

2019-24 Regulatory Proposal

Pass Through Event Proposal

CONTENTS

1.0	Introduction	2
2.0	Background	2
2.1	What are pass throughs and why are they necessary?.....	2
	2.2 When are pass throughs appropriate?	3
3.0	Relevant regulatory requirements	3
4.0	Cost pass throughs approach.....	4
	4.1 Identifying the need for additional nominated pass through events	4
	4.2 Approach risk management	5
	4.3 Assessing the appropriate regulatory treatment of risks.....	6
	4.4 External review of regulatory treatment of risks.....	8
	4.5 Consideration of cost impacts to consumers	8
	4.6 Decision to nominate additional pass through events	9
5.0	Insurance cap event.....	10
	5.1 Rationale.....	10
	5.2 Proposed definition.....	10
	5.3 Nominated pass through considerations	11
6.0	Natural disaster event.....	12
	6.1 Rationale.....	12
	6.2 Proposed definition.....	14
	6.3 Nominated pass through considerations	14
7.0	Terrorism event	16
	7.1 Rationale.....	16
	7.2 Proposed definition.....	17
	7.3 Nominated pass through considerations	17
8.0	Insurer's credit risk.....	19
	8.1 Rationale.....	19
	8.2 Proposed definition.....	19
	8.3 Nominated pass through considerations	20
	Appendix 1 – Alignment between insurance cover and hazardous events	21

1.0 Introduction

This document sets out in detail Endeavour Energy's proposed nominated pass through events for the 2019-24 regulatory control period. Endeavour Energy'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).

Endeavour Energy has assessed the key risks it faces, as a distribution 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 2019-24 regulatory control period include:

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

Endeavour Energy 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. Each of these pass-through events were proposed by Endeavour Energy in our regulatory proposal for the current regulatory control period and subsequently approved by the AER. These same events have also largely been nominated by other DNSPs and approved by the AER in their respective determinations.

The remainder of this document discusses Endeavour Energy'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; Endeavour Energy'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 Endeavour Energy'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

2.0 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 catastrophic and place the DNSP in financial distress.

2.2 When are pass throughs appropriate?

The use of a pass through event is restricted by the Rules and the AER's determination. 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, 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 DNSPs to undertake efficient and prudent risk management.

3.0 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 the relevant regulatory control period.

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.....

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.

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

4.0 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 current 2014-19 regulatory control period, Endeavour Energy undertook a thorough risk assessment of its operations using the bow-tie risk analysis methodology. The results of this analysis were cross-checked against Endeavour Energy's historical risk register to ensure that key risks were captured and assessed on a consistent basis.⁷

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

In developing our 2019-24 regulatory proposal, we have carefully reviewed the appropriateness of nominating specific residual risks that are best managed through the cost pass through mechanism

⁶ Clause 6.6.1(a1) to (4), NER.

⁷ Further details on Endeavour Energy's approach towards managing risk can be found in section 4.2.....

provided in the Rules. Risks to the network are routinely identified, assessed and managed in accordance to 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 2019-24 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 2019-24 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.

4.2 Approach risk management

Endeavour Energy's approach to risk management is outlined in its Group Board Policy on Risk Management, which is aimed at enabling, developing and 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 electricity services to Endeavour Energy's customers.⁸

Endeavour Energy's Risk Management Policy, is implemented through its Risk Management Framework and Corporate Risk Management Plan.⁹ Our Risk Management Framework sets out the foundation documents and organisational arrangements for designing, implementing, monitoring, reviewing and continually improving risk management throughout the business.¹⁰

Endeavour Energy'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.

In addition, Endeavour Energy maintains 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/consultants (currently Aon and Marsh) and Endeavour Energy's internal insurance specialists to establish the appropriate levels of coverage, implement appropriate insurance market negotiation strategies and to efficiently and effectively manage claims.

