ATTACHMENT 4.6
PASS THROUGH EVENT PROPOSAL

Contents

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1. Introduction

This document sets out in detail Essential Energy's proposed nominated pass through events for the 2015-19 regulatory control period. Essential 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
- 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 a number of risks which we consider should be managed via nominated pass through events, rather than an allowance under our distribution determination.

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

- a insurance cap event
- a natural disaster event
- terrorism event
- an insurer's credit risk event
- an aviation hazards 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 aviation hazards event

Section 10 – outlines the application of pass through.

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 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 principles[1] and the National Electricity Objective[2] to not provide a means for DNSPs to recover the costs from such an event, as the financial impacts could be a catastrophic and place the DNSP in financial distress.

When are pass throughs appropriate?

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

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

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

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

[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.

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3. Relevant regulatory requirements

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

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

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

1) whether the event proposed is an event covered by a category of pass through event specified in clause 6.6.1(a1)(1) to(4);
2) whether the nature or type of event can be clearly identified at the time the determination is made for the service provider;
3) whether a prudent service provider could reasonably prevent an event of that nature or type from occurring or substantially mitigate the cost impact of such an event;
4) whether the relevant service provider could insure against the event, having regard to:
    - (a) the availability (including the extent of availability in terms of liability limits) of insurance against the event on reasonable commercial terms; or
    - (b) whether the event can be self-insured on the basis that:
        - i. it is possible to calculate the self-insurance premium; and
        - ii. (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 Essential 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.

[6] Clause 6.6.1(a1) to (4), NER.

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4. Cost pass through approach

Identifying the need for additional nominated pass through events

In reaching the decision to nominate cost pass through events to apply during the 2015-19 control period, Essential 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 Essential Energy's historical risk register to ensure that key risks were captured and assessed on a consistent basis.[7]

From this process, Essential 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 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 the residual risks were likely to have a material impact or low probability of occurrence, Essential 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, Essential Energy had regard to the PTE considerations and the likely cost impacts to customers from adopting this approach.

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

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

Approach to risk management

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

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

Essential Energy's Risk Management Framework utilises the bow-tie risk methodology to assess strategic and operational 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. Figure 1 illustrates the bow-tie risk methodology.

In addition, Essential Energy maintains comprehensive insurance arrangements that are regularly reviewed to align with the bow-tie methodology. Advice is also obtained from external risk and insurance brokers/consultants (currently Aon and Marsh) and Essential 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.

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

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[7] Further details on Essential Energy's approach towards managing risk can be found in section 3.2, with a table summarising our approach contained in Appendix 1.
[8] Refer to Attachment 4.7 – EY, *Review of regulatory treatment of risk: Ausgrid, Endeavour Energy, Essential Energy,* April 2014.
[9] Refer to Essential Energy Board Policy: Risk Management, Document CECO0002.03, 28 August 2013.
[10] Essential Energy's 2013/14 Risk Management Plan, July 2013.
[11] Essential Energy's Risk Management Framework outlines a: Risk Management Policy, Risk Management Strategy, Risk Matrix, Risk Assessment Methodology, Corporate Risk Management Plan Development, Risk Management Reporting Requirements.

