Pass Through Events

2024-29 Regulatory Proposal

Endeavour Energy

POWER together

Contents

Executive summary

This document sets out in detail our proposed nominated pass through events for the 2024-29 regulatory control period. Our 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).

We have assessed the key risks we face as a distribution network service provider (DNSP) 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 2024-29 regulatory control period include:

- insurance coverage event;
- natural disaster event;
- terrorism event; and
- insurer's credit risk event.

We consider 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.

These four pass-through events were nominated in our regulatory proposal for the current regulatory control period and were subsequently approved by the AER (noting the insurance coverage event has replaced the previous insurance cap event to reflect more accurately the nature of the provision). These same events have also largely been nominated by other DNSPs and approved by the AER in their respective recent determinations.

The remainder of this document discusses our 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; our proposed definitions for each nominated pass through event; and how each nominated pass through event meets the nominated pass through event considerations (PTE considerations) set out in Chapter 10 of the Rules.

Background

What are pass throughs and why are they necessary?

The regulatory framework recognises that a 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 incremental 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 principles[1] and the National Electricity Objective[2] 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.

When are pass throughs appropriate?

The use of a pass through event is restricted by the Rules and the AER's determination. 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.

Under the Rules they are limited to the following defined events;

- a tax change event;
- a service standard event;
- a regulatory change event; and
- a retailer insolvency event.[3]

However, DNSPs 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. DNSPs must satisfy the AER that the 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, the AER needs to be satisfied that:

- the nominated event is not covered by an existing category of pass through event
- the nominated event can be clearly identified at the time the determination is made
- a prudent DNSP could not reasonably prevent an event of that nature or type from occurring or substantially mitigate its cost impact and could not insure (or self-insure) against the events on reasonable commercial terms.[5]

[1] S 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.
[2] S 7 of the NEL.
[3] Cl. 6.6.1(a1) and Chapter 10 of the National Electricity Rules (NER).
[4] Cl. 6.5.10 of the NER.
[5] Chapter 10 of the Rules

The AER must take these considerations into account when deciding whether to accept or reject a DNSP'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.

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 DNSPs to undertake efficient and prudent risk management.

Cost pass throughs approach

Identifying the need for additional nominated pass through events

In reaching the decision to nominate cost pass through events to apply during the 2019-24 regulatory control period, we undertook a thorough risk assessment of our operations using the bow-tie risk analysis methodology. The results of this analysis were cross-checked against our historical risk register to ensure that key risks were captured and assessed on a consistent basis.

From this process, we 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 Endeavour Energy 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, we 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, we had regard to the PTE considerations and the likely cost impacts to customers from adopting this approach.

In developing our 2024-29 regulatory proposal, we have carefully reviewed the appropriateness of nominating the same residual risks as those which are best managed through the cost pass through mechanism provided in the Rules. Risks to the network are routinely identified, assessed and managed in accordance with our Risk Management Framework with risk assessments embedded as a standard 'business as usual' activity. This regular monitoring of risk allows us to determine whether specific, residual risk events are most efficiently managed through the pass through mechanism or alternatively, directly by the business (and included in our building block proposal). As was the case when nominating pass through events for the current regulatory control period, our proposed pass through events for the 2024-29 regulatory control period have been made with regard to the PTE conditions in the Rules.

We consider there will not be any material change in our circumstances or operating environment from the current regulatory control period that require changes to our approved nominated pass through events for the 2024-29 regulatory control period. We expect our potential exposure to the residual risk events currently managed by the pass through mechanism to remain unchanged and therefore propose to nominate the same pass through events previously approved by the AER.

Risk management

Our approach to risk management

Our approach to risk management is outlined in the Group Board Policy on Risk Management, which is aimed at enabling, developing and sustaining a positive culture of risk management to enable the ongoing development and innovation of our operations through strategic initiatives while supporting the efficient delivery of safe, reliable and sustainable electricity services to our customers.[6]

Our Risk Management Policy is implemented through our Risk Management Framework and Corporate Risk Management Plan which details our key risks and control measures for preventing and mitigating the risk. Our Risk Management Framework sets out organisational arrangements for designing, implementing, monitoring, reviewing and continually improving risk management throughout the business. The framework is premised on:

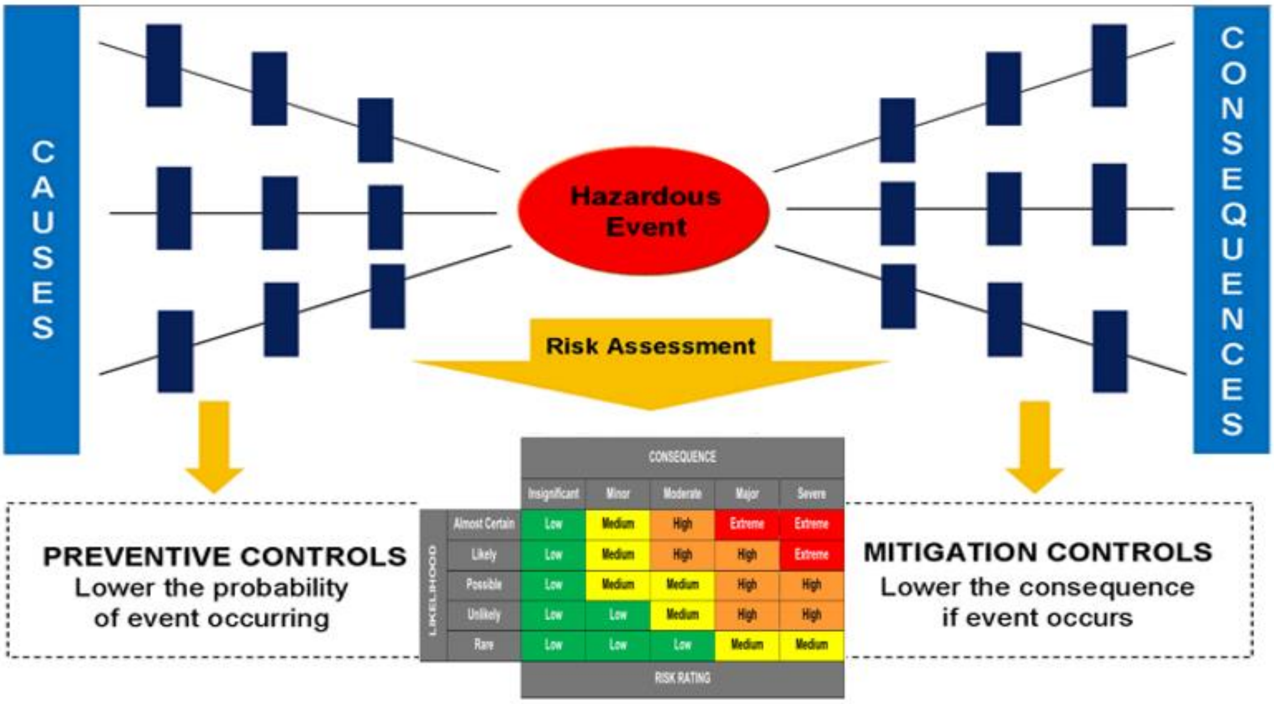
- The clear identification of risk roles and responsibilities represented by the "Three Lines of Defence" (see Figure 1).
- Establishing and maintaining an integrated risk management process through documented policies, procedures and risk management plans, that are aligned with the business' internal and external contexts.
- The identification of strategic, financial and operational risks that may impact the achievement of corporate objectives, and the documentation of these in the Corporate Risk Management Plan.
- The assessment of identified risks against predefined consequence and likelihood criteria to determine the risk rating via a Risk Matrix and appropriate treatment. The risk matrices are reviewed annually and approved by the Board.
- The management of risks to levels that are tolerable and in line with the Board approved Risk Appetite Statement. Where it is not reasonably practicable to eliminate the risk, the business will manage the risk to as low as reasonably practicable (ALARP). The business will not undertake any activity where the residual risk is assessed as "Extreme" without an approved treatment action plan to reduce the risk to a tolerable level or the specific approval of the Audit and Risk Committee where the external factors are wholly outside the control of the business.

Figure 1: The Three Lines of Defence

[6] Endeavour Energy Group Board Policy: Risk Management, 25 August 2022.

Our Risk Management Framework utilises the bow-tie risk methodology to assess our key risks. The bow-tie methodology considers plausible worst case hazardous events and identifies both the preventative and mitigative controls in place to either reduce the likelihood or mitigate the consequence of the event should it occur. Figure 2 illustrates the bow-tie risk methodology.

Figure 2: Bow-tie risk methodology



Assessing the appropriate regulatory treatment of risks

In preparing our 2024-29 regulatory proposal, 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, we 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 we have in place prudent and effective measures to address most risks, we have identified some risks which are beyond our control to prevent and have a low probability of occurrence or are unpredictable. Consequently, we 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 the 2024-29 regulatory control period, we had regard to whether we were able to 'effectively' self-insure for the risk. That is, whether we would have the capacity to effectively pool enough risk to cover the severity of the likely impact should the risk occur.

We have determined that it is only appropriate to self-insure for risks associated with workers compensation. Our forecast self-insurance costs to manage these risks form part of our total proposed opex requirements which have been derived by adopting the 'revealed cost' base-step-trend expenditure forecasting approach.

In terms of addressing residual risks which are not addressed by our proposed 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, we determined that Endeavour Energy was the most appropriate party to bear the costs associated with this event, and as a result absorb the cost impacts associated with the risk materialising. 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, Endeavour Energy 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 2019-24 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 Endeavour Energy 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 Endeavour Energy's regulatory proposal;
- are likely to have a significant cost impact; and
- fall 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 Endeavour Energy to catastrophic financial consequences if the risks were to eventuate.

We note that our approach to cost pass throughs is consistent with the AER's position in relation to these types of events and with the revenue pricing principles in the NEL. Furthermore, it limits any erosion of our incentive to use market based mechanisms to mitigate cost impacts that would arise.

External review of regulatory treatment of risks

In 2014, we engaged Ernst & Young (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 risk management approach (including insurance arrangements) adopted by Endeavour Energy was appropriate and efficient for each of the risks identified; and 2) advise on the appropriate regulatory treatment of each risk based on Endeavour Energy's current and/or proposed risk management approach. Key findings from EY's report include:

- Endeavour Energy's proposed approach towards self-insurance and cost pass through is appropriate from a commercial risk management and regulatory treatment perspective.

- Endeavour Energy's insurance arrangements encompass a robust and thorough renewal and review process.
- self-insuring worker's compensation is appropriate for Endeavour Energy because it is cost effective; and
- the nominated pass through events proposed by Endeavour Energy are appropriate because they capture the risks which are beyond the control of the Endeavour Energy to prevent or mitigate. They also cannot be effectively or efficiently insured due to the likely significant cost impacts and appear to satisfy the nominated PTE considerations in the Rules.