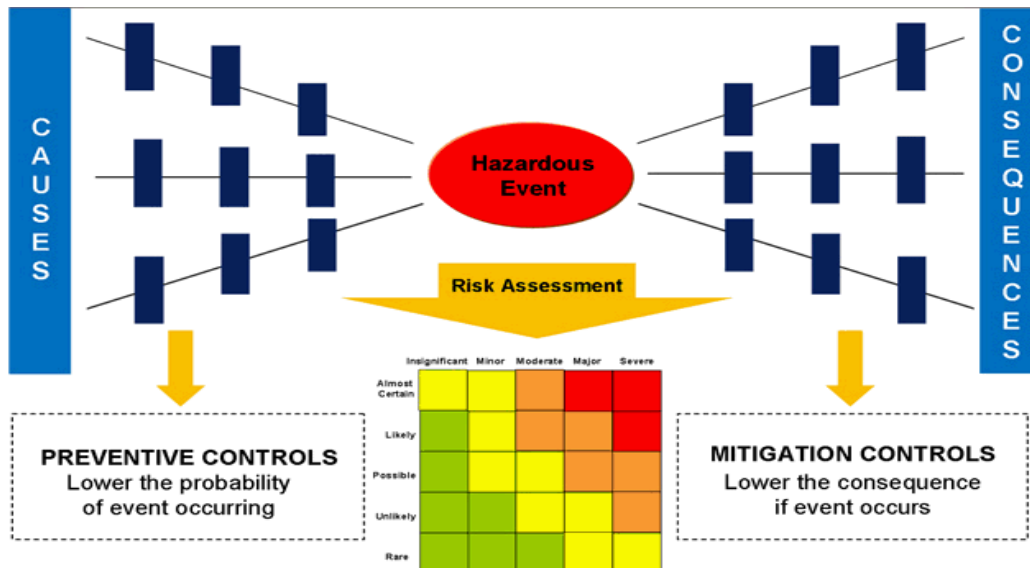
The Corporate Risk Management Plan details Endeavour Energy's key risks and control measures for preventing and mitigating the risk.

⁸ Endeavour Energy Group Board Policy: Risk Management, 31 August 2017.

⁹ Endeavour Energy's 2016/17 Corporate Risk Management Plan, November 2017.

¹⁰ Endeavour Energy's Risk Management Framework outlines a: Risk Management Policy, Risk Appetite Statement, 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 our 2019-24 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, Endeavour Energy 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 Endeavour Energy 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, Endeavour Energy 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 2019-24 regulatory control period, Endeavour Energy had regard to whether it was able to ‘effectively’ self-insure for the risk. That is, whether Endeavour Energy would have the capacity to effectively pool enough risk

to cover the severity of the likely impact should the risk occur.¹¹ 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;¹²
- ii. whether the risk is negatively asymmetric;¹³
- iii. AER information requirements;¹⁴ and
- iv. administrative and reporting requirements.¹⁵

Having regard to the above self-insurance considerations, Endeavour Energy determined that it was 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 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, Endeavour Energy 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 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
- 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

¹¹ 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.

¹² 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.

¹³ 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.

¹⁴ 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.

¹⁵ 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 RJN, which as noted above is ongoing.....

expose the network service provider to catastrophic financial consequences if the risks were to eventuate.

Endeavour Energy 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.¹⁶

4.4 External review of regulatory treatment of risks

Endeavour 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 Endeavour Energy is 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.¹⁷

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 general approach to risk management has not significantly changed since this review was undertaken. We maintain a vigilant approach to mitigating unavoidable risks through prudent insurance and self-insurance arrangements and consider the key findings made previously by EY remain valid. This consistency between regulatory control periods supports our repeated nomination of the existing pass through events approved by the AER.

4.5 Consideration of cost impacts to consumers

In determining whether to nominate cost pass through events as part of our regulatory proposal, Endeavour Energy 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.

¹⁶ 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.

¹⁷ A copy of EY's Report: Review of regulatory treatment of risk, April 2014, has been provided in Attachment 4.8 of our proposal.....

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.¹⁸

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.¹⁹

Consequently, there are no immediate impacts to customers from the AER approving Endeavour Energy's 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.

