

Attachment 9.4

Pass through events proposal

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1. Introduction

This document sets out in detail Essential Energy's proposed nominated pass through events for the 2019-24 regulatory period. Essential Energy's decision to nominate certain events as pass through events has been based on our assessment of factors including:

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

Essential Energy has assessed the key risks it faces, as a network service provider operating in New South Wales, against the above criteria. Following our assessment, we have identified 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 period include:

- > an insurance cap event
- > a natural disaster event
- > terrorism event
- > an insurer's credit risk event
- > insurer credit risk event
- > a war event
- > a major cyber event
- > major supplier credit risk event

Essential 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.

The remainder of this document discusses Essential 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; Essential 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 Essential 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 proposed war event
- Section 10 – outlines proposed major cyber event
- Section 11 – outlines proposed major supplier credit risk event

2. Background

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 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.

When are pass throughs appropriate?

The use of pass through events is restricted by the Rules and the AER's determination. The Rules include defined events that apply to all DNSPs such as a tax change event; service standard event; regulatory change event; and a retailer insolvency event.¹ However, DNSPs are also able to propose additional pass through events as part of their regulatory proposal.² This is because DNSPs may face risks that fall outside of the defined events in the Rules, which are uncontrollable and may have a material impact on the costs of providing direct control services.

While DNSPs have the ability to nominate additional pass through events, this does not necessarily mean they will be approved by the AER; nor does it mean that pass throughs should be used in place of prudent risk mitigation measures. DNSP's must satisfy the AER that proposed pass through events meet 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 period.

The PTE considerations enshrined in the Rules reflect additional cost pass throughs that 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.³

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

3. Relevant regulatory requirements

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

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

In proposing nominated pass through events DNSPs 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);

¹ Refer to clause 6.6.1(a1) and Chapter 10 of the National Electricity Rules (NER).

² Refer to clause 6.5.10 of the NER.

³ AEMC 2012, Cost pass through arrangements for Network Service Providers, Rule Determination, 2 August 2012, p 8.

- 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 takes these considerations into account when deciding whether to accept or reject Essential Energy's nominated pass through events. In addition, the AER also has regard to the National Electricity Objective (NEO) and the revenue and pricing principles in the NEL.

4. Cost pass through approach

Identifying the need for additional nominated pass through events

Essential Energy has identified a several risks which cannot be fully mitigated or prevented through prudent risk controls and appropriate levels of commercial insurance. In most cases it was determined that Essential 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 a risk was likely to have a material impact or low probability of occurrence, Essential Energy considered whether it was feasible to 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, Essential Energy had regard to the PTE considerations and the likely cost impacts to customers from adopting this approach.

For additional information on our Risk Management process please refer to the Risk Management Chapter within our full Regulatory Proposal.

Assessing the appropriate regulatory treatment of risks

In preparing for our 2019-24 distribution determination, we assessed our approach for managing risks from a regulatory perspective to ensure that risks are appropriately provisioned for and allocated appropriately.

Risks faced by a DNSP are managed through a combination of:

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

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

Whilst Essential Energy has implemented prudent and effective measures to address most of the risks it faces, some risks have been identified which are beyond our control to prevent and have a low probability of occurrence or are unpredictable. Consequently, Essential Energy considered whether it was appropriate to manage our exposure to risks of this nature via a self-insurance allowance or nominated pass through event.

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

In determining whether it would be appropriate to self-insure for certain risks during its 2019-24 regulatory period, Essential Energy had regard to whether it was able to 'effectively' self-insure for the risk. That is, whether Essential Energy would have the capacity to effectively pool sufficient resources to cover the severity of the likely impact should the risk occur. 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
- ii. whether the risk is negatively asymmetric
- iii. AER information requirements
- iv. administrative and reporting requirements.

Having regard to the above self-insurance considerations, Essential Energy determined that it was not appropriate to self-insure for risks through the inclusion of a forecasted allowance as part of its base year operating expenditure.