Our Risk Management Framework has evolved since this review was undertaken. Our Risk Management Policy is based on based on AS/NZS ISO 31000:2018 Risk Management - Guidelines and we have updated and developed our policies and plans to reflect changes in our operating environment and to ensure our compliance with our obligations to the relevant Acts, regulations, codes and licence conditions.

Nevertheless, our general approach to risk management has not significantly changed and we continue to maintain a vigilant approach to mitigating unavoidable risks through prudent insurance and self-insurance arrangements. For this reason, we consider the key findings made previously by EY remain valid. This consistency supports our repeated nomination of the existing pass through events that were approved by the AER for the current regulatory control period.

Role of external insurance

We maintain comprehensive insurance arrangements which are regularly reviewed to align with the Corporate Risk Management Plan. Advice is also obtained from external risk and insurance brokers and/or consultants and our internal insurance specialists to establish the appropriate levels of coverage, implement appropriate insurance market negotiation strategies and to manage claims efficiently and effectively.

As discussed earlier, a PTE consideration the AER needs to have regard in deciding whether to accept a nominated pass through event is whether the relevant DNSP could insure against the event, having regard to the availability (including the extent of availability in terms of liability limits) of insurance against the event on reasonable commercial terms.

Over the past few years, we have found it increasingly challenging to obtain insurance coverage at the same cost and terms agreed to at the commencement of the current regulatory period. This has been largely driven by multiple, catastrophic bushfires and weather related events – both in Australia and overseas – which has resulted in insurers significantly increasing the price for coverage or withdrawing coverage from the market completely. Our insurance advisors have indicated they expect material price increases to continue in the 2024-29 regulatory control period.

Nevertheless, we consider that it remains prudent to manage our insured risks by continuing to obtain coverage at these higher prices. That is, risks will be transferred to the third-party insurers rather than borne by our customers through the cost pass through mechanism. However, the increase in premiums means that our historical insurance costs, including the amount in our revealed FY23 base year will not be reflective of our insurance costs for 2024-29. To ensure we can maintain appropriate coverage related to bushfire damage, injury and general liability and have the opportunity to recover the incremental increase in insurance costs, we have proposed an opex step change.

We recognise some DNSPs have previously proposed opex step changes to recover forecast insurance cost increases in conjunction with nominating the risk of insurance cost increases beyond the forecast amount arising from any further volatility in insurance markets as a pass through event.[7] In assessing the proposed event, the AER considered on balance that the long term interests of consumers would be better served if the appropriate incentives remain with DNSPs to actively work to moderate expected increases in insurance premiums over the next regulatory control period.[8]

[7] These DNSPs include Powercor, Jemena, AusNet Services and United Energy and were proposed in their 2021-26 proposals (in the case of Jemena) and 2021-26 revised proposals (for Powercor, AusNet Services and United Energy).
[8] AER, Final decision – Powercor, Attachment 15: Pass through events, April 2021, p.11

Consequently, the AER did not approve the nominated insurance premiums event, but instead included the forecast insurance premium as part of its opex forecast for the following regulatory control period. We agree with the AER that cost pass throughs should be a last option for DNSPs to pursue cost recovery and have opted to propose only an opex step change.

Consideration of cost impacts to consumers

In determining whether to nominate cost pass through events as part of our regulatory proposal, we have considered 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 and the required materiality threshold is met. 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 any application to pass through the cost of the event to customers. In several of its recent decisions (including Endeavour Energy's cost pass through application for the 2019-20 bushfires), the AER approved cost pass through amount has been lower than the relevant DNSPs proposed amount.

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:

1) that the event falls within a prescribed or nominated pass through category;
2) the event materially increases the costs of providing standard control services; and
3) set out the amount that the network service provider proposes should be recovered.[9]

If the network service provider is unable to demonstrate requirements both 1) and 2), then the pass through event will not be approved. Costs are not recovered from customers and the DNSP 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 failed to take any actions which increased the magnitude of the amount.[10]

Consequently, there are no immediate impacts to customers from the AER approving our nominated pass through events. Approval of these events merely enables Endeavour Energy 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.

[9] Materially in this context is defined in the Rules as the change in costs from the event exceeding 1% of the DNSP's annual revenue requirement.
[10] Clause 6.6.1(j), NER.

Decision to nominate pass through events

Endeavour Energy 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 DNSP.

We have undertaken a thorough risk assessment of our operations using the bow-tie risk analysis methodology and have identified a number of risks which either cannot be mitigated or which would be uneconomical for us to mitigate.[11] These risks are generally beyond our control to prevent. For example, natural disaster related events such as major floods, fires, earthquakes, 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 us to forecast the severity and frequency of these risks accurately for the forthcoming regulatory control period. Consequently, Endeavour Energy 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:

- The risk might not eventuate, or the severity of the impact could be significantly less than estimated – this could result in Endeavour Energy 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.
- The risk eventuates and Endeavour Energy 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, Endeavour Energy 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 are a:

- **Insurance coverage event**
- **Natural disaster event**
- **Terrorism event**
- **Insurer's credit risk event**

In proposing these events we have had regard to the PTE considerations in Chapter 10 of the Rules. We consider accepting each of these nominated events would be consistent with the:

- nominated PTE 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;[12] 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.

[11] The cost of taking out external insurance or adopting certain risk mitigation measures may be inefficient given the low probability of the risk occurring and substantial cost that would be imposed on customers.
[12] AEMC 2012, Cost pass through arrangements for Network Service Providers, Rule Determination, 2 August 2012, p 8.

