

Essential Energy

8.07 Pass through events proposal

January 2023



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1. Introduction

This document sets out in detail Essential Energy's proposed nominated pass through events (PTEs) for the 2024–29 regulatory period. Our decision to nominate certain events as PTEs is based on our assessment of factors including:

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

We have assessed the key risks we face, and identified those risks that should be managed via nominated PTEs, rather than through an allowance under our distribution determination.

Clause 6.6.1 of the NER allows Distribution Network Service Providers (DNSPs) to propose additional events as PTEs in their regulatory submissions to the Australian Energy Regulator (AER). Our nominated additional PTEs for the 2024–29 regulatory period are:

1. an insurance coverage event
2. a natural disaster event
3. a terrorism event
4. an insurer's credit risk event
5. a major cyber event – new for the 2024–29 regulatory period.

The pass through provisions are a prudent and efficient means for managing our exposure to certain risks. This includes risks that are wholly or partially beyond our control to prevent or mitigate, cannot be effectively insured against, have a low probability of occurrence, and are likely to meet the AER's materiality threshold as stipulated in the NER.

The remainder of this document discusses Essential Energy's proposed nominated PTEs in more detail. Specifically, it sets out our approach to determining the need for additional PTEs, the regulatory requirements for nominated cost pass throughs, our proposed definitions for each nominated PTE, and how each nominated PTE meets the considerations contained in Chapter 6 of the NER.

2. Background

What are cost pass throughs and why are they necessary?

The regulatory framework recognises that a DNSP cannot reasonably be expected to forecast costs of unforeseen events over the forthcoming regulatory period. This issue is addressed in Section 6.6.1 of the NER 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 events that are not included in the regulatory allowance.

When are pass throughs appropriate?

A building block proposal may include a proposal for events that should be defined as PTEs under clause 6.6.1 (a1) (5) of the NER. This is because DNSPs face risks that may fall outside the defined pass through events. These events are largely beyond the control of the DNSP but may have a material impact on the costs of providing direct control services.

While DNSPs can nominate additional PTEs, this does not necessarily mean they will be approved by the AER. It also does not mean that pass throughs should replace prudent risk mitigation measures. DNSPs must satisfy the AER that any proposed PTE meets the considerations specified in the NER when seeking approval.

The PTE considerations contained in the NER reflect additional cost pass throughs that should only be approved under limited circumstances. Specifically, these are circumstances in which 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 DNSP's reasonable control. Further, they should only be approved in circumstances where commercial insurance and self-insurance are unavailable on a reasonable basis or in situations where the DNSP is unable to mitigate or avoid the event without creating unacceptable risks.

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 clause 6.6.1 of the NER is designed to allow a DNSP to recover the costs it incurs providing standard control services that are material and beyond its control.

Clause 6.6.1 (a1) stipulates that any of the following is a PTE for a distribution determination:

1. a regulatory change event
2. a service standard event
3. a tax change event
4. a retailer insolvency event
5. other events specified in a distribution determination as a PTE for the determination.

Pass through considerations

In nominating other PTEs, DNSPs must have regard for:

1. whether the proposed event is covered by a category of PTE specified in clause 6.6.1 (a1) (1) to (4)
2. whether the type or nature of the event can be identified at the time the determination is made for the DNSP
3. whether a prudent DNSP could reasonably prevent an event from occurring or substantially mitigate its financial effects
4. whether the DNSP 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
 - b. whether the event can be self-insured on the basis that:
 - i. it is possible to calculate the self-insurance premium
 - ii. the potential cost to the relevant DNSP would not have a significant impact on the DNSP's ability to offer network services
5. any other matter the AER considers relevant and which the AER has notified DNSPs is a nominated PTE consideration.

The AER will review these considerations when deciding whether to accept or reject the DNSP's nominated PTE. In addition, the AER also has regard to the National Electricity Objective (NEO), and the revenue and pricing principles contained in the NER.

4. Cost pass through approach

Identifying the need for additional nominated PTEs

We have identified risks that cannot be fully mitigated or prevented through prudent risk controls and appropriate levels of commercial insurance. In most cases, we determined that we were 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, in cases that a risk was likely to have a material impact or low probability of occurrence, we considered the feasibility of insuring against the risk or if the risk would be more appropriately addressed via a cost pass through. In deciding that it was appropriate to address certain risks via a cost pass through, we examined the PTE considerations and the likely cost impacts on customers from adopting this approach.