4.6 Decision to nominate additional 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 network service provider.

Endeavour Energy 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.²⁰ 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 Endeavour Energy 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:

- 1) 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

¹⁸ 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.

¹⁹ Clause 6.6.1(j), NER.

²⁰ 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.....

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 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, which are to apply as nominated pass through events during the 2019-24 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.

5.0 Insurance cap event

5.1 Rationale

Endeavour Energy 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. 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 from 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;²¹
- 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;²² 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.²³

5.2 Proposed definition

Endeavour Energy proposes an ‘insurance cap event’ as a pass through event for the 2019-24 regulatory control period, defined as follows:

An insurance cap event occurs if:

1. *Endeavour Energy makes a claim or claims and receives the benefit of a payment or payments under a relevant insurance policy,*

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

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

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

2. *Endeavour Energy incurs costs beyond the relevant policy limit of the relevant insurance policy at the time of the event that gives rise to the relevant claim,*
3. *the costs beyond the relevant policy limit materially increase the costs to Endeavour Energy in providing prescribed distribution services.*

For this insurance cap event a relevant insurance policy is an insurance policy held during the 2019/20 – 2023/24 regulatory control period or a previous regulatory control period in which Endeavour Energy was regulated.

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 DNSP would obtain in respect of the event,*
- iii. any assessment by the AER of Endeavour Energy's insurance documented in respect of its distribution determination for the relevant period.*

Endeavour Energy 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.

We note the AER has previously approved an insurance cap event as a pass through event for Endeavour Energy. Similar insurance cap events have also been widely approved by the AER for DNSPs operating across the NEM. Our proposed definition for an insurance cap event aligns with the definition approved by the AER in their most recent draft regulatory determination for Transgrid.

5.3 Nominated pass through considerations

In support of this pass through event, Endeavour Energy 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 Endeavour Energy, as evidenced by the proposed definition and 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 Endeavour Energy 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 their most recent respective determinations for Endeavour Energy and other DNSPs.
- Endeavour Energy has obtained efficient levels of insurance cover to commensurate with our assessment of our business risk.²⁴ However, the coverage of such insurance is typically capped, with levels of cover above the cap typically requiring higher premiums. Endeavour Energy 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 Endeavour Energy'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

²⁴ Refer to Appendix 1: Extract from Endeavour Energy's 2016/17 Corporate Risk Management Plan, November 2017, Section 4.0.....

- ii. Catastrophic nature of such an event and the associated cost impacts to Endeavour Energy.

Endeavour Energy 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, Endeavour Energy has sought to obtain efficient levels of insurance that 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 of insurance cover.²⁵ 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.²⁶

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, 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. For instance, should Endeavour Energy not maintain an appropriate level of insurance coverage, the AER would be able to consider whether Endeavour Energy 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.’²⁷

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

Endeavour Energy has not included a self-insurance allowance for liabilities incurred above relevant insurance policy limits. Historically, Endeavour Energy has never had a loss above an insurance cap. Our ongoing risk management improvements have 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, Endeavour Energy does not consider that we would be in a position to effectively self-insure against our exposure to such an event.

6.0 Natural disaster event

6.1 Rationale

Endeavour Energy 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, floods and cyclones. Such events typically result in DNSPs incurring substantial costs, including those potentially arising from property damage to Endeavour Energy’s assets.

Natural disaster related risks were once managed via a general nominated pass through. However, as general nominated pass through events are no longer considered appropriate by the AER, Endeavour Energy proposes that a ‘natural disaster event’ be included as a pass through event, during the 2019-24 regulatory control period. 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.

25 Refer to Appendix 1 - Extract from 2013 Endeavour Energy’s 2016/17 Corporate Risk Management Plan, November 2017, Section 4.0

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

27 Clause 6.6.1(j)(3), NER.....

Whilst Endeavour Energy notes that there may be 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,²⁸ 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.²⁹ Whilst the eligible pass through amount does encapsulate both the incurred and likely to be incurred costs from an event,³⁰ it is doubtful that Endeavour Energy would be in a position to provide a credible estimate for such claims given the difficulties involved in estimating claims on a prospective basis.³¹

Consequently, it is expected that both pass through events are necessary in order to provide Endeavour Energy 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 Endeavour Energy's assets, would be more appropriately recovered through an 'insurance cap event.'