We consider that each event meets the necessary requirements to be approved as a nominated cost pass through event. Notably, these pass through events are the same as those which we nominated, and the AER subsequently approved for the 2019-24 regulatory control period. However, we have proposed amendments to some definitions. The reasons for this are discussed in the sections below.

Insurance coverage event

Rationale

We consider that the most efficient and appropriate means of managing our exposure to the risk of incurring liabilities beyond our insurance coverage is via the cost pass through mechanism. This is because the probability of such an occurrence is extremely low, mitigation through commercial and self-insurance are not available on reasonable grounds and the cost impacts from such an event would be catastrophic.

A similar event - the 'insurance cap event' applies for the 2019–2024 regulatory period which enables us to recover material costs that are incurred above our insurance policy limit. The AER’s decision predated the significant changes observed in insurance markets discussed previously. During the 2019-24 period, the AER refined the name and definition of this event to better recognise the possibility of future coverage gaps and that DNSPs often have multiple insurance policies. Gaps in a DNSP’s insurance coverage may occur due to movements in the insurance liability market and result in the DNSP becoming unable to find suitable insurance providers to fill withdrawn capacity, or if it cannot economically justify higher premiums.

As a result, the broader coverage of the amended ‘insurance coverage event’ definition applies only under what the AER has defined as ‘changed circumstances’. This is where there are movements in the relevant insurance liability market that are beyond the control of a DNSP, and those movements mean that it is no longer possible for a DNSP to take out an insurance policy or set of insurance policies at all, or on reasonable commercial terms.

We have updated the pass-through event to better reflect the scope of insurance coverage for our liabilities and the recent changes in the global insurance market discussed previously. The scope of the cover provided by a relevant insurance policy or policies includes the bands of liability for which Endeavour Energy is insured.

Proposed definition

We propose an ‘insurance coverage event’ as a pass through event for the 2024-29 regulatory control period, defined as follows:

> ***An insurance coverage event occurs if:***
>
> ***1. Endeavour Energy:***
>
> > ***a) makes a claim or claims and receives the benefit of a payment or payments under a relevant insurance policy or set of insurance policies; or***
> >
> > ***b) would have been able to make a claim or claims under a relevant insurance policy or set of insurance policies but for changed circumstances; and***
>
> ***2. Endeavour Energy incurs costs:***
>
> > ***a) beyond a relevant policy limit for that policy or set of insurance policies; or***
> >
> > ***b) that are unrecoverable under that policy or set of insurance policies due to changed circumstances; and***
>
> ***3. The costs referred to in paragraph 2 above materially increase the costs to Endeavour Energy in providing direct control services.***
>
> ***For the purposes of this insurance coverage event:***

'changed circumstances' means movements in the relevant insurance liability market that are beyond the control of Endeavour Energy, where those movements mean that it is no longer possible for Endeavour Energy to take out an insurance policy or set of insurance policies at all or on reasonable commercial terms that include some or all of the costs referred to in paragraph 2 above within the scope of that insurance policy or set of insurance policies.

'costs' means the costs that would have been recovered under the insurance policy or set of insurance policies had:

i. the limit not been exhausted; or

ii. those costs not been unrecoverable due to changed circumstances.

A relevant insurance policy or set of insurance policies is an insurance policy or set of insurance policies held during the regulatory control period or a previous regulatory control period in which Endeavour Energy was regulated; and

Endeavour Energy will be deemed to have made a claim on a relevant insurance policy or set of insurance policies if the claim is made by a related party of Endeavour Energy in relation to any aspect of Endeavour Energy's network or business; and

Endeavour Energy will be deemed to have been able to make a claim on a relevant insurance policy or set of insurance policies if, but for changed circumstances, the claim could have been made by a related party of Endeavour Energy in relation to any aspect of Endeavour Energy's network or business.

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

i. the relevant insurance policy or set of insurance policies for the event

ii. the level of insurance that an efficient and prudent DNSP would obtain, or would have sought to obtain, in respect of the event;

iii. any information provided by Endeavour Energy to the AER about Endeavour Energy's actions and processes; and

iv. any guidance published by the AER on matters the AER will likely have regard to in assessing any insurance coverage event that occurs.

Our proposed definition for insurance coverage events is necessarily different from our current approved 'insurance cap event' but is consistent with the definition approved by the AER in more recent distribution determinations. The change in definition captures the risk of our inability to obtain the same level or scope of cover under an insurance policy or program of policies that was not previously captured under the 'insurance cap event'.

We consider that this pass through event would continue to provide a prudent and efficient means for addressing the risks associated with costs arising from third party liability claims, in excess of insured limits or where coverage gaps emerge in the suite of insurance policies due to continued deterioration in global insurance markets.

Nominated pass through event considerations

In support of this pass through event, we note 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 Endeavour Energy, as evidenced by the fact that the AER has previously accepted this event and the definition in their most recent distribution determinations.
- the extent to which we can reasonably prevent a claim occurring which exceeds the insurance coverage or can substantially mitigate the cost impact of such an event, is limited. We note that the AER has

previously concluded that although DNSPs could take steps to reduce its risk exposure to these events, expenditure beyond a certain level aimed at completely eliminating the risk is likely to be imprudent or inefficient. In that context, sharing the risk with customers is appropriate and more likely to be in the long-term interests of consumers with respect to price.