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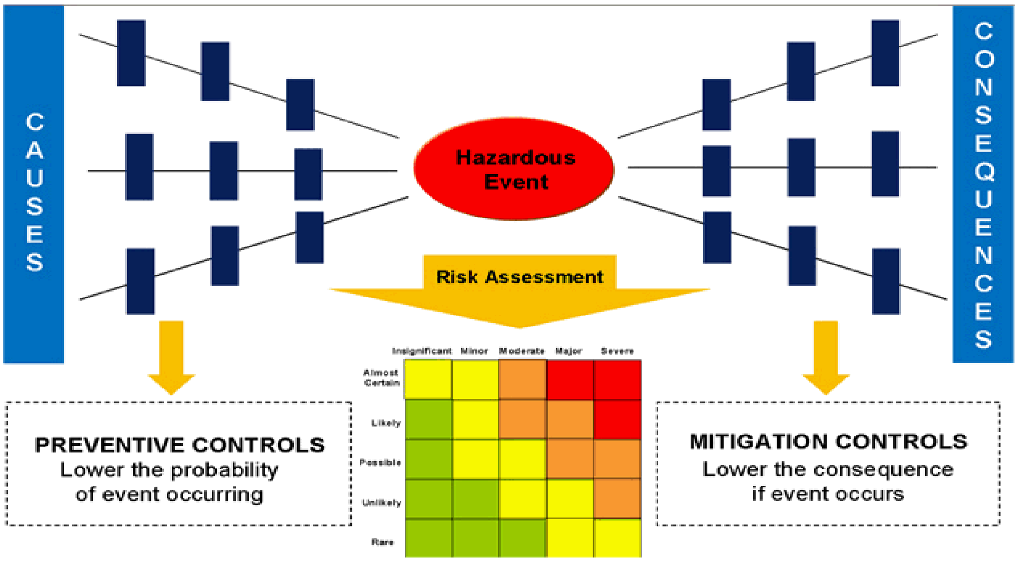
Figure 1: Bow-tie risk methodology



Assessing the appropriate regulatory treatment of risks

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

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

1) forecast operating expenditure (opex) – this includes external insurance
2) forecast capital expenditure (capex)
3) rate of return
4) self insurance
5) pass-through
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, Essential 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 Essential Energy has in place prudent and effective measures to address most of the risks it faces, Essential Energy has identified some risks which are beyond our control to prevent and have a low probability of occurrence or are unpredictable. Consequently, Essential 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 its 2015-19 regulatory control 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 enough risk to cover the severity of the likely impact should the risk occur.[12] Other considerations that we also had regard to included:

i. whether the risk is practically quantifiable and does not merely relate to the loss of value;[13]
ii. whether the risk is negatively asymmetric[14]
iii. AER information requirements[15]
iv. administrative and reporting requirements.[16]

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 opex.

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 2015-19 regulatory control period are risks that:

- are uncontrollable, in the sense that they cannot reasonably or practicably be mitigated or prevented
- have a low probability of occurrence and are unpredictable
- cannot be effectively insured, in the sense that external insurance is unavailable on commercial terms or Essential 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 Essential Energy's regulatory proposal
- are likely to have a significant cost impact
- falls outside of the defined pass through events in the Rules.

Given the nature of these risks, we consider cost pass throughs to be the most appropriate and cost efficient means for managing these types of risks. We do not consider that self insurance would be an appropriate means for managing risks of this nature as quantifying a self insurance allowance would be either subjective (due to the nature of the risk and a wide range of possible values), or could potentially expose the network service provider to catastrophic financial consequences if the risks were to eventuate. Essential 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.[17]

External review of regulatory treatment of risks

The NSW DNSPs (Essential Energy, Endeavour Energy, Ausgrid) 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 Essential Energy is appropriate and efficient for each of the risks identified; and 2) advise on the appropriate

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

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

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

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

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

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

regulatory treatment of each risk based on Essential Energy's current and/or proposed risk management approach.[18]

Key findings from EY's report include:

- Essential Energy's proposed approach towards self insurance and cost pass through is appropriate from a commercial risk management and regulatory treatment perspective;
- Essential Energy's insurance arrangements encompass a robust and thorough renewal and review process;
- the nominated pass through events proposed by Essential Energy are appropriate because they capture the risks which are beyond the control of the NSW DNSPs to prevent or mitigate. They also cannot be effectively or efficiently insured due to the likely significant cost impacts and appear to satisfy the nominated PTE considerations in the Rules.

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 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 any application to pass through the cost of the event to customers.

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

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

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

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

Consequently, there are no immediate impacts to customers from the AER approving 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.

[18] A copy of EY's Report: Review of regulatory treatment of risk, April 2014, has been provided in Attachment 4.7 of our proposal.
[19] Materiality in this context is defined as 1% of the network service provider's annual revenue requirement. Refer to definition of materiality in Chapter 10 of the NER.
[20] Clause 6.6.1(j), NER.

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 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.