For more information on our Risk Management Framework, please refer to **Chapter 6** in our Regulatory Proposal (Proposal).

Assessing the appropriate regulatory treatment of risks

In preparing for our 2024–29 distribution determination, we assessed our approach to managing risks from a regulatory perspective to ensure they are appropriately provisioned for and allocated.

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

1. forecast operating expenditure – including payment of premiums for insurance
2. forecast capital expenditure
3. rate of return
4. self-insurance
5. cost pass through
6. not covered, i.e. retained by the business (impact of the risks is not significant).

In determining which mechanism should be used for efficiently managing a risk, we considered the nature of the risk and whether an allowance was already made through our forecast operating expenditure, forecast capital expenditure or rate of return.

While we have implemented prudent and effective measures to address most of the risks we face, we identified some risks as unpredictable, beyond our control to prevent and with a low probability of occurring. Consequently, we considered whether it was appropriate to manage our exposure to these risks via a self-insurance allowance or nominated PTEs.

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

In determining this for our 2024–29 regulatory period, we considered whether we could pool sufficient resources to cover the severity of the likely impact, should the risk occur. Other considerations included:

- > whether the risk is practically quantifiable and does not merely relate to the loss of value
- > whether the risk is negatively asymmetric
- > AER information requirements
- > administrative and reporting requirements.

Regarding the above self-insurance considerations, we determined it was not appropriate to self-insure for some risks through the inclusion of a forecast allowance as part of our base-year operating expenditure.

Consequently, in deciding to manage our exposure to certain risks via the nominated pass through provisions, we have exhausted all other means for addressing the risk under the regulatory framework. Therefore, the events we are proposing as nominated PTEs are risks that:

- > are uncontrollable and cannot be reasonably or practicably mitigated or prevented
- > have a low probability of occurring and are unpredictable
- > cannot be effectively insured against as external insurance is unavailable on commercial terms
- > we would not have sufficient capacity to pool enough resources to cover the severity of the likely impact
- > are not accounted for in our Proposal
- > are likely to have a significant cost impact

- > fall outside the defined PTEs in the NER.

Given the nature of these risks, we consider cost pass throughs to be the most appropriate and cost-efficient means for managing them. We do not consider self-insurance an appropriate means for managing these types of risks as quantifying a self-insurance allowance would be subjective (due to the nature of the risk and a wide range of possible values), or could potentially expose us to catastrophic financial consequences if the risks occurred.

We note that our approach to cost pass throughs is consistent with the AER's position in relation to these types of events and the revenue pricing principles contained in the NEL, and preserves incentives under the NER framework.

Consideration of cost impacts to consumers

In determining whether to nominate PTEs as part of our Proposal, we considered the likely cost impacts to customers from adopting this approach. There are no immediate costs to customers from an AER-approved cost pass through event. In addition, there are no cost impacts to customers if the event does not occur during the regulatory period.

Costs associated with PTEs are only recovered from customers if the event occurs. Even then, there is no guarantee 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.

PTEs (whether prescribed in the NER or nominated) merely operate as a gateway for DNSPs to access the pass through approval process under clause 6.6.1 of the NER. A DNSP must satisfy several requirements to recover the costs associated with a PTE.

The AER is not required to approve a cost pass through merely because the event occurred. A DNSP must first apply to the AER demonstrating that a PTE has occurred. The DNSP must:

1. show that the event falls within a prescribed or nominated pass through category
2. demonstrate that it materially changes the costs of providing standard control services
3. set out the amount it proposes should be recovered.

If the DNSP can't demonstrate the first two requirements, the application will not be approved. Costs cannot be recovered from customers and the DNSP must absorb the shortfall.

In addition, just because an event is approved as a pass through it does not mean the AER will approve the DNSP's proposed amount. In determining the amount, the AER must consider 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 DNSP's decisions and actions in relation to the event. This includes whether the provider has failed to take action that could reasonably reduce the magnitude of the eligible pass through amount, and whether the provider took or omitted to take any actions that increased the magnitude of the amount.

Consequently, there are no immediate impacts to customers from the AER approving our nominated PTEs. Approving these PTEs merely enables us to access the pass through approval process under the NER, which provides a mechanism for further analysis and determination by the AER. The provisions of the approval process enable the AER to apply the same level of scrutiny and assessment to a pass through application as it would to a regulatory proposal. This ensures only the efficient costs from the event are recovered.