We obtain appropriate levels of insurance that are commensurate with our risk exposure. We have done this by undertaking a prudent and thorough assessment of our business risk and aligning our exposure to such risks with appropriate levels and scope of insurance cover. Each year we review the limits of our insurance policies in conjunction with our broker/advisor taking into account updated underwriting information and discussions with our operating divisions.

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 or less coverage in light of the nature of the risk, probability of occurrence and cost of purchasing additional levels of coverage.

We do not propose to take out higher levels of insurance to mitigate our general risk exposure, 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. Indeed higher levels of insurance are not currently available in the global insurance market (September 2022). Rather, the insurance coverage event would protect us from rare, high cost impact events which would be uneconomical to insure. Our customers benefit from not having to fund excessive premiums where insurance, if available, would be uneconomic. Consumers then only bear the risk should an 'insurance coverage event' occur. The event therefore provides for an appropriate sharing of risk between us and our customers and is more likely to be in the long-term interests of consumers with respect to price.

Further, nominating the 'insurance coverage event' will not dilute incentives for undertaking appropriate levels of insurance cover. We have an incentive to choose the most efficient mix of risk mitigation mechanisms for our liabilities insurance coverage.

For instance, should we not maintain an appropriate level of insurance coverage, the AER would be able to consider whether we had, '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.'[13] Also, via their guidance note the AER has provided clear guidance on how it proposes to assess whether an DNSP has acted prudently and efficiently in its actions leading to an insurance coverage pass through event and its expectations of the information a DNSP should provide, which includes analysis supporting the appropriateness of its insurance positions, to facilitate the assessment.

Natural disaster event

Rationale

We consider the approval of a 'natural disaster event' cost pass through is necessary, as it captures uncertain, potential high cost impact events outside our control. Natural disaster events include bushfires and other extreme weather events such as earthquakes, floods and cyclones. Such events typically result in DNSPs incurring substantial costs, including those potentially arising from property damage to Endeavour Energy's assets. The value and appropriateness of a natural disaster event can be evidenced through the several cost pass through applications successfully submitted by NSPs in recent years, including Endeavour Energy, related to major storms, floods and bushfire events.

We proposed that a 'natural disaster event' be included as a pass through event, during the 2019-24 regulatory control period noting it had been approved in our 2014-19 regulatory determination. We considered that this represented the most efficient means for managing risks of this nature and in addition, was consistent with the

[13] Clause 6.6.1(j)(3), NER.

PTE considerations and pricing principles in the NEL. We propose we should continue to have access to a ‘natural disaster event’ in our 2024-29 distribution determination.

A ‘natural disaster event’ is necessary in order to provide us with an opportunity to recover efficient, incremental costs for responding to a natural disaster event, where such costs are material. It is anticipated that material costs, such as works to repair or replace property and network damage and from the event and other response activities will be recovered via a ‘natural disaster event’. We are unable to self-insure for natural disaster events.

Endeavour Energy notes that accepting a ‘natural disaster event’ is consistent with the approach adopted by the AER over the past few regulatory cycles for all NSPs operating in the NEM. In accepting proposed ‘natural disaster event’ as a pass through event, the AER has previously acknowledged that it is inevitable that some overlap exists between the ‘natural disaster event’ and ‘insurance coverage event.’ We do not consider this overlap to be an issue, as the AER 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.

Consequently, approval of a natural disaster and insurance coverage event merely provides us 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.

Proposed definition

Endeavour Energy proposes a ‘natural disaster event’ as a pass through event for the 2024-29 regulatory control period, defined as follows:

> ***Natural disaster event means any individual or series of related natural disaster events including but not limited to cyclone, fire, flood or earthquake that occurs during the 2024–29 regulatory control period that changes the costs to Endeavour Energy in providing direct control services, provided the cyclone, fire, flood, earthquake or other event was:***
>
> > ***(a) a consequence of an act or omission that was necessary for the service provider to comply with a regulatory obligation or requirement or with an applicable regulatory instrument; or***
> >
> > ***(b) not a consequence of any other act or omission of the service provider.***
>
> ***Note: In assessing a natural disaster event pass through application, the AER will have regard to, amongst other things:***
>
> > ***(1) whether Endeavour Energy has insurance against the event;***
> >
> > ***(2) the level of insurance that an efficient and prudent NSP would obtain in respect of the event.***
> >
> > ***(3) Whether a relevant government authority has made a declaration that a natural disaster has occurred***
> >
> > ***(4) the reasonable actual extent of the event, or series of related events, having regard to relevant factors including, but not limited to, enduring weather systems and earthquake aftershocks.***

Our proposed definition captures the key unpredictable, potentially high cost natural disaster events outside of the control of DNSPs. As evidenced by the 2019-20 Black Summer Bushfires, natural disaster related events pose a key risk and responding to these events and repairing the damage to the network can result in substantial cost impacts to DNSPs.

Our proposed definition aligns largely, although not completely, with the definition approved by the AER in recent distribution determinations. These differences and our reasons for proposing them are explained below.

A consequence of an act or omission by the DNSP that was necessary

A key difference from the definition approved by the AER for our current regulatory period which has been applied to other DNSPs since is the addition of the natural disaster event being **"*a consequence of an act or omission that was necessary for the service provider to comply with a regulatory obligation or requirement or with an applicable regulatory instrument*".**

This change was adopted as a result of other DNSPs raising issues where compliance with regulations could prevent those network service providers from meeting pass through requirements. Specifically, there were concerns that where a DNSP is prohibited from clearing vegetation to a greater extent than is reasonably necessary to meet vegetation clearance regulations and requirements, there could still remain a possibility that vegetation could provide a source of ignition for a bushfire start. In such circumstances and in the absence of the amendment, the natural disaster event definition would not be met because it could be argued that the impact on the distribution infrastructure was a consequence of an 'omission' of the respective DNSP.