Consequently, in reaching the decision to manage our exposure to certain risks via the nominated pass through provisions, Essential 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 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 Essential Energy would not have sufficient capacity to pool enough resources to cover the severity of the likely impact should the event occur
- > are not already accounted for in Essential Energy's regulatory proposal
- > are likely to have a significant cost impact if they were to occur
- > 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 the network service provider to catastrophic financial consequences if the risks were to eventuate. Essential Energy notes that its 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 National Electricity Law (NEL), and preserves incentives under the Rules framework.

Consideration of cost impacts to consumers

In determining whether to nominate cost pass through events as part of our regulatory proposal, Essential 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 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 any application to pass through the cost of the event to customers.

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

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

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.

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

Decision to nominate additional pass through events

Essential Energy adopts prudent risk and asset management measures to ensure the safety, reliability and security of electricity supply for its customers as detailed in the Risk Management chapter of our Regulatory Proposal. As noted above, we are compensated for undertaking risk prevention/mitigation activities under the regulatory framework through allowances under forecast capital expenditure, forecast operating expenditure (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.

Essential Energy has identified a number of risks which either cannot be mitigated or would be uneconomical for us to militate against. 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 Essential Energy to forecast the severity and frequency of these risks accurately for the forthcoming regulatory period.

Consequently, Essential 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 Essential Energy being overcompensated for the risk it bears during the regulatory 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 Essential 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, Essential 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 Essential Energy has sought to manage 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. Essential Energy believes that this is the most efficient way for managing these risks and consider that this approach delivers the best outcome for customers.

The events Essential Energy are proposing be approved as part of our regulatory determination, which are to apply as nominated pass through events during the 2019-24 regulatory 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
- > insurer’s credit risk event – this is discussed in further detail in Section 8
- > war event – this is discussed in further detail in Section 9
- > major cyber event – this is discussed in further detail in Section 10
- > major supplier credit risk event – this is discussed further in Section 11.

In proposing these events Essential Energy has had regard to the PTE considerations in Chapter 10 of the Rules. Essential Energy considers that each event meets the necessary requirements to be approved as a nominated cost pass through event.

5. Insurance cap event

Rationale

Essential 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
- > 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
- > 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.

Proposed definition

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

An insurance cap event occurs if:

1. *Essential Energy makes a claim or claims and receives the benefit of a payment or payments under a relevant insurance policy,*
2. *Essential Energy incurs costs beyond a relevant policy limit, and*
3. *the costs beyond the relevant policy limit materially increase the costs to Essential Energy in providing direct control services.*
4. *For this insurance cap event:*

the relevant policy limit is the greater of:

- a. *Essential Energy’s actual policy limit at the time of the event that gives, or would have given rise to a claim, and*

b. *the policy limit that is explicitly or implicitly commensurate with the allowance for insurance premiums that is included in the forecast operating expenditure allowance approved in the AER's final decision for the regulatory period in which the insurance policy is issued.*

5. *A relevant insurance policy is an insurance policy held during the 2019-24 regulatory period or a previous regulatory period in which Essential Energy was regulated.*

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

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

Essential 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.

Nominated pass through considerations

In support of this pass through event, Essential 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 Essential Energy, as evidenced by the proposed definition.
- > The extent to which Essential Energy can reasonably prevent a claim occurring which exceeds its insurance cap, or can mitigate the cost impact of such an event, is limited.
- > Essential Energy has obtained adequate levels of insurance cover commensurate with our assessment of our business risk. However, the coverage of such insurance is typically capped, with levels of cover above the cap typically requiring higher premiums. Essential 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 Essential 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
 - ii. Catastrophic nature of such an event and the cost impacts to Essential Energy from such an event;
- > Essential 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.

Essential Energy has sought to obtain efficient levels of insurance commensurate with our risk exposure. This has been achieved by undertaking a prudent and thorough assessment of our business risk and aligning our exposure to such risks with appropriate levels of insurance cover. 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. Similarly, liability insurance limits are reviewed annually including utilising the most recent externally provided bushfire probability and maximum probable loss analysis. As part of this review process, consideration is given to whether it is appropriate to purchase additional coverage in light of the nature of the risk, probability of occurrence and cost of purchasing additional levels of coverage.