Decision to nominate additional PTEs

We adopt prudent risk and asset management measures to ensure the safety, reliability and security of electricity supply for our customers, as detailed in **Chapter 6** of our Proposal. As noted above, we are compensated for undertaking risk prevention and 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 we face as a DNSP.

We have identified several risks that either cannot be mitigated or would be uneconomical for us to militate against. These risks are wholly or partially beyond our control to prevent. These include natural disaster-related events such as major floods, fires, earthquakes and storms, and acts of terrorism.

These types of risks are also highly unpredictable and generally have a low probability of occurrence. The uncertain and unpredictable nature of these risks makes it difficult for us to forecast the severity and frequency accurately for the forthcoming regulatory period.

Consequently, we have not made provisions for these types of risks in other elements of our Proposal, as this could give rise to undesirable outcomes. For instance:

1. the risk might not occur, or the severity of the impact could be significantly less than estimated. This could result in us being overcompensated for the risk we bear during the regulatory period. This is undesirable because customers would pay a higher price than necessary for their electricity supply.
2. the risk occurs and we underestimate 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, we could have insufficient cash flows to meet our obligations as a DNSP, which could result in financial distress.

To avoid these outcomes, we have sought to manage our exposure to high-impact, low-probability events that are largely or partially beyond our control by proposing them as nominated PTEs. We believe this is the most appropriate and efficient way for managing these risks and consider this approach provides the best outcome for customers.

In proposing the following events, we have considered the PTE considerations in clause 6.6.1 of the NER. We have concluded that each of the nominated events meets the necessary requirements to be approved by the AER.

5. Insurance coverage event

Rationale

We consider the cost pass through mechanism the most efficient and appropriate means of managing the risk of incurring unexpected loss exceeding our insurance coverage. As the probability of such a loss is extremely low, insurance is not always available on reasonable, cost-effective terms. This could result in potentially catastrophic cost impacts. For the current 2019–24 regulatory determination, the AER approved the inclusion of an ‘insurance cap event’ as a PTE. We request that a similar ‘insurance coverage event’ is included as a PTE in our 2024–29 regulatory determination. The change in PTE from ‘insurance cap’ to ‘insurance coverage’ aligns with a recent guidance note published by the AER.¹

Further, accepting an insurance coverage event as a nominated PTE would be consistent with the:

- > nominated PTE considerations
- > policy intent for nominated cost PTEs; 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
- > revenue and pricing principles in the NEL – specifically that a regulated DNSP should be given an opportunity to recover at least the efficient costs incurred in providing direct control services or complying with a regulatory requirement.

Proposed definition

We propose that for the 2024–29 regulatory period, the definition of an ‘insurance coverage event’ as a PTE is as follows:

An insurance coverage event occurs if:

1. *Essential Energy makes a claim or claims, and receives a payment or payments, under a relevant insurance policy*
2. *Essential Energy incurs costs beyond a relevant policy limit, or which otherwise fall outside the scope of the cover provided, under the relevant insurance policy or program of insurance policies*

¹ AER, [*Final guidance note, Guidance note on insurance coverage pass through events*](#), July 2021.

3. *the costs are beyond the policy limit, or otherwise outside the scope of the cover provided, under the relevant insurance policy or program of insurance policies increase the costs to Essential Energy in providing direct control services*
4. *the relevant policy limit is the greater of:*
 - a. *Essential Energy's actual policy limit (or sub-limit) at the time of the event that gives, or would have given, rise to a claim*
 - 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 2024–29 regulatory period or a previous regulatory period in which Essential Energy was regulated.*

To avoid doubt, in assessing an insurance coverage event cost pass through application under rule 6.6.1 (j), the AER will have regard to:

1. the insurance premium proposal we submit in our Regulatory Proposal
2. the forecast operating expenditure allowance approved in the AER's final decision
3. the reasons for that decision.