We consider this scenario is also valid for Endeavour Energy and propose it be included in the definition.

Natural disaster declaration

We note the AER has tended to not include the reference to a government authority making a natural disaster declaration among the factors it is required to have regard to. This factor was included in the natural disaster event definition for our 2019-24 regulatory period and we propose it be retained for the 2024-29 regulatory period. We note where this reference has not been included in the definition, the AER has stated its removal will not prevent the AER from having regard to whether a declaration has been made.

We consider a declaration of a natural disaster by a government should remain a relevant, if not determinative, factor in the AER's assessment of a natural disaster event. We accept that there may be circumstances where a declaration is not made but the definition and assessment criteria are satisfied. However, where a declaration has been made this would be compelling evidence in support of a natural disaster cost pass through proposal. It would be difficult to fathom a circumstance wherein a natural disaster is declared by a government but not recognised by the AER as one in assessing a pass-through proposal (setting aside the assessment of the efficiency and prudency of the costs incurred).

Furthermore, we note a declaration by a government authority has been consistently included by the AER in other pass through decisions as a factor it will have regard to in its definition of a "terrorism event". As an official government-level statement allows in the event of a terrorism event, we believe such a declaration could assist in determining the occurrence and defining the scope of a natural disaster event.

We therefore consider this factor should be maintained and note it does not bind the AER, nor prevent us from making an application under a natural disaster event, but simply ensures regard is had to what we consider to be a highly relevant factor.

A natural disaster can involve a series of related events

Natural disasters can occur in many forms. For instance, cyclones and earthquakes are generally observed as a single, identifiable event and usually occur in isolation. In contrast, and as observed during the 2019-20 Black Summer bushfires and the East Coast storms during that summer, the occurrence of multiple bushfires and storms, where they are caused by a common underlying factor(s), could be considered as a single natural disaster event.

Our proposed definition clarifies our ability to make a cost pass through application following a natural disaster event which involves several individual events – akin to the numerous and dispersed bushfires which underpinned our 2019-20 bushfire natural disaster event. This recognition is pertinent given the events over recent years and expectations that communities will be more frequently and materially impacted by climate change.

Our proposed definition reflects our belief that there is scope to refine the definition to make it clear that a natural disaster can involve multiple events of the same kind, spread across disparate geographical locations and often occurring on different days (but within a reasonable timeframe such as a season or summer). Where the underlying cause is the same, we believe it is reasonable a series of interrelated events should be considered collectively as a single pass through event.

We also note that the AER's assessment would continue to have regard to what constitutes a series of related events. The AER has previously stated that whether multiple natural disasters can be considered as a single natural disaster pass through event, must be determined on a case-by-case basis having regard to all the surrounding circumstances. Whilst the AER has typically applied the existing definition in a manner consistent with this understanding of the dynamic nature of natural disasters, we note there has been different interpretations between some applicant DNSPs and the AER on whether multiple events could be considered a single event for the purpose of their respective pass through application.

We consider it good practice for the definition to be updated to reflect the possibility for multiple events to be considered holistically within a natural disaster event cost pass through application. Our proposed definition could also assist in removing any potential for ambiguity over whether the criteria is met for a natural disaster cost pass through.

Nominated pass through considerations

Endeavour Energy 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
- the nature and type of the event can be clearly identified at the time the AER makes its determination, as evidenced by the fact that the AER has previously accepted this event for each DNSP operating in the NEM in their most recent respective determinations.
- the extent to which we can reasonably prevent a natural disaster or can substantially mitigate the cost impact of such an event, is limited.

Whilst we cannot prevent a natural disaster from occurring, we do have in place a number of preventative measures in relation to potential natural disasters. For instance, our bow-tie risk methodology 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 our asset and risk management activities and encompasses both prevention and mitigation.

Also, in accordance with the requirements of the Electricity Supply (Safety and Network Management) Regulation 2014 (NSW), we have in place an Electricity Network Safety Management System (ENSMS), which also complies with Australian Standard AS 5577 – Electricity network safety management systems. The ENSMS details the risks associated with the operation of the electrical network as well as the controls that are used to eliminate these risks or reduce them to ALARP. The assessment and management of these risks is discussed in a set of Formal Safety Assessments (FSAs).

To minimise the bushfire risk, the Bushfire FSA detail the hazards and control mechanisms that Endeavour Energy applies to the risk that its network and activities associated with the design, construction, maintenance and operation of the network will start a bushfire or other vegetation-related fire.

Bushfires represent the most significant natural disaster risk. Our key bushfire prevention and mitigation strategies include:

- <u>Identification of bushfire risks.</u> We identify bushfire prone zones in collaboration with the NSW Rural Fire Service (RFS). Our assets are subsequently classified on an area basis according to their level of bushfire risk.
- <u>Improving the standards for electricity assets.</u> We implement an audit regime to ensure compliance with internal and industry standards and codes. We have 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 spreaders; and installation of high voltage substation/control point equipment. In addition, we seek to use fire resistant material and low risk equipment for assets in high risk bushfire areas.
- <u>Prudent maintenance procedures aimed at mitigating bushfire risks.</u> 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 patrol and defect rectification of overhead mains. Where necessary, these inspections are carried out from helicopters, fixed wing aircraft and unmanned aerial vehicles.