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

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

As noted above, Essential Energy has not included a self-insurance allowance for liabilities incurred above relevant insurance policy limits. Historically, Essential Energy has never had a loss above an insurance cap. Therefore, given the difficulties in calculating a reliable self-insurance amount and the likely severity of the cost impacts, Essential Energy does not consider that we would be in a position to effectively self-insure against our exposure to such an event.

6. Natural disaster event

Rationale

Essential 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 and cyclones; and Government declared state of emergency events. Such events typically result in DNSPs incurring substantial costs, including those arising from property damage to Essential Energy's assets.

Previously, natural disaster related risks were managed via a general nominated pass through. However, as general nominated pass through events are no longer considered appropriate, Essential Energy considers that a 'natural disaster event' be included as a pass through event, during its 2019-24 regulatory determination. Essential Energy considers that this represents the most efficient means for managing risks of this nature in the forthcoming regulatory period; and in addition, is consistent with the PTE considerations and pricing principles in the NEL.

Costs associated with third party claims are 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. Whilst the eligible pass through amount does encapsulate both the incurred and likely to be incurred costs from an event, it is doubtful that Essential 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.

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

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.

Consequently, approval of a natural disaster and insurance cap event merely provides Essential 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. Essential Energy notes 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;
- > 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; 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.

Proposed definition

Essential Energy proposes a 'natural disaster event' as a pass through event for the 2019-24 regulatory period, defined as follows:

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

The term 'major' in the above paragraph means an event that is serious and significant. It does not mean material as that term is defined in the Rules (that is 1 per cent of the DNSP's annual revenue requirement for that regulatory year).

Note: In assessing a natural disaster event pass through application, the AER will have regard to:

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

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

Nominated pass through considerations

Essential 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 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.
- > Whilst Essential 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. Essential 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 Essential Energy's asset and risk management activities and encompasses both prevention and mitigation.
 - Development and adherence to Essential Energy's bushfire risk management plan. Essential Energy's key bushfire prevention and mitigation strategies include:
 - Identification of bushfire risks – Essential Energy identifies bushfire prone zones in collaboration with external agencies including the NSW Rural Fire Service (RFS) and the University of Melbourne. Essential Energy's assets are subsequently classified on an area basis according to their level of bushfire risk. Inspection and maintenance activities are prioritised in these areas accordingly.
 - Improving the standards for electricity assets – Essential Energy implements an audit regime to ensure compliance with internal and industry standards and codes. Essential Energy has established the Bushfire Risk Assurance Panel and the Bushfire Risk Working Group to provide strong governance over the identification and management of bushfire risk.
 - Prudent maintenance procedures aimed at mitigating bushfire risks. This includes routine above ground inspections to detect defects and prioritise their repair or replacement. For areas designated as fire prone, the procedures require an annual pre-summer patrol 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. Employees 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 System Control Room. In addition, in our highest bushfire risk areas we manage 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, Essential Energy manages vegetation safety clearances on our network according to our Vegetation Management Plan. For bare conductors in bushfire prone areas, the vegetation clearances are increased by a further 0.5 metres.
- Working with other agencies to ensure a coordinated approach to bushfire risk management. Essential 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.
- Where possible, Essential 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, Essential Energy designs its major substations to withstand certain wind and earthquake loads to mitigate any damage arising from floods, storms and earthquakes.
- In the event of a natural disaster event, Essential Energy has in place a Major Incident Management Plan to ensure that impacts from such events are minimised and managed in a coordinated and timely manner.

Essential 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 Essential Energy from such events. It would be inappropriate for Essential Energy to take out higher levels of insurance cover for natural disaster events given the low probability of a major natural disaster event occurring and the unavailability of insurance against damage to ‘poles and wires’ at a reasonable cost. 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.

Essential 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 Essential Energy does not consider that we would be in a position to effectively pool enough resources to cover the cost impacts from such an event.

7. Terrorism event

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.

Essential Energy proposes that a ‘terrorism event’ be included as a pass through event, as part of its regulatory determination for the 2019-24 regulatory period, as this represents the most prudent and efficient means for managing a risk of this nature in its forthcoming regulatory period.

Accepting a ‘terrorism event’ as a nominated pass through event would also 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
- > 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.

