



# **FINAL DECISION**

## **Ergon Energy Distribution Determination 2020 to 2025**

### **Attachment 14 Pass through events**

June 2020

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## Note

This attachment forms part of the AER's final decision on the distribution determination that will apply to Ergon Energy for the 2020–25 regulatory control period. It should be read with all other parts of the final decision.

The final decision includes the following attachments:

### Overview

Attachment 1 – Annual revenue requirement

Attachment 2 – Regulatory asset base

Attachment 3 – Rate of return

Attachment 4 – Regulatory depreciation

Attachment 5 – Capital expenditure

Attachment 6 – Operating expenditure

Attachment 7 – Corporate income tax

Attachment 8 – Efficiency benefit sharing scheme

Attachment 9 – Capital expenditure sharing scheme

Attachment 10 – Service target performance incentive scheme

Attachment 12 – Classification of services

Attachment 13 – Control mechanisms

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## 14 Pass through events

The pass through mechanism of the National Electricity Rules (NER) recognises that a distributor can be exposed to risks beyond its control, which may have a material impact on its costs. A cost pass through enables a distributor to recover (or pass through) the costs of defined yet unpredictable, high cost events that are not built into our distribution determination. The NER includes the following prescribed pass through events for all distributors:<sup>1</sup>

- a regulatory change event
- a service standard event
- a tax change event
- a retailer insolvency event.

In addition to these prescribed events, other pass through events may be 'nominated' by a service provider for a regulatory control period.<sup>2</sup>

This attachment sets out our final decision on the nominated pass through events that will apply to Ergon Energy for the 2020–25 regulatory control period.

### 14.1 Final decision

Our final decision pursuant to clause 6.12.1(14) of the NER is to include four nominated pass through events applying to direct control services. We approve the insurer credit risk, natural disaster and terrorism nominated pass through events as set out in Ergon Energy's revised proposal for the final decision. Events with these names are included in Ergon Energy's present distribution determination, however, we have amended the definitions of the events such that the drafting is consistent with our recent decisions for other network service providers. We also approve an insurance coverage event in place of the existing insurance cap event. The insurance coverage event includes the circumstances covered by the existing insurance cap event, however, it has been expanded to cover additional circumstances. These new circumstances are potential changes in insurance liability market conditions that may lead to insurance coverage gaps.

Our amended definitions are set out in Table 14.1. The reasons for our decision are set out in section 14.5.

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<sup>1</sup> NER, cl. 6.6.1(a1)(1)–(4). Each of these prescribed events is defined in Chapter 10 (Glossary) of the NER.

<sup>2</sup> NER, cl. 6.6.1(a1)(5).

**Table 14.1 Approved cost pass through definitions**

Pass through event	Definition
Insurance coverage	<p>An insurance coverage event occurs if:</p> <ol style="list-style-type: none"> <li>1. Ergon Energy:               <ol style="list-style-type: none"> <li>a) makes a claim or claims and receives the benefit of a payment or payments under a relevant insurance policy or set of insurance policies; or</li> <li>b) would have been able to make a claim or claims under a relevant insurance policy or set of insurance policies but for changed circumstances; and</li> </ol> </li> <li>2. Ergon Energy incurs costs:               <ol style="list-style-type: none"> <li>a) beyond a relevant policy limit for that policy or set of insurance policies; or</li> <li>b) that are unrecoverable under that