- 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. 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.
- 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.
- Emergency Management. In the event of a natural disaster event, we have in place an Incident Management Plan which is designed to ensure that impacts from major disruptive events, including natural disasters, are minimised and managed in a coordinated and timely manner.

Finally, we consider that our current level of commercial insurance cover in relation to natural disasters is appropriate and represents a prudent approach for mitigating the cost impact to us from such an event. It would be inappropriate for us 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.

Terrorism event

Rationale

We propose that a 'terrorism event' be included as a pass through event for the 2024-29 regulatory control period as it represents the most prudent and efficient means for managing a risk of this nature. The event applied to our 2019-24 determination and has been consistently accepted as a cost pass through event by the AER in previous determinations.

Terrorism events, both generally and considered within the context of the cost pass through mechanism, are quite rare events but have the potential to inflict significant costs depending on the nature and scale of the damage and disruption caused. Whilst we have systems in place to mitigate the risk of a terrorism event occurring, we cannot completely eliminate the risk of such an event occurring.

A 'terrorism event' is necessary in order to provide us with an opportunity to recover efficient, incremental costs for responding to a natural disaster event, where such costs are material.

Proposed definition

We propose a 'terrorism event' as a pass through event for the 2024-29 regulatory control period, defined as follows:

> ***Terrorism event means 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***
> - ***changes the costs to Endeavour Energy in providing direct control services.***

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

- ***whether Endeavour Energy has insurance against the event;***
- ***the level of insurance that an efficient and prudent NSP would obtain in respect of the event; and***
- ***whether a declaration has been made by a relevant government authority that a terrorism event has occurred.***

Our proposed definition is consistent with the definition approved by the AER for our 2019-24 determination as well as recent regulatory determinations for other DNSPs. However, in the context of our increased focus on utilising new technology platforms and relying on rich sources of data to manage the network, and the growing incidence of cyber-attacks on the technology systems of large local and international corporations from unknown overseas actors, we consider there is scope to provide clarity on whether the risks from cyber-attacks or electronic system hacks are provided for in the cost pass through framework.

In our view, the 'terrorism' event remains a valid and enduring threat, but it also risks becoming antiquated and narrow in its language and focus. By its current definition, the event refers to acts done for, or in connection with, political, religious, ideological, ethnic or similar purposes of reasons. This could be applied in a limited away to exclude other acts of aggression or malice. For instance, cyber-attacks done for ransom or the sake of causing disruption alone, rather than to stoke public fear, intimidate or for the reasons discussed above.

We note some networks have previously nominated pass through events for other malicious acts such as cyber-attacks and war. Where cyber-attacks events have been proposed (either as a stand-alone event or explicitly incorporated within the definition of a terrorism event), the AER's decision has been to reject the proposal. Several reasons have been given for doing so.

For instance, in responding to Ausgrid's proposal to include activities which disrupt critical infrastructure technology such as malware within the definition of a terrorism event, the AER considered the references to be unnecessary and counter-productive: referring expressly to one species of terrorist attack (i.e. cyber threats) tends to raise questions as to whether other types of attack are included.[14]

In the most recent determinations for the Victorian DNSPs, the AER has generally acknowledged the risk posed by major cyber events. However, it considered as DNSPs are best placed manage this risk, they should also bear the cost impact of such events. The AER also recognised DNSPs are obligated to comply with stringent cyber security compliance requirements, which would have the effect of substantially mitigating the risk and cost impacts of major cyber events. The AER also expressed concerns on how a major cyber cost pass through event could deter DNSPs from adopting best practices for managing these risks including through market based mechanisms (i.e. insurance).

The AER has previously confirmed cyber-terrorism would be captured by the terrorism event, although any distinction between what may distinguish cyber-terrorism from a major cyber event in the context proposed by DNSPs has not been made clear. The AER has also considered a war event may be too broadly defined to satisfy the pass-through considerations besides where a physical invasion of Australia occurs. On this point, we do not consider establishing the nexus between an act of war and increased costs to be any more or less difficult than doing so for a terrorism event. The only difference between an act of war versus an act of terrorism is likely to be the belligerents involved and their motivations.

Although we believe the potential significant impact of a cyber-attack supports a more explicit recognition of this risk within the terrorism event, we have not proposed a change to the definition at this stage. We consider it would be better if the definition was consistent across each DNSP and would encourage the AER to engage further with DNSPs on determining the appropriate wording of this event. A potential starting point is to consider how the interpretation of a cyber event risk corresponds to the definition of a terrorist act as defined in the Commonwealth Criminal Code Act 1995 which, among other actions, includes any action that seriously

[14] AER, Ausgrid 2019-24 draft decision

interferes with, seriously disrupts, or destroys, an electronic system including a system used for, or by, an essential public utility.[15]

There may also be merit in changing the 'Terrorism' event name itself to 'Acts of aggression' and/or adjusting the definition to focus on intentional and malicious acts of aggression rather than a subset of them (terrorist attacks). Alternatively, the AER could re-confirm and/or clarify how the event as currently defined remains suitable in an evolving geopolitical environment. We consider acts of war, terrorism and/or cyber-attacks to be so similar in nature that they should be captured collectively by this nominated pass-through event.

Nominated pass through considerations

We consider that including a 'terrorism event' (as defined above) represents the most prudent and efficient means for managing a risk of this nature. 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, as evidenced by the proposed definition and the fact that the event has been widely approved by the AER in recent determinations.
- Our 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 security measures to reduce the likelihood of such an event from occurring.