Proposed definition

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

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

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

Nominated pass through considerations

Essential 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 period. In addition, Essential Energy notes 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 Essential Energy, as evidenced by the proposed definition and the fact that the event was previously prescribed in the Rules.
- > Essential 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, a number of prudent measures are in place to reduce the likelihood of such an event from occurring. These include:
 - Essential 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 include scheduled inspection/maintenance of on-site security controls, remote alarm monitoring, and the use of mobile patrols including alarm response capabilities. Security controls and activities are matched to the risk profile of the asset.
 - Essential Energy works in association with the relevant agencies to determine which Essential Energy sites should be classified as a 'critical infrastructure' and to comply with National Guidelines for Protecting Critical Infrastructure from Terrorism. Risk assessments are conducted annually for all critical infrastructure sites.
- > Essential Energy has commercial insurance cover which may partially respond following an act of terrorism. However, Essential 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 Essential 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 Essential 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 Essential Energy and therefore reduce the amount claimed under any cost pass through.

Essential 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 some commercial market capacity for terrorism insurance is re-emerging both internationally and domestically, the quantum of commercial market capacity likely to be significantly below the current scheme operated by the Australian Reinsurance Pool Corporation.

It would be inappropriate to manage the risk of a terrorism event via a self-insurance allowance, as there is a lack of reliable data to calculate a credible self-insurance premium for this event. Even if a self-insurance premium could be calculated, Essential 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 period, Essential 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 Essential Energy would be retaining or absorbing its exposure to such a risk. Under such circumstances, Essential 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.

8. Insurer's credit risk event

Rationale

Essential Energy has in place a number of mitigation strategies to avoid being in a situation where one of its insurers becomes insolvent. Whilst the likelihood of this risk materialising is very low it is not improbable. Consequently, to manage our exposure to any of our insurers becoming insolvent, Essential Energy proposes an 'insurer's credit risk event' to apply during its 2019-24 regulatory period.

Essential 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;
- > Policy intent for nominated cost pass through events – that is that a DNSP should not be placed in a position where it is unable to mitigate or avoid the event without creating unacceptable risk; and
- > Revenue and pricing principles in the NEL – specifically, that a regulated DNSP 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.

Proposed definition

Essential Energy proposes an 'insurer's credit risk event' as a pass through event for the 2019-24 regulatory period, defined as follows:

The insolvency of a nominated insurer of Essential Energy, as a result of which Essential Energy:

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

Nominated pass through considerations

In relation to the nominated PTE considerations, Essential 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 the type of event can be clearly identified at the time of this determination, as recognised by the AER in its earlier determinations.
- > Essential 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- or equivalent. Also multiple insurers are used on the Essential Energy's liability and Industrial Special Risks (ISR) insurance policies, therefore spreading the risks amongst several insurers and minimising reliance on any one insurer.
- > It is not economically viable for Essential Energy to insure (commercial or self-insurance) against this event as the probability of this occurring is extremely low. Further, given the risk mitigation strategies outlined above, it is not viable to commercially insure this risk with another insurer.

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

9. War event

Rationale

Essential Energy considers the approval of a 'war event' cost pass through is necessary, as it captures a key category of uncertain, potential high cost impact events outside our reasonable control. Such an event would typically result in DNSPs incurring substantial costs, including those arising from interruptions to supply chains and property damage to Essential Energy's assets.

Essential Energy also considers that including a 'war event' (as defined below) represents the most prudent and efficient means for managing a risk of this nature in its forthcoming regulatory control period. In addition, Essential Energy notes that such an approach is also consistent with the nominated PTE considerations.

Proposed definition

Essential Energy proposes a 'war event' as a pass through event for the 2019-24 regulatory period, defined as follows:

A nation state (whether acting alone or on behalf of or in connection with another nation state) declares war, attacks, invades or occupies another nation state, increasing the costs to Essential Energy in providing direct control services.

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

- i. whether Essential Energy has insurance against the event;
- ii. the level of insurance that an efficient and prudent DNSP would obtain in respect of the event; and
- iii. whether a declaration has been made by a relevant government authority that an act of war has occurred or a state of war exists.