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

In addition, these types of risks are also highly unpredictable and generally have a low probability of occurrence. The uncertain and highly unpredictable nature of these risks makes it difficult for Essential Energy to forecast the severity and frequency of these risks accurately for the forthcoming regulatory control 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 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 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 2015-19 regulatory control period are a:

- insurance cap event – this is discussed in further detail in Section 5
- natural Disaster event – this is discussed in further detail in Section 6
- terrorism event – this is discussed in further detail in Section 7
- insurer's credit risk event – this is discussed in further detail in Section 8
- aviation hazards event – this is discussed in further detail in Section 9

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.

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

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

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

> nominated PTE considerations[22]

> policy intent for nominated cost pass through events – that is that a NSP should not be placed in a position where it is unable to mitigate or avoid the event without creating unacceptable risk[23]

> revenue and pricing principles in the NEL – specifically, that a regulated NSP should be provided with an opportunity to recover at least the efficient costs it has incurred in providing direct control services or complying with a regulatory obligation or requirement.[24]

Proposed definition

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

An insurance cap event occurs if:

1. *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 the relevant policy limit, and*
3. *the costs beyond the relevant policy limit materially increase the costs to Essential Energy in providing direct control services.*

For this insurance cap event:

4. *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 control period in which the insurance policy is issued.*
5. *A relevant insurance policy is an insurance policy held during the 2015-19 regulatory control period or a previous regulatory control period in which 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.

[22] Chapter 10 of the NER, refer to definition of nominated cost pass through considerations.
[23] AEMC 2012,Cost pass through arrangements for Network Service Providers, Rule Determination,2 August 2012, p 8.
[24] Refer to s 7(A)(2)(a) and (b) of the NEL.

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Essential Energy's proposed definition for this event is the same as the definition used by the AER in its recent determination of ElectraNet and SP AusNet's cost pass through proposals.[25] In addition, Essential Energy notes that similar insurance cap events for the Victorian DNSPs,[26] Aurora in Tasmania[27], and Powerlink in Queensland[28] have been previously accepted by the AER.

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 clause6.6.1(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 AER has previously accepted this event for the Victorian DNSPs, Aurora, Powerlink, ElectraNet and SP AusNet's determinations.
- 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. We note that the AER has previously concluded that an insurance cap event satisfies this consideration in its determinations for the Victorian DNSPs, Aurora, Powerlink and ElectraNet.
- Essential Energy has obtained efficient levels of insurance cover to commensurate with our assessment of our business risk.[29] However, the coverage of such insurance is typically capped, with levels of cover above the cap typically requiring higher premiums. 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 does 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, Essential 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.[30] 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.[31] Similarly liability insurance limits are reviewed annually including utilising externally provided bushfire probability and maximum probable loss analysis. As part of this review process, consideration is given to whether it is appropriate to purchase additional coverage in light of the nature of the risk, probability of occurrence and cost of purchasing additional levels of coverage.

Further, clause 4(b) of our proposed definition of an 'insurance cap event' is specifically aimed at ensuring that incentives for undertaking appropriate levels of insurance cover are maintained. Clause 4(b) provides that in assessing any pass through application for an 'insurance cap event' the AER is to take into account the allowance

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[25] AER, *Final Decision, ElectraNet Transmission determination 2013 to 2017-18,* April 2013, p 187-195. See also AER, *Final Decision – SP AusNet Transmission Determination 2014-15 to 2016-17,* 30 January 2014, p 56.
[26] AER, *Victorian electricity distribution network service providers distribution determination 2011-2015, Final Decision*, October 2010, p 197.
[27] AER, *Final distribution determination: Aurora Energy Pty Ltd 2012-13 to 2016-17,* April 2012, p 183.
[28] AER, *Decision, Powerlink nominated pass through events: Application to amend Powerlink's 2012-17 transmission determination,* March 2013, p 5.
[29] Refer to Appendix 2B Extract from Essential Energy's 2013/14 Risk Management Plan, July 2013, pp 126-128.
[30] Refer to Appendix B - Extract from Essential Energy's 2013/14 Risk Management Plan, July
[31] For example updated reinstatement values of our assets for Industrial Special Risks (ISR) insurance.