Endeavour Energy notes that accepting both nominated pass through events is consistent with the approach adopted by the AER in their most recent regulatory determinations for each of the 13 DNSPs 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 cap event.' However, the AER did not perceive this overlap to be an issue, as they are 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.

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.³²

Consequently, approval of a natural disaster and insurance cap event merely provides Endeavour Energy 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;³³

28 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.

29 Clause 6.6.1(c), NER.

30 Clause 6.6.1(c)(6)(i), NER.

31 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.

32 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.

33 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;³⁴ 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.³⁵

6.2 Proposed definition

Endeavour Energy proposes a ‘natural disaster event’ as a pass through event for the 2019-24 regulatory control period, defined as follows:

A Natural Disaster Event means any natural disaster including but not limited to fire, flood or earthquake that occurs during the 2019/20 – 2023/24 regulatory control period that increases the costs to Endeavour Energy in providing prescribed distribution services, provided the fire, flood, earthquake 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:

- whether Endeavour Energy has insurance against the event; and*
- the level of insurance that an efficient and prudent NSP would obtain in respect of the event.*

This proposed pass through event clearly captures a key category of uncertain, potentially high cost events outside of Endeavour Energy’s control. As evidenced by the 2009 Victorian Bushfires, natural disaster related events pose a key risk to network service providers and can result in substantial cost impacts to the business.

We note that a ‘natural disaster event’ was previously approved by the AER for Endeavour Energy for the current regulatory control period. Furthermore, ‘natural disaster event’ have since been approved as pass through events for all other DNSPs operating in the NEM. Our proposed definition aligns with the definition approved by the AER in the most recent draft regulatory determinations for Transgrid and ElectraNet.

6.3 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. 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.*³⁶

- 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.³⁷
- 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

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

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

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

37 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.....

accepted this event for each DNSP operating in the NEM in their most recent respective determinations.

- Whilst Endeavour Energy 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. Endeavour Energy 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 Endeavour Energy's asset and risk management activities and encompasses both prevention and mitigation.³⁸
 - Development and adherence to Endeavour Energy's bushfire risk management plan. Our key bushfire prevention and mitigation strategies include:³⁹
 - Identification of bushfire risks – Endeavour Energy identifies bushfire prone zones in collaboration with the NSW Rural Fire Service (RFS). Endeavour Energy's assets are subsequently classified on an area basis according to their level of bushfire risk.⁴⁰
 - Improving the standards for electricity assets – Endeavour Energy implements an audit regime to ensure compliance with internal and industry standards and codes. Endeavour Energy 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 spreaders⁴¹; and installation of high voltage substation/control point equipment.⁴² In addition, Endeavour Energy seeks to use fire resistant material and low risk equipment for assets in high risk bushfire areas.⁴³
 - 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 patrol⁴⁴ and defect rectification of overhead mains. Where necessary, these inspections are carried out from helicopters, fixed wing air craft and now 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.⁴⁵ 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.⁴⁶
 - Management of safe vegetation clearances. To help prevent the possibility of trees or bushland vegetation causing bushfires, we manage vegetation safety

38 Endeavour Energy's 2016/17 Corporate Risk Management Plan, November 2017.

39 Refer to D11/88008 Endeavour Energy's Network Management Plan, June 2012, Chapter 4 Bushfire Risk Management Plan.

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

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

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

43 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 our assets causing a bushfire to spread.

44 Endeavour Energy 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.

45 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.

46 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.....

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. Endeavour Energy participates in Regional Bushfire Risk Management forums, industry debriefs following bushfires, works closely with the NSW RFS and provides ‘hands on’ assistance during bushfires.
 - o Where possible, Endeavour Energy 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, Endeavour Energy 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, Endeavour Energy 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.