Nominated pass through considerations

In relation to the nominated war event considerations, Essential Energy notes the following:

- > The proposed 'war 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 Essential Energy, as evidenced by the proposed definition.
- > War risks are a standard exclusion from commercial insurance policies. Consequently, obtaining insurance cover for this type of risk on commercial grounds is difficult, or impossible.
- > The potential magnitude of the cost impact of a war event means that it is a risk that Essential 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.

10. Major cyber event

Rationale

Essential Energy considers the approval of a 'major cyber event' cost pass through is necessary, as it captures a key category of uncertain, potential high cost impact events outside our reasonable control. Such an event would typically result in DNSPs incurring substantial costs, including those arising from loss of and/or damage to Essential Energy's technology systems and assets.

Essential Energy also considers that including a 'major cyber event' (as defined below) represents the most prudent and efficient means for managing a risk of this nature in its forthcoming regulatory control period. In addition, Essential Energy notes that such an approach is also consistent with the nominated PTE considerations.

Proposed definition

Essential Energy proposes a 'major cyber event' as a pass through event for the 2019-24 regulatory period, defined as follows:

Major cyber event means any significant interruption to technology systems and assets occurring during the 2019-24 regulatory control period that materially increases the costs to Essential Energy in providing direct control services.

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

- i. Essential Energy's efforts to prevent the event from occurring and mitigate its consequences;
- ii. the prevention and mitigation actions that an efficient and prudent DNSP would have implemented;
- iii. whether Essential Energy has insurance against the event; and
- iv. the level of insurance that an efficient and prudent DNSP would obtain in respect of the event.

Nominated pass through considerations

In relation to the nominated major cyber event considerations, Essential Energy notes the following:

- > The proposed 'major cyber event' is not covered by a category of pass through event specified in clause 6.6.1(a1)(1) to (4) of the Rules.
- > Although linked to a terrorism event, a major cyber event may occur without it being terrorism related.
- > The nature and type of the event can be clearly identified at the time the AER makes its determination for Essential Energy, as evidenced by the proposed definition.
- > Essential Energy's has in place controls to limit the probability and cost impact of a major cyber event. However, these controls cannot eliminate the possibility of such an event occurring, which could have a significant cost impact.
- > Essential Energy has commercial insurance cover which would, in limited circumstances, be triggered by major cyber event. However, the availability of comprehensive and appropriate cyber insurance at a reasonable cost remains limited.
- > The potential magnitude of the cost impact of a major cyber event means that it is a risk that Essential Energy believes cannot be credibly self-insured. The low probability of such an event and pace of change in the external environment also mean that there is a lack of data on which to base a reliable calculation of a self-insurance premium.

11. Major supplier credit risk event

Rationale

Essential Energy considers the approval of a 'major supplier credit risk event' cost pass through is necessary, as it captures a key category of uncertain, potential high cost impact events outside our reasonable control. Such an event would typically result in DNSPs incurring substantial costs, including disruption associated with transition to alternative suppliers of specialised products and services.

Essential Energy also considers that including a 'major supplier credit risk event' (as defined below) represents the most prudent and efficient means for managing a risk of this nature in its forthcoming regulatory period. In addition, Essential Energy notes that such an approach is also consistent with the nominated PTE considerations.

Proposed definition

Essential Energy proposes a 'major supplier credit risk event' as a pass through event for the 2019-24 regulatory period, defined as follows:

A major supplier credit risk event occurs if a major supplier to Essential Energy becomes insolvent and, as a result, goods or services procured by Essential Energy are subject to material additional or higher costs than those which applied under the contract with the insolvent supplier.

Note: In assessing a major supplier credit risk event pass through application, the AER will have regard to, amongst other things, Essential Energy's attempts to mitigate costs and prevent the event from occurring by reviewing and considering the supplier's track record, size, credit rating (if applicable) and reputation.

Nominated pass through considerations

In relation to the nominated major supplier credit risk event considerations, Essential Energy notes the following:

- > The proposed 'major supplier credit risk 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 Essential Energy, as evidenced by the proposed definition.
- > Whilst the occurrence of a major supplier credit risk event is largely beyond our control to prevent, a number of prudent measures are in place to reduce the likelihood of such an event from occurring. However, insurance against this risk is limited in its availability and scope, and measures in place cannot eliminate the possibility of such an event occurring, which could have a significant cost impact.