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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.'[32]

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. In addition, ongoing risk management improvements following the restructure of the NSW DNSPs has in our view made the risk of such an event occurring even less likely. Therefore, given the difficulties in calculating a reliable self insurance amount and the likely severity of the cost impacts, Essential Energy does not consider that we would be in a position to effectively self insure against our exposure to such an event.

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

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. 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 by the AER, Essential Energy considers that a 'natural disaster event' be included as a pass through event, during its 2015-19 regulatory determination. Essential Energy considers that this represents the most efficient means for managing risks of this nature in the forthcoming regulatory control period; and in addition, is consistent with the PTE considerations and pricing principles in the NEL.

Whilst Essential Energy notes that there maybe some overlap between a 'natural disaster event' and an 'insurance cap event' it is anticipated that both events will be necessary, as the costs associated from third party claims are unlikely to be captured by a 'natural disaster event.' This is because the costs impacts from third party claims are often delayed and tend to only crystallise months after the event,[33] 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.[34] Whilst the eligible pass through amount does encapsulate both the incurred and likely to be incurred costs from an event,[35] 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.[36]

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.'

Essential Energy notes that accepting both nominated pass through events is consistent with the approach adopted by the AER in its determinations for ElectraNet,[37] Aurora, [38] and SP AusNet.[39] In accepting Aurora's 'natural disaster event', the AER acknowledged it is inevitable that some overlap exists between the 'natural disaster event' and 'insurance cap event.'[40] However, the AER did not perceive this overlap to be an issue, as it is suitably placed to determine which event is most appropriate for making a cost claim and ensuring that any cost to be recovered from the event is not double counted.[41]

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

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[33] 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.
[34] Clause 6.6.1(c), NER.
[35] Clause 6.6.1(c)(6)(i), NER.
[36] 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.
[37] AER, *Final Decision – ElectraNet Transmission Determination 2013-14 to 2017-18,* 30 April 2013, p 192-195.
[38] AER, *Draft Distribution Determination, Aurora Energy Pty Ltd 2012-13 to 2016-17,* November 2011, p 39.
[39] AER, *Final Decision – SP AusNet Transmission Determination 2014-15 to 2016-17,* 30 January 2014, p 55-56.
[40] Ibid, p 39 and 287.
[41] Ibid. See also clause 6.6.1(j), NER.

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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.[42]

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;[43]

> 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;[44] 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.[45]

Proposed definition

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

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

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

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

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

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 the recent Victorian Bushfires, natural disaster related events pose a key risk to network service providers and can result in substantial cost impacts to the business.

Essential Energy notes that a 'natural disaster event' has been previously approved by the AER for the Victorian DNSPs[46] and in the AER's recent determination for Aurora in Tasmania[47] and ElectraNet in South Australia.[48] Essential Energy has based our definition of this event on the AER's recent definition of a 'natural disaster event' used in ElectraNet and SP AusNet's transmission determinations.[49]

Nominated pass through considerations

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

[42] 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.
[43] Chapter 10 of the NER, refer to definition of nominated cost pass through considerations.
[44] AEMC 2012,Cost pass through arrangements for Network Service Providers, Rule Determination,2 August 2012, p 8.
[45] Refer to s 7(A)(2)(a) and (b) of the NEL.
[46] AER, *Victorian electricity distribution network service providers distribution determination 2011-2015, Draft Decision,* June 2010, p 726-728.
[47] AER, *Final Distribution Determination, Aurora Energy Pty Ltd 2012-13 to 2016-17,* 30 April 2012, p 183-185.
[48] AER, *Final Decision – ElectraNet Transmission Determination 2013-14 to 2017-18,* 30 April 2013, p 187-198.
[49] Ibid, p 188. AER, *Final Decision – SP AusNet Transmission Determination 2014-15 to 2016-17,* 30 January 2014, p 55.

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- 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.[50]
- 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.[51]
- 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 Enegry's key bushfire prevention and mitigation strategies include:[52]
    - Identification of bushfire risks – Essential Energy identifies bushfire prone zones in collaboration with the NSW Rural Fire Service (RFS). Essential Energy's assets are subsequently classified on an area basis according to their level of bushfire risk. [53] 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 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 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, the procedures require an annual pre-summer patrol[54] 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.[55] Notification of total fire ban days is via SMS from our Network Control Room. In addition, in our highest bushfire risk area we have been trialling for the last two years to 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.[56]
    - 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 In bushfire prone areas the vegetation clearances are increased by at least a further 0.5 metres.