- We have an ongoing program to meet our 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 our assets with the NSW Counter Terrorism Branch, Ministry for Police and Emergency Services.
- Implementation of a Security Improvement Plan (SIP) which allows us to operate and meet the NSW Distributor's Critical Infrastructure Licence Conditions 9 and 10 and enhance cyber security capability to protect customers, assets, and data.
- For each of our critical infrastructure sites we undertake 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.
- Our personnel also undertake periodic inspections of all of our major substations. These inspections are intended to detect any breaches of the perimeter and/or any attempted intrusions.
- We inspect and risk assess 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. Following this review, recommendations are made for repair, upgrade or modification as required.
- We have rolled out electronic perimeter security systems at selected critical infrastructure assets. The equipment installed includes video cameras, infra-red movement sensors and electronic alarms.

We have commercial insurance cover which would respond to some acts of terrorism, however, we do not have specific cover for terrorism or cyber-attacks. The insurance market has seen a considerable increase in cyber related claims and it is no longer commercially viable to purchase this type of insurance. Alternatively the terms of cover are so narrow and restrictive that very little is covered by the insurance policy. Consequently

[15] Criminal Code Act 1995, Part 5.3 – Terrorism, Division 100 – Preliminary, Section 100.1 – Definitions, p.177

obtaining insurance cover for this type of risk on commercial grounds is either commercially unviable or provides little cover.

Furthermore, the potential magnitude of the cost impact of a terrorism event means that it is a risk that we believe 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 we have some commercial insurance that may respond to a terrorism event, 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 Endeavour Energy and therefore reduce the amount claimed under any cost pass through.

Endeavour Energy 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 Terrorism Insurance Act Review 2021 found that some commercial market capacity for terrorism insurance is re-emerging both internationally and domestically, it found that the global commercial market capacity available for Australian terrorism insurance is considered short of the level required to cover against large, but possible, terrorism incidents.[16]

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, we have 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 2024-29 regulatory control period, we would be exposed to terrorism related risks not covered by commercial insurance. Under such circumstances, Endeavour Energy 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.

Insurer's credit risk

Rationale

We have in place a number of mitigation strategies to avoid being in a situation where one of our insurers becomes insolvent. For instance, we take out insurance with multiple insurers, therefore spreading the risk and minimising the reliance on any one insurer.

However, as demonstrated by the global financial crisis, whilst the likelihood of this risk materialising is very low, it is not impossible. Consequently, to manage our exposure to any of our insurers becoming insolvent, we propose an 'insurer's credit risk event' to apply during the 2024-29 regulatory control period.

This event is contained within our distribution determination for the 2019-24 regulatory period. This event has also been accepted as a pass through event by the AER in more recent regulatory decisions.

Proposed definition

Endeavour Energy proposes an 'insurer's credit risk event' as a pass through event for the 2024-29 regulatory control period, defined as follows:

> ***An insurer's credit risk event occurs if:***
>
> - ***A nominated insurer of Endeavour Energy becomes insolvent, and as a result, in respect of an existing or potential insurance claim for a risk that was insured by the insolvent insurer, Endeavour Energy:***

[16] Australian Government, Terrorism Insurance Act Review, December 2021.

a. ***is subject to a higher or lower claim limit or a higher or lower deductible than would have otherwise applied under the insolvent insurer's policy; or***

b. ***incurs additional costs associated with funding an insurance claim, which would otherwise have been covered by the insolvent insurer.***

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

- ***Endeavour Energy'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***
- ***In the event that a claim would have been made after the insurance provider became insolvent, whether Endeavour Energy had reasonable opportunity to insure the risk with a different provider.***

Our proposed definition for 'insurer's credit risk event' is unchanged from that approved by the AER for the current regulatory control period. Furthermore, our proposed definition for this event mirrors the definition approved by the AER in the regulatory determinations for other DNSPs.

Nominated pass through considerations

In relation to the nominated PTE considerations, Endeavour Energy 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 type of the event can be clearly identified at the time the AER makes its determination for Endeavour Energy, as evidenced by the fact that the event has been widely approved by the AER in numerous recent determinations.
- It is not economically viable for Endeavour Energy 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.

Endeavour Energy 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- as a safeguard to ensure insurance purchases are limited to reputable providers who have the capacity to satisfy any claims. Also multiple insurers are used on Endeavour Energy's liability and Industrial Special Risks (ISR) insurance policies, therefore spreading the risks amongst several insurers and minimising our reliance on any one insurer.

In the 2015-19 draft determination for Endeavour Energy, the AER initially rejected our proposed 'insurer's credit risk' event on the basis that the event is preventable if insurance purchases are limited to reputable providers who have the capacity to satisfy any claims. Furthermore, it was claimed that NSPs can access adequate information to assess the viability of an insurer with regard to their track record, credit rating and reputation, inferring NSPs therefore have some control over the outcome of such events.

This decision was reversed in their final 2015-19 determination as the AER acknowledged that Endeavour Energy may potentially suffer a significant loss as a consequence of an insurer becoming insolvent and is limited in the extent to which these losses can be prudently avoided. As previously stated, we continue to exhibit a prudent approach to managing risk via obtaining adequate insurance coverage by entering into agreements with a range of reputable providers with a minimum A- credit rating. Yet, we remain exposed to potentially significant losses outside of the protections offered by the pass through mechanism. We consider our proposed 'insurer's credit risk event' is consistent with the PTE considerations and should be approved on this basis.

endeavourenergy.com.au

Endeavour Energy

POWER together