blend of cover.

As an efficient and prudent NSP, we set our insurance limits based on credible risk based scenario analysis, worst foreseeable loss studies, asset values, industry benchmarks and professional broker advice.

13.4 Terrorism event

13.4.1 Definition

We nominate Terrorism as a pass through event for the regulatory period 2018-19 to 2022-23. Our proposed definition of this event is as follows:

A terrorism event is:

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 increases the costs to ElectraNet in providing prescribed transmission services.

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

- a) whether ElectraNet has insurance against the event,
- b) the level of insurance that an efficient and prudent NSP would obtain in respect of the event, and
- c) whether a declaration has been made by a relevant government authority that an act of terrorism has occurred.

13.4.2 Rationale

We believe that a pass through mechanism is currently the most appropriate regulatory approach for addressing the costs arising from a terrorism event, for the following reasons:

- The nature of a terrorism event is such that the associated costs are highly uncertain and extremely difficult to forecast with a reasonable degree of accuracy.
- A “Terrorism event” is no longer defined as a prescribed pass through event.
- The nature and type of the event can be clearly identified at the time that the AER makes its determination for us.
- The extent to which we can reasonably prevent a terrorism event from occurring and/or can substantially mitigate the cost impacts of such an event is limited. That said, we have a range of measures in place which are intended to protect against acts of terrorism, and mitigate the impacts of an event should one occur.
- The relative infrequency and potentially very high costs of terrorism events create significant practical challenges to self-insure for such events. A pass through mechanism provides a more appropriate arrangement for managing the cost impacts if a terrorism event occurs and causes a material increase in our costs.
- Many insurance policies have terrorism exclusions which describe excluded terrorist acts in much broader terms than contained within the *Terrorism Insurance Act 2003* (TIA). Hence an incident may be deemed a ‘terrorism’ incident by an insurer and may trigger a policy exclusion but never become a “declared terrorist incident” as defined by the TIA.

A pass through mechanism has the advantage of allowing the AER to evaluate the efficient costs arising from a terrorism event after the event has occurred. A pass through mechanism therefore avoids the need to make a prior allowance for the expected costs of a terrorism event, either by including a forecast cost as an operating expenditure or through a self-insurance premium.

The event definition set out in Section 13.4.1 above is consistent with the wording contained in the AER’s recent draft decision for Powerlink.

13.4.3 Risk mitigation

We will manage terrorism risk with a primary focus on key assets and critical infrastructure. We participate in the Australian Reinsurance Pool Corporation (ARPC) under the *Terrorism Insurance Act 2003*.

13.5 Natural disaster event

13.5.1 Definition

We nominate that a Natural Disaster Event be included as a pass through event for the regulatory period 2018-19 to 2022-23. Our proposed definition of this event is as follows:

Natural Disaster Event means any natural disaster including but not limited to fire, flood or earthquake that occurs during the 2018-19 to 2022-23 regulatory control period that increases the costs to

ElectraNet in providing prescribed transmission services, provided the fire, flood or other event was not a consequence of the acts or omissions of the service provider.

Note: In assessing a Natural Disaster Event pass through application, the AER will have regard to, amongst other things:

- a) whether ElectraNet has insurance against the event; and
- b) the level of insurance that an efficient and prudent NSP would obtain in respect of the event.

13.5.2 Rationale

The above definition of a Natural Disaster Event is consistent with the wording contained in the AER's recent draft decision for AusNet Transmission Group.

In that decision, the AER removed the reference to whether a government authority has declared an occurrence to be a natural disaster. In that decision, the AER explained that its inclusion had received criticism in other regulatory processes on the basis it could create uncertainty and introduce irrelevant considerations. While the AER did not accept these concerns, it accepted that it is unnecessary to refer to a government authority declaration explicitly in the definition¹.

We believe the AER's wording for AusNet Transmission Group is also appropriate for us. In South Australia, severe localised storms can cause massive damage to the network but may not be catastrophic in terms of homes lost or loss of life. A case in point is the recent September 2016 storms which destroyed 20 towers and caused a blackout for the whole state of South Australia. This event was a natural disaster in nature and magnitude in terms of the damage to the network.

Our view is that the AER should make its own assessment of whether an event is a natural disaster, considering the relevant facts.

13.5.3 Risk mitigation

Natural disaster events, by definition, cannot be prevented or avoided. ElectraNet employs a range of strategies to minimise and mitigate the exposure of the transmission network to natural disasters. These include technical preventative measures such as minimum design standards to withstand seismic, flood and fire (and other natural catastrophes) along with risk transfer (insurance cover) for certain assets.

For assets such as towers and lines, the exposure to natural disasters is reduced as far as reasonably practicable through design standards and the meshed nature of the network.

Due to South Australia's geographic and demographic composition, beyond localised events, there are exposures to extreme events that a prudent and efficient NSP is unable to mitigate or insure against. Risk transfer (insurance) is not commercially available to ElectraNet for towers and lines. This consideration, coupled with the losses we experienced as a result of the storms of September 2016, demonstrates that the Natural Disaster Nominated Pass Through mechanism provides the most cost effective risk mitigation strategy.

¹ AER, Draft Decision, AusNet Services transmission determination 2017–18 to 2021–22, Attachment 13 – Pass through events, July 2016, page 16.

13.6 Insurer credit risk event

13.6.1 Definition

We nominate that an Insurer Credit Risk be included as a pass through event for the regulatory period 2018-19 to 2022-23. Our proposed definition of this event is as follows:

An Insurer Credit Risk event occurs if:

A nominated insurer of ElectraNet becomes insolvent, and as a result, in respect of an existing, or potential, claim for a risk that was insured by the insolvent insurer, ElectraNet:

1. is subject to a materially higher or lower claim limit or a materially higher or lower deductible than would have otherwise applied under the insolvent insurer's
2. incurs additional costs associated with self-funding an insurance claim, which would otherwise have been covered by the insolvent insurer.

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

- a) ElectraNet's attempts to mitigate and prevent the event from occurring by reviewing and considering the insurer's track record, size, credit rating and reputation, and
- b) in the event that a claim would have been made after the insurance provider became insolvent, whether ElectraNet had reasonable opportunity to insure the risk with a different provider.

13.6.2 Rationale

We have significant insurance coverage (\$145 million for Industrial Special Risks and \$800 million for Combined General Liability) and hence an insurer not being able to pay all, or part, of a claim could materially affect us.

Although we mitigate this risk to the best of our ability, the insolvency of one or more of our insurers is an event that is outside our control. Hence, we believe that a pass through mechanism is currently the most appropriate regulatory approach for addressing the costs arising from a nominated insurer becoming insolvent.

The event definition set out in Section 13.6.1 above wording is consistent with the wording contained in the AER's recent draft decision for Powerlink.

13.6.3 Risk mitigation

We set minimum requirements for the credit grading of participating underwriters at A minus (A-) with Standard and Poor's, or equivalent. We also manage risk through appropriate vertical and horizontal apportionment across our policies both domestically and internationally. This is supported by appropriate due diligence activities by us and our Brokers.



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