Endeavour Energy 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 Endeavour Energy from such an event. It would be inappropriate for Endeavour Energy 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.

Endeavour Energy 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.

7.0 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.⁴⁷ Consequently, this event no longer automatically eligible as a pass through event and requires a DNSP to specifically propose it for approval by the AER as a nominated pass through event.

Endeavour Energy proposes that a ‘terrorism event’ be included as a pass through event for the 2019-24 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;⁴⁸
- 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;⁴⁹ 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.⁵⁰

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

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

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

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

7.2 Proposed definition

Endeavour Energy proposes a ‘terrorism event’ as a pass through event for the 2019-24 regulatory control period, defined as follows:

A terrorism event occurs if:

An act (including, but not limited to, the use of force or violence or the threat of force or violence) of any person or group of persons (whether acting alone or on behalf of or in connection with any organisation or government), which from its nature or context is done for, or in connection with, political, religious, ideological, ethnic or similar purposes or reasons (including the intention to influence or intimidate any government and/or put the public, or any section of the public, in fear) and which materially increases the costs to Endeavour Energy in providing prescribed distribution services.

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

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

We note that a terrorism event was previously approved by the AER for Endeavour Energy for the current regulatory control period. Furthermore, terrorism events have since been approved as pass through events for a vast majority of DNSPs operating in the NEM. Our proposed definition for this event mirrors the definition approved by the AER in the most recent draft regulatory determinations for Transgrid and ElectraNet.

7.3 Nominated pass through considerations

Endeavour Energy 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 Endeavour Energy, as evidenced by the proposed definition and the fact that the event has been widely approved by the AER in numerous recent determinations.
- Endeavour Energy’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:
 - Endeavour Energy 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 Endeavour Energy assets with the NSW Counter Terrorism Branch, Ministry of Policy and Emergency Services, which has resulted in 62 Endeavour Energy sites being classified as ‘critical infrastructure.’⁵¹

⁵¹ 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

- For each of its critical infrastructure sites Endeavour Energy 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.⁵²
- Endeavour Energy 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.
- Endeavour Energy 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.⁵³ Following this review, recommendations are made for repair, upgrade or modification as required.
- Endeavour Energy 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.
- Endeavour Energy has commercial insurance cover which would likely be triggered by an act of terrorism. However, Endeavour Energy 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 Endeavour Energy 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 Endeavour Energy 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 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 2012⁵⁴ 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.

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, Endeavour Energy 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 2019-24 regulatory control period, Endeavour Energy 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 Endeavour Energy would be retaining or absorbing its exposure to such a risk. 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

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."

52 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, Endeavour Energy's national threat level rating is medium, which requires us to detect incidents within 24hours.

53 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: 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.

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

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.

8.0 Insurer's credit risk

8.1 Rationale

Endeavour Energy 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 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, Endeavour Energy proposes an 'insurer's credit risk event' to apply during the 2019-24 regulatory control period.

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

- Nominated PTE considerations;⁵⁵
- 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;⁵⁶ 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.⁵⁷

8.2 Proposed definition

Endeavour Energy proposes an 'insurer's credit risk event' as a pass through event for the 2019-24 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:

- 1. 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*
- 2. 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,

- 1. 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*
- 2. 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.*

We note that an 'insurer's credit risk event' was previously approved by the AER for Endeavour Energy for the current regulatory control period. Furthermore, 'insurer's credit risk event' have since been

⁵⁵ Chapter 10 of the NEL, refer to definition of nominated cost pass through considerations.

⁵⁶ AEMC 2012, Cost pass through arrangements for Network Service Providers, Rule Determination, 2 August 2012, p 8.

⁵⁷ Refer to s.7(A)(2)(a) and (b) of the NEL.

approved as pass through events for a vast majority of DNSPs operating in the NEM. Our proposed definition for this event mirrors the definition approved by the AER in the most recent draft regulatory determinations for Transgrid and ElectraNet.

8.3 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.
- 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-. Also multiple insurers are used on the Endeavour Energy'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 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.

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 NSP's 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 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.