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[50] AER, *Draft Distribution Determination, Aurora Energy Pty Ltd 2012-13 to 2016-17,* November 2011, p 39.
[51] 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.
[52] Refer toCEOP8022 Network Management Plan, 22 September 2013, Chapter 4 Bushfire Risk Management Plan.
[53] To identify bushfire prone areas Essential Energy uses bushfire prone land maps prepared by local councils and certified by the Commission of the NSW RFS. Essential Energy overlays these maps with our geospatial asset information to identify assets in bushfire prone areas.
[54] Essential 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.
[55] Risk mitigation procedures are used during construction and maintenance activities to ensure that we do not start a bush fire as per the Section 7 of the Network Management plan – Bushfire Risk management Plan – Chapter 4.
[56] 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.

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- 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, in accordance with AS/NS 117.0 – 2002 to mitigate any damage arising from floods, storms and earthquakes.
- In the event of a natural disaster event, Essential 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.

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 an event.[57] 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. 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 risk to cover the cost impacts from such an event.

[57] Refer to Appendix B- Extract from Essential Energy's 2013/14 Risk Management Plan, July 2013

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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.[58] Consequently, while the transitional amendments in the Rules (clause 11.49.2) provides that the 'terrorism event' remains a pass through event for the remainder of the network service provider's current regulatory period and the transitional regulatory control period, this event will no longer apply for Essential Energy's 2015-19 regulatory period unless it is approved by the AER as a nominated pass through event.

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

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

- nominated PTE considerations[59]
- 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[60]
- 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.[61]

Proposed definition

Essential Energy proposes a 'terrorism event' as a pass through event for the 2015-19 regulatory control period, defined as follows:

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

[58] National Electricity Amendment (Cost pass through arrangements for Network Service Providers) Rule 2012 No.4.
[59] Chapter 10 of the NER, refer to definition of nominated cost pass through considerations.
[60] AEMC 2012,Cost pass through arrangements for Network Service Providers, Rule Determination,2 August 2012, p 8.
[61] Refer to s 7(A)(2)(a) and (b) of the NEL.

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- 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.
- Working in association with the relevant NSW Police Counter Terrorism branch and the Ministry of Policy and Emergency Services to determine which Essential Energy sites should be classified as as 'critical infrastructure [62] For each of its critical infrastructure sites site inspections are conducted every 24 hours to identify any breaches in the perimeter barrier of a site.[63]
- Essential Energy personnel also undertake regular inspections of all of our major substations at intervals of 1-3 months . These inspections are intended to detect any breaches of the perimeter and/or any attempted intrusions.
- Essential Energy is planning to refresh its security inspections and risk assessments so that all physical perimeter security measures are reviewed annually. This annual review process will include a reassessment of substation perimeter security for functionality and integrity, with associated recommendations for[64] repairs, upgrades or modifications as required.

> Essential Energy has commercial insurance cover which would likely be triggered by 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 the recent Terrorism Insurance Act Review 2012[65] found that some commercial market capacity for terrorism insurance is re-emerging both internationally and domestically, it found that insurance capacity remains insufficient to cover demand. Furthermore, there is insufficient capacity for individual risks in Australia, with the quantum of commercial market capacity likely to be significantly below the current $13.4 billion scheme operated by the Australian Reinsurance Pool Corporation.

It would be inappropriate to manage the risk of a terrorism event via a self insurance allowance, as there is a lack of reliable data to calculate a credible self insurance premium for this event. Even if a self insurance premium could be calculated, 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 2015-19 regulatory control 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,

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

[63] 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 thenational threat level rating is medium, which requires Essential Energy to detect incidents within 24hours.