We consider that including this PTE would provide an 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 PTE, we note that:

- > the event is not covered by a category of PTE specified in clause 6.6.1(a1) (1) to (4) of the NER
- > the nature and type of 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 we can reasonably prevent a claim occurring that exceeds our insurance coverage, or can mitigate the cost impact of such an event, is limited
- > we have 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 or being unavailable. We have not sought to take out higher levels of insurance to mitigate our exposure to such an event as we believe that would be inefficient and disproportionate given the low probability of us incurring liabilities above our insurance coverage
- > including an insurance coverage event as a PTE represents a more appropriate means for managing our risk exposure given the:
 - complexity associated with developing credible self-insured risk quantifications for very low-probability events, such as those above existing liability limits and/or caps
 - catastrophic nature of such an event and the potential cost impacts to us
- > we have proposed an insurance coverage event as we consider this to be the most prudent and efficient means of mitigating our exposure to risks of this nature.

We have sought to obtain levels of insurance commensurate with our risk exposure. This was achieved by undertaking a prudent assessment of our business risk and aligning our exposure to risks with appropriate levels of insurance cover. We regularly review the limits of our insurance policies in conjunction with external advisers, accounting for updated underwriting information and discussions with our operating divisions. Similarly, liability insurance limits are reviewed regularly including using the most recent externally provided bushfire probability and maximum probable loss analysis. As part of this review process, we review whether it is appropriate to purchase additional cover considering the nature of the risk, the probability of occurrence and the cost of cover. In consultation with our insurance broker, we also frequently consider benchmarking insurance limits purchased by comparable DNSPs.

As noted above, we have not included a self-insurance allowance for liabilities incurred above relevant insurance policy limits. Historically, we have never had a material loss above our insurance coverage. Therefore, given the

complexities in calculating and implementing a reliable self-insurance facility and the potential severity of the cost impacts, Essential Energy could not effectively self-insure against such an event.

6. Natural disaster event

Rationale

We consider the approval of a 'natural disaster event' cost pass through as necessary. It captures a key category of uncertain, potential high-cost impact events outside our reasonable control. Natural disasters include bushfires, floods and other extreme natural events such as earthquakes and cyclones, as well as government declared states of emergency. Such events typically result in DNSPs incurring substantial costs, including those arising from damage to assets.

For the current 2019–24 regulatory determination, the AER approved the inclusion of this PTE. We request that natural disaster event continues to be included as a PTE during our 2024–29 regulatory determination. This is because it represents the most efficient means for managing risks of this nature in the forthcoming regulatory period. In addition, it is consistent with the PTE considerations and pricing principles in the NEL.

We anticipate that material capital consequences, such as damage to our assets from an event, will be recovered via a natural disaster event PTE. However, third-party claims, such as fire-related claims arising from a bushfire caused or exacerbated by our assets, would be more appropriately recovered through an insurance coverage event (in the unlikely event that we exceed our applicable insurance limits).

Retaining natural disaster event as a nominated PTE would also be consistent with the:

- > nominated PTE considerations
- > policy intent for nominated PTEs – meaning a DNSP 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, a regulated NSP should be given an opportunity to recover at least the efficient costs incurred in providing direct control services or complying with a regulatory obligation or requirement.

Proposed definition

We propose that for the 2024–29 regulatory period, the definition of 'a natural disaster event' as a PTE is as follows:

Any natural disaster event or series of related events, 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 2024–29 regulatory period and materially increases the costs to Essential Energy of 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 NER (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:

1. whether Essential Energy has insurance against the event
2. the level of insurance an efficient and prudent DNSP would obtain in respect of the event
3. maintaining assets at a level expected of the industry
4. the reasonable actual extent of the event, or series of related events, having regard to relevant factors including, but not limited to, enduring weather systems and earthquake aftershocks.

This PTE clearly captures a key category of uncertain, potentially high-cost events outside Essential Energy's control. As evidenced by recent major bushfires and floods, natural disaster-related events pose a key risk to DNSPs and can result in substantial cost impacts.