Appendix 1 – Alignment between insurance cover and hazardous events

The maintenance of comprehensive insurance policies is an effective control that transfers the financial risk associated with a hazardous event to the insurer.

Endeavour Energy holds insurances that, in full or in part, limit the financial impact of hazardous events, where applicable.

Below is a summary of the insurance policy covers held by Endeavour Energy.

Class of Insurance	Description of Risks Covered	Limits of Liability/Deductible
1. Insurance to meet legal requirements		
Motor vehicle Compulsory Third Party	Compulsory third party insurance purchased at time of registration of each vehicle.	As per the NSW legislation
Excess of Loss Workers Compensation (NSW)	Work related injuries to company employees above \$500k.	\$ Unlimited limit of liability for any one occurrence in respect of NSW self insurance license. Self insured retention of \$500k per claim.
2. Insurance to protect against loss or damage to the business's network assets		
Industrial Special Risk/Property Insurance Policy	Buildings, contents, stock, depots, substations and mobile subs against fire, flood, explosion, earthquake, storm damage, transit etc.	\$350m limit any one event, \$15m additional Increase in cost of working, \$50m removal of debris,\$7.5m loss of rent,\$750K inland transit. Excess \$250k for substation losses including contract works, \$100K for all other losses and 7 days for any other loss.
Mobile Plant & Equipment	Specified mobile plant and equipment against own damage and third party property damage.	\$10m any one accident. High value test vehicles and mobile substations & switch rooms/trailers agreed values plus \$30m road risk liability. Deductible \$2.5K road risk and \$25K other.
Crime	Employee fraud	\$10m limit in annual aggregate. Deductible \$100K.
Corporate Travel	Employees/directors during business travel (overnight stay or journey >75kms excluding daily commuting).	Death/cap benefits up to \$1m, o/seas medical expenses unlimited, kidnap/extortion \$1m, baggage \$20K. Deductible \$250 for electronic equipment.
Contract Works material damage	Construction works against fire, flood, explosion, earthquake, storm damage etc.	\$11m limit. Deductible \$100K.
Marine Transit	All cargoes and/or interest and/or stock owned by or under the responsibility of the insured.	\$300K limit. Deductible \$5K.
Motor Vehicle Insurance Policy	Comprehensive cover for company vehicles including own damage and third party property damage.	\$30m liability limit with excess cover to \$860m under Group liability program. Auto additions \$500K. \$900k annual aggregate deductible.
Asbestos Liability (newly purchased)	Removal of asbestos waste	\$10m (Including Defence Costs) Excess \$5K each and every Occurrence (inclusive of costs) other than claims arising out of Personal Injury to contractors, sub-contractors and/or labour hire personnel engaged by or on behalf of the Insured where a deductible of \$25,000 each and every Occurrence (costs inclusive) will apply
3. General liability		
Bush Fire Liability	Legal liability for third party injury and/or property damage arising from bushfire.	\$860m limit. Deductible \$100K each injury claim and \$10m each property damage claim.
General Liability - failure to supply	Legal liability for third party injury and/or property damage plus pure financial loss arising from liability for failure to supply arising out of business activities including products liability.	\$860M limit including failure to supply and full failure to supply cover \$180m. Deductible \$100K each claim.
Professional Indemnity	Legal liability for claims made as a result of acts, errors or omissions arising out of professional activities.	\$50m annual aggregate limit. Deductible \$100K for each claim.
4. Directors and Officers liability		
Directors and Officers (D&O) Liability	Claims made for wrongful acts of directors and officers.	\$150m annual aggregate limit. Deductible \$100K for company for each claim and nil for directors and officers.

The table below details the insurance cover held to minimise the financial impact of the hazardous events within the 2017/18 Corporate Risk Management Plan.