[64] 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 risk assessments and audits:Securing Government Business – Protective Security Guidance for Executives; Energy Networks Association document, ENA DOC 015-2006 (ENA DOC 015) National Guidelines for Prevention of Unauthorised Access to Electricity Infrastructure; NSW Critical Infrastructur Protectoin Management Framework (2005), NSW Policy Counter Terrorism Plan;

[65] Australian Government, Terrorism Insurance Act Review, May 2012.

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

Rationale

Essential 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 recent global financial crisis, whilst the likelihood of this risk materializing is very low it is not improbable. Consequently, to manage our exposure to any of our insurer's becoming insolvent, Essential Energy proposes an 'insurer's credit risk event' to apply during its 2015-19 regulatory control 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;[66]

> 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;[67] 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.[68]

Proposed definition

Essential Energy proposes an 'insurer's credit risk event' as a pass through event for the 2015-19 regulatory control 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 insurer's, is subject to materially higher or lower claim limit or a materially higher or lower deductible than would have applied under that policy.

Essential Energy notes that a similar pass through event was approved for the Victorian DNSP's and also Aurora.[69]

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.[70]

> 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-. 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 minimises our reliance on any one insurer.

> It is not economically viable for Essential 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.

[66] Chapter 10 of the NER, refer to definition of nominated cost pass through considerations.
[67] AEMC 2012,Cost pass through arrangements for Network Service Providers, Rule Determination,2 August 2012, p 8.
[68] Refer to s 7(A)(2)(a) and (b) of the NEL.
[69] AER, *Victorian electricity distribution network service providers distribution determination 2011-2015, Final Decision,* October 2010; AER, *Final Distribution Determination; AER, Aurora Energy Pty Ltd 2012-13 to 2016-17,* 30 April 2012.
[70] Ibid.

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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[71].

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

9. Aviation line strike event

Rationale

The Australian Transport Safety Bureau (ATSB) undertook an analysis of line strike accidents based on 1994-2004 data and released their report in September 2006. The report found that the majority of line strike accidents were associated with aerial agriculture operations (62%) followed by aircraft performing other aerial work (20%) including activities such as surveying, spotting, search and rescue and fire fighting. Given the ATSB findings and the fact that Essential Energy's overhead distribution network consists of over 200,000 kilometres of overhead powerlines and covers approximately 95% of the land area of NSW in predominantly rural areas with exposure to significant variations in geographic and climatic conditions, Essential Energy's exposure to the risk of line strike is higher than other NSW DSNP's. By comparison, Ausgrid's network consists of approximately 32,000 kilometres of overhead powerlines and Endeavour Energy's network consists of approximately 23,000 kilometres of overhead powerlines with a large proportion located in metropolitan and semi-metropolitan areas.

The aviation line strikes event was a nominated pass through event for the 2009-14 regulatory control period. During the control period Essential Energy approached the NSW government for legislative protection for liabilities for powerlines, where those powerlines otherwise comply with Australian and safety standards, to date there has been no finalisation to this representation. In the interim, Essential Energy commenced scoping work, research and consultation in order to determine the specification of the necessary work and associated costs to mitigate the risk exposure arising from the NSW Court of Appeal Decision Sheather v Country Energy (2007) NSWCA179.

In August 2008 the New South Wales Deputy State Coroner handed down findings as to the deaths of five persons in two line strike accidents in Dunedoo (2004) and Parkes (2006). In those findings the Deputy State Coroner made recommendations directed to Country Energy (now Essential Energy) which have also been factored into the Government submission and risk mitigation considerations.

Aviation line strikes are uncontrollable events and any increased obligations placed on Essential Energy are externally imposed and therefore difficult to quantify.

Essential Energy proposes the continuation of 'aviation line strike event' to apply during its 2015-19 regulatory control period given that no decision has yet been made by Government on the submission made for legislative protection.

Proposed definition

Essential Energy notes that a pass through event was approved by the AER for the 2009-14 regulatory control period in line with the below definition.