Nominated pass through considerations

We consider that retaining natural disaster events is consistent with the nominated PTE considerations for the following reasons:

- > The proposed natural disaster event is not covered by a category of PTE specified in clause 6.6.1 (a1) (1) to (4) of the NER.
- > The AER recognises potential overlap with other allowances or events such as liability outside the insurance coverage. However, it will consider any specific cost claim under the most appropriate event and ensure it is not double counted.
- > While we cannot prevent a natural disaster from occurring, we do have mitigation strategies in place for potential natural disasters. These include:
 - adopting the bow tie risk methodology. We assess each risk according to this. For a particular risk, such as bushfires, this approach captures the causes, defences against those causes, consequences of the event and mitigation factors. The improved understanding of bushfire risks that comes from the bow tie approach underpins our asset and risk management activities, and encompasses prevention and mitigation.
 - developing and adhering to Essential Energy's bushfire risk management plan. The key bushfire prevention and mitigation strategies include:
 1. identifying bushfire risks – we identify bushfire-prone zones in collaboration with external agencies including the NSW Rural Fire Service (RFS) and the University of Melbourne. Our assets are subsequently classified on an area basis according to their level of bushfire risk. Inspection and maintenance activities are prioritised accordingly
 2. improving the standards for electricity assets – we have an audit regime to ensure compliance with internal and industry standards and codes. We have established the Bushfire Risk Assurance Panel and the Bushfire Risk Working Group to provide strong governance over the identification and management of bushfire risk
 3. ensuring prudent maintenance procedures – we use these to mitigate 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 aircraft and unmanned aerial vehicles
 4. implementing 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 season 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 days by switching the re-close function on nominated high-voltage distribution and sub-transmission feeders from automatic to manual
 5. managing safe vegetation clearances – to help prevent the possibility of trees or bushland vegetation causing bushfires, we manage vegetation safety clearances on our network according to our Vegetation Management Plan. For bare conductors in bushfire-prone areas, the vegetation clearances are increased by a further 0.5 metres
 6. working with other agencies to ensure a coordinated approach to bushfire risk management – we participate in regional bushfire risk management forums and industry debriefs following bushfires, and work closely with the NSW RFS, including providing hands-on assistance during bushfires.
 - Where possible, we seek to locate our 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 ground. In addition, we design our 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, we have established a Major Incident Management Plan to ensure that impacts from such an event are minimised and managed in a coordinated and timely manner.

We consider that our current level of commercial insurance cover in relation to natural disasters is appropriate and represents a prudent approach for mitigating the cost impact. 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.

We have not included a self-insurance amount in our Proposal for natural disaster events. In the event of a major natural disaster event, we would not be in a position to effectively pool enough resources to cover the cost impacts.

7. Terrorism event

Rationale

We propose that a 'terrorism event' is included as a PTE as this is the most prudent and efficient means for managing a risk of this nature. For the 2019–24 regulatory determination, the AER approved this PTE. We request that a 'terrorism event' is included as a PTE in our 2024–29 regulatory determination.

Accepting a terrorism event as a nominated PTE would also be consistent with the:

- > nominated PTE considerations
- > policy intent for nominated PTEs – meaning a DNSP should not be 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 DNSP should be given an opportunity to recover at least the efficient costs incurred in providing direct control services or complying with a regulatory obligation or requirement.

Proposed definition

We propose that for the 2024–29 regulatory period, the definition of a 'terrorism event' as a PTE is 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 of providing direct control services. This includes (without limitation) actions that seriously interfere with, disrupt or destroy, an electronic system including a system used for, or by, an essential public utility.

Nominated pass through considerations

We consider that including a terrorism event (as defined above) represents the most prudent and efficient means for managing a risk of this nature in our forthcoming regulatory period. In addition, we note such an approach is also consistent with the nominated PTE considerations. Specifically:

- > the proposed terrorism event is not covered by a category of PTE specified in clause 6.6.1 (a1) (1) to (4) of the NEL
- > 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 the event was previously prescribed in the NEL
- > Essential Energy's ability to reasonably prevent a terrorism event from occurring and/or substantially mitigate the cost impact from the event is limited. While the terrorism event is largely beyond our control to prevent, several measures are in place to reduce the likelihood of such an event.

Measures taken to reduce the threat of a terrorism event includes:

- > compliance with the critical infrastructure conditions in our electricity Distributor's Licence
- > our ongoing program to meet our obligations in relation to infrastructure security. Our program ensures the security of our assets and includes scheduled inspection and maintenance of on-site security controls, remote alarm monitoring, and mobile patrols that can respond to alarms (security controls and activities are matched to the risk profile of the asset)

- > working with the relevant agencies to determine which of our sites should be classified as 'critical infrastructure' and to comply with National Guidelines for Protecting Critical Infrastructure from Terrorism. Risk assessments are conducted annually for all critical infrastructure sites
- > our insurance arrangements, which may provide partial cover following an act of terrorism. The potential magnitude of the cost impact of a terrorism event means it is a risk that Essential Energy believes cannot be credibly self-insured. The low probability of such an event means there is a lack of data on which to base a reliable calculation of a self-insurance premium.