BR Number	Hazardous Event	Residual Risk Rating	Self-insured retention limit	Insurance Policy
BR1 SAFETY				
1.1	Exposure to unintended discharge of electricity	High	\$500k \$100k N/A	Excess of Loss Workers Compensation (NSW) General Liability Contractor Insurance
1.2	Exposure to hazardous chemicals/materials	High	\$500k \$100k \$5k N/A	Excess of Loss Workers Compensation (NSW) General Liability) – sudden & accidental Pollution aspects Asbestos Liability Contractor Insurance
1.3	Fall from height	High	\$500k \$100k N/A	Excess of Loss Workers Compensation (NSW) General Liability Contractor Insurance
1.4	Motor vehicle accident	High	\$500k \$100k \$900k N/A N/A	Excess of Loss Workers Compensation (NSW) General Liability Third party property damage Self-Insured; damage to own vehicles and Third Party Property Damage (to \$900k in the aggregate per year) Contractor Insurance CTP Insurance
1.5	Unintended contact with mobile plant	Medium	\$500k \$100k N/A	Excess of Loss Workers Compensation (NSW) General Liability Contractor Insurance
1.6	Struck by falling or moving object	Medium	\$500k \$100k N/A	Excess of Loss Workers Compensation (NSW) General Liability Contractor Insurance
1.7	Incident while undertaking lifting operations	Medium	\$500k \$100k N/A	Excess of Loss Workers Compensation (NSW) General Liability Contractor Insurance
1.8	Uncontrolled collapse of excavation work	Medium	\$500k \$100k \$100k N/A	Excess of Loss Workers Compensation (NSW) General Liability Contract Works Policy Contractor Insurance
1.9	Breach of a controlled worksite when working near or around traffic	High	\$500k \$100k N/A	Excess of Loss Workers Compensation (NSW) General Liability Contractor Insurance
1.10	Exposure to hazardous manual tasks	High	\$500k \$100k N/A	Excess of Loss Workers Compensation (NSW) General Liability Contractor Insurance
1.11	Exposure to work related psychological stress or traumatic event (psychological or physical)	High	\$500k \$100k N/A	Excess of Loss Workers Compensation (NSW) General Liability Contractor Insurance
1.12	Uncontrolled release of a pressurised substance	Medium	\$500k \$100k N/A	Excess of Loss Workers Compensation (NSW) General Liability Contractor Insurance

BR Number	Hazardous Event	Residual Risk Rating	Self-insured retention limit	Insurance Policy
1.13	Slips, trips and falls (excluding fall from height)	High	\$500k \$100k N/A	Excess of Loss Workers Compensation (NSW) General Liability Contractor Insurance
1.14	Exposure to environmental elements (heat & cold)	Medium	\$500k \$100k N/A	Excess of Loss Workers Compensation (NSW) General Liability Contractor Insurance
1.15	Exposure to non-ionising radiation	Low	\$500k \$100k N/A	Excess of Loss Workers Compensation (NSW) General Liability Contractor Insurance
1.16	Incident while working in a confined space	Low	\$500k \$100k N/A	Excess of Loss Workers Compensation (NSW) General Liability Contractor Insurance
1.17	Striking object (moving or fixed) with part of body	Medium	\$500k \$100k N/A	Excess of Loss Workers Compensation (NSW) General Liability Contractor Insurance
1.18	Exposure to sound or sound pressure	Low	\$500k \$100k N/A	Excess of Loss Workers Compensation (NSW) General Liability Contractor Insurance
1.19	Exposure to a biological hazard including flora/fauna	Medium	\$500k \$100k N/A	Excess of Loss Workers Compensation (NSW) General Liability Contractor Insurance
BR2 NETWORK				
2.1	Performance of the Network is inadequate to meet customers' supply expectations	High	\$100k \$100k	General Liability – failure to supply D&O – wrongful act
2.2	The Network has insufficient capacity/capability to meet the demands placed on it	Low	\$100k	D&O – wrongful act
2.3	Major fire caused by the Network or Network activity	High	\$10m \$100k \$100k \$250k \$100k	GLIS (Bushfire) General Liability D&O wrongful act Industrial Special Risk (ISR) – Substations ISR – Other Endeavour Property
2.4	Loss of upstream supply	Medium	\$100k N/A	ISR – sub limit \$10m for Increased Costs of Working if it arises from an insured event Contractor Insurance
BR3 FINANCE				
3.1	Adverse revenue impacts resulting from an unfavourable regulatory determination	High	N/A	Uninsured business risk