> **Aviation hazards event:** this event occurs if:
> 1. Essential Energy pursue ~~requests~~ legislative protection from the government for potential liabilities (related to the findings in Sheather v Country Energy and the coronial inquests in the Mudgee Court 30.4.07 to 4.5.07 and Forbes Court 21.7.08 to 1.8.08) arising from powerlines, where those powerlines otherwise comply with Australian and industry standards, and
>
> 2. The relevant government authority advises that Essential Energy will not be provided with legislative protection from liability for these events, and
>
> 3. A strategy and feasibility study is completed by or for Essential Energy, in consultation with CASA and the relevant regulatory authorities, that identifies actions necessary to mitigate the risks of aviation hazards.

Nominated pass through considerations

In relation to the nominated aviation line strike 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 type of event can be clearly identified at the time of this determination, as recognised by the AER in its earlier determinations.

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- The event is uncontrollable.
- Although the event is foreseeable, the timing and cost impact can not be reasonably forecast at this time.
- The event is not insurable. Whilst the AER in the 2009-14 regulatory determination noted that Essential Energy;
    - Approach the government for legislative protection from liability for powerlines, where those powerlines otherwise comply with Australian and safety standards, or
    - Modify Essential Energy's risk practices and implement further controls to mitigate these risks.

Essential Energy has made every endeavour to carry out the AER's recommendations. A reasonable decision as to the scope content and cost of the feasibility study cannot be determined until the Government makes a decision on the legislative change.

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10. Application of pass through provisions to alternative control services

Essential Energy proposes that the pass through provisions for defined and nominated pass through events apply to alternative control services on the basis that the pass through provisions in the Rules apply to direct control services, which applies to both standard control services and alternative control services.[72]

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

Essential Energy supports the AER's view that it is appropriate to apply the pass through provisions of the Rules to alternative control services, as all direct control services are subject to the distribution determination.[73] Essential Energy also supports the AER's view that the Rules do not preclude the pass through provisions from applying to alternative control services for defined events and nominated events accepted by the AER.[74]

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

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

[72] Refer to Chapter 10 of the NER – definitions of 'negative change event', 'positive change event', 'regulatory change event', 'tax change event', 'service standard event', and 'retailer insolvency event.' See also Essential Energy proposed definition for its proposed nominated pass through events for 'an insurance cap event,' 'natural disaster event', 'terrorism event' and 'insurer's credit risk event.'
[73] AER, *Draft Decision – South Australia: Draft distribution determination 2010-11 to 2014-15,* 25 November 2009, p 407. See also AER, *Draft Decision – Queensland: draft distribution determination 2010-11 to 2014-15,* 25 November 2009, p 347.
[74] AER, *Draft Decision – New South Wales: draft distribution determination 2009-10 to 2013-14,* 21 November 2008, p 286.

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Appendix 1 – Summary of Essential Energy's approach to risk management

Risk	Description	Risk Management Approach	Treatment of residual risk
Asbestos	Liability for claims related to the impact of asbestos (both retrospectively and prospectively) on employees and third parties	There are two components to the risk, (1) the risk of exposure to customers and the community and 2) the risk of exposure to workers and contractors Insurance - 1) is dealt with via the NSW DNSPs Group Liability Insurance Scheme (GLIS) cover up to $50m with a deductible of $100k. - 2) is dealt with through Essential Energy's insurance for workers compensation – retro paid loss (EML) Risk controls - Asbestos awareness training - Asbestos safety management plan - Risk management policy and plan	Residual risks above insurance cap amounts to be managed via the 'insurance cap event'
Gradual pollution	Unintentional pollution of the surrounding environment from underground fuel tank leakage, transformer oil, contamination from treated poles etc	Risk controls - Environmental policy - Risk management policy and plan	Risk is retained by the business
Electric and magnetic fields (EMF)	Adverse health impacts caused by EMF and regulatory changes impacting the undertaking of "live line" work	Insurance – GLIS Risk controls - Environmental policy - Monitoring of global research and developments	Residual risks for above insurance cap amounts to be managed via the 'insurance cap event'
Business continuity	Future incidents/events that could significantly impact on the business' ability to continue business as usual	Insurance - Limited group cover through Industrial Special Risks(ISR), and property insurance (additional up to $15m however this does not include loss of revenue rather it covers the extra cost of relocating the business) Risk controls - -emergency evacuations plans - - incident management plans - - facility incident response plan	Residual risk is retained by the business

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

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

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