If a terrorism event occurs, an existing commercial policy could be called upon, thereby reducing the costs incurred directly by Essential Energy and reducing the amount claimed under any cost pass through.

We consider that our current insurance levels are appropriate in light of the nature of the risk and availability of insurance on commercial grounds.

It would be inappropriate to manage the risk of a terrorism event via a self-insurance allowance as there is a lack of reliable data to calculate a credible self-insurance premium for this event. Even if a self-insurance premium could be calculated, we have serious reservations about whether we would be able to 'effectively' self-insure for such an event given the potential magnitude of the cost impacts.

Should the AER disagree with our position and determine a terrorism event should not be included as a nominated PTE for our 2024–29 regulatory period, we would be exposed to terrorism-related risks not covered by insurance arrangements. In effect, this would mean we would be retaining or absorbing our exposure to such a risk. Under such circumstances, we reserve the right to amend our 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 that supports the acceptance of a terrorism event as a nominated PTE.

8. Insurer's credit risk event

Rationale

We currently have several mitigation strategies to avoid a situation where one of our insurers becomes insolvent. While the likelihood of this risk materialising is very low, it is not impossible. Consequently, to manage our exposure, we propose that an 'insurer's credit risk event' applies during the 2024–29 regulatory period. For the 2019–24 regulatory determination, the AER approved the inclusion of this PTE. We request that an insurer's credit risk event continues to be included as a PTE in our 2024–29 regulatory determination.

We note that accepting an insurer's credit risk event as a nominated PTE would also be consistent with the:

- > nominated PTE considerations
- > policy intent for nominated PTEs – meaning a DNSP 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 DNSP should be given an opportunity to recover at least the efficient costs incurred in providing direct control services or complying with a regulatory obligation or requirement.

Proposed definition

We propose that for the 2024–29 regulatory period, the definition of an 'insurer's credit risk event' as a PTE is as follows:

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

1. *incurs materially higher or lower costs for insurance premiums than those allowed for in its distribution determination*
2. *in respect of a claim for a risk that would have been insured by Essential Energy's insurers, is subject to a 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 event is not covered by a category of PTE specified in clause 6.6.1(a1) (1) to (4) of the NER
- > the nature and type of event can be identified at the time of this determination, as recognised by the AER in its earlier determinations
- > we have placed key insurable risks through the New South Wales Government's Treasury Managed Fund facility
- > we seek to mitigate the risk of insurers becoming non-viable by regularly monitoring and reporting on Standard & Poor's (S&P's) rating movements for insurers. Our minimum acceptable S&P rating for an insurer is A- or equivalent. 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.

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

9. Major cyber event

We propose that a 'major cyber event', as per the definition provided below, should be approved by the AER as a nominated PTE for the 2024–29 regulatory period.

Rationale

The frequency, scale, sophistication and severity of cyberattacks is increasing globally, and critical infrastructure is often targeted.

According to the Australian Cyber Security Centre's (ACSC's) Annual Cyber Threat Annual Report², in 2021–22 Australia saw an increase in the number and sophistication of cyber threats, making crimes such as extortion, espionage and fraud easier to replicate on a greater scale than in previous years. Over this period, the ACSC received more than 76,000 cybercrime reports, an increase of nearly 13 per cent from the previous financial year and equating to one attack every seven minutes. The ACSC noted the following:

- > Cyberspace has become a key battleground, as illustrated by Russia's use of malware designed to destroy data and prevent computers from booting up in Ukraine.
- > Russia is not alone in its use of cyber operations to pursue strategic interests. In July 2021, the Australian Government said China's Ministry of State Security exploited vulnerabilities in Microsoft Exchange.
- > Australia is a relatively prosperous country, making it an attractive target for cyber criminals.
- > Both state and cyber criminals view critical infrastructure as attractive targets, and the continued targeting of Australia's critical infrastructure puts essential services at risk.

The increasingly interconnected and digitised world we live in is driving the need to better protect our assets, systems and data. Organisations around the world are spending significant sums to improve cybersecurity for themselves and their customers, but the frequency and severity of major cyberattacks is escalating.

In May 2021, petrol prices on the east coast of the United States surged after the operator of the country's biggest fuel pipeline, Colonial Pipeline, shut down amid a ransomware attack. The five-day cyber siege had significant customer and financial impacts. Although the cost to Colonial Pipeline in fines and ransomware payments was estimated at US\$6 million, the true cost and impact on the economy and wider society was much greater.

In 2021–22, Russia targeted Ukrainian electrical infrastructure, using malware to compromise high-voltage substations. In addition, Russian-aligned cyber-crime groups have threatened to attack the critical infrastructure of Ukraine's allies.

² Australian Signals Directorate, [Annual Cyber Threat Report](#), July 2021 – June 2022.

In Australia, Optus and Medibank Private have recently suffered significant losses as a result of cyberattacks. The cost of the Optus attack is still being determined, but estimates are in the hundreds of millions of dollars. The cost of the Medibank Private attack is estimated to be around \$35 million.

The trend and message is clear – cybercrime is becoming more frequent, more sophisticated and more severe. Organisations, in particular those that own or operate critical infrastructure, must improve their cybersecurity. Even then, the risk of a major cyber event cannot be eliminated.

In recent years, we have invested significantly to increase our cybersecurity capabilities and maturity. We are planning to increase our investment over the 2024–29 regulatory period, as outlined in *Attachment 10.07.02 – Cyber Security Investment Case*. We will increase our level of cyber maturity and gain compliance with recognised cybersecurity standards. However, no matter how much we spend on cybersecurity and how diligent we are in protecting our assets, systems and data, it is impossible to completely protect ourselves against determined and sophisticated cyberattacks.

Like many prudent organisations, we have commercial insurance arrangements in place that cover some of the costs of major cyberattacks, to a certain value. However, due to the uncertain nature and cost of major cyber events, it is impossible to guarantee that this insurance will cover all types of cyber events and all the associated costs. In addition, due to their variable nature, consequence and potential cost, Essential Energy cannot adequately self-insure against major cyberattacks. Furthermore, the lack of available data makes it impossible to accurately determine an appropriate self-insurance premium for major cyberattacks.

Organisations also need to consider the cost benefit of investing in cybersecurity. The number, severity and cost of future cyberattacks is unknown, and organisations need to balance the cost of their investments in cybersecurity against the actual risks faced. In developing our cybersecurity plans for 2024–29, we believe we have struck the right balance.

We believe major cybersecurity events meet the criteria of a nominated PTE due to the low probability of the event occurring, the potential high cost of such an event, the inability to guarantee such an event will not occur, and the inability to fully insure against such an event (both commercially or through self-insurance).

We submit that a major cyber event is no less preventable, and potentially as serious, as other categories of PTE accepted by the AER. We also consider that including a major cyber event (as defined below) represents the most prudent and efficient means for managing a risk of this nature in our forthcoming regulatory period. In addition, we note that such an approach is consistent with the nominated PTE considerations.

Proposed definition

We propose that for the 2024–29 regulatory period, the definition of a ‘major cyber event’ as a PTE is as follows:

Major cyber event means any maliciously caused significant interruption to technology systems or assets occurring during the 2024–29 regulatory control period that materially increases the costs to Essential Energy of providing direct control services.

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

1. Essential Energy’s efforts to prevent the event from occurring and mitigate its consequences
2. the prevention and mitigation actions that an efficient and prudent DNSP would have implemented
3. whether Essential Energy has insurance against the event
4. the level of insurance 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 PTE specified in clause 6.6.1(a1) (1) to (4) of the NER.
- > Although potentially a terrorism event, a major cyber event may occur without it being terrorism related.
- > The nature and type of event can be clearly identified at the time the AER makes its determination for Essential Energy, as evidenced by the proposed definition.

- > Essential Energy has controls to limit the probability and cost impact from 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 insurance arrangements that would, in some circumstances, respond to a major cyber event. However, the availability of comprehensive and appropriate cyber insurance, at a reasonable cost, remains limited.
- > Domestic and international cyberattacks affecting some of the largest and most reputable corporate entities demonstrate the limited ability of organisations to prevent all cyber events from occurring.
- > The potential magnitude of the cost impact of a major cyber event means 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 there is a lack of data on which to base a reliable calculation of a self-insurance premium.