BR Number	Hazardous Event	Residual Risk Rating	Self-insured retention limit	Insurance Policy
3.2	Unfavourable variance in operating expenditure resulting in adverse profitability impacts	High	N/A	Uninsured business risk
3.3	Unfavourable variance in capital expenditure resulting in adverse cash flow impacts	High	N/A	Uninsured business risk
3.4	Adverse earnings impacts resulting from a failure to deliver commercially viable unregulated business activities	Medium	N/A	Uninsured business risk
3.5	Adverse cash flow impacts due to variance in budgeted vs actual energy volumes and/or pricing	High	N/A	Uninsured business risk
3.6	Financial loss due to Retailer non-payment	Medium	N/A	Uninsured business risk
3.7	Misalignment between insurance program and business requirements	High	N/A	Uninsured business risk
3.8	Ineffective management of insurable incidents	Medium	N/A	Uninsured business risk
3.9	Adverse impacts on returns on investment resulting from misaligned debt strategies	Medium	N/A	Uninsured business risk
BR4 COMPLIANCE				
4.1	Disputes leading to litigation	Medium	\$100k \$100k	General Liability D&O Contractor Insurance
4.2	Non-compliance with legislation or licence conditions	Medium	\$100k \$100k	General Liability D&O
4.3	Corrupt conduct by an employee, consultant or contractor	Medium	\$100k	Crime Policy (limit \$10m) Contractor Insurance
BR5 REPUTATION				
5.1	Misalignment between Community /Stakeholder expectations and management decisions	High	\$100k	D&O
5.2	Ineffective management response to an incident/crisis	Medium	N/A	Uninsured Business Risk
5.3	Failure to meet minimum customer service obligations (including NECF obligations)	Medium	N/A	Uninsured Business Risk
5.4	Failure to operate a critical process at the pre-agreed level within the maximum allowable outage (MAO) timeframe following a business continuity incident	Medium	N/A	Uninsured Business Risk

BR Number	Hazardous Event	Residual Risk Rating	Self-insured retention limit	Insurance Policy
BR6 ENVIRONMENT				
6.1	Polluting the environment	Medium	\$100k N/A	General Liability – sudden & accidental Pollution aspects Contractor Insurance
6.2	Unauthorised development or damage to flora, fauna or heritage	Medium	\$100k N/A	General Liability Contractor Insurance
6.3	Inappropriate management of waste and/or contaminated materials	Medium	\$100k N/A	General Liability – sudden & accidental Pollution aspects Contractor Insurance
6.4	Excessive and intrusive emissions	Low	N/A	Uninsured Business Risk
BR7 PEOPLE				
7.1	Reduced employee engagement following significant organisational change	Medium	N/A	Uninsured Business Risk
7.2	Loss of key knowledge and/or experience	Medium	N/A	Uninsured Business Risk
BR8 STRATEGY				
8.1	Failure to develop a robust Strategy	Medium	\$100k	D&O
8.2	Failure to deliver Strategy	High	\$100k	D&O
8.3	Failure to deliver the strategic objective of growing unregulated business activities in line with both the business plan and regulatory obligations	High	N/A	Uninsured business risk
BR9 Technology				
9.1	Loss of Information, Communications and Technology (ICT) and/or Operational Technology (OT) service	Medium	\$100k \$100k N/A	ISR policy General Liability Contractor Insurance Note: Cyber Risk has limited cover under ISR and General Liability
9.2	Breach of data/information integrity and/or security (e.g. following a cyber security intrusion event)	High	\$100k \$100k N/A	ISR policy General Liability Contractor Insurance Note: Cyber Risk has limited cover under ISR and General Liability
BR10 Lease Obligations				
10.1	Breach of contractual and associated obligations arising out of the lease transaction documents	High	\$100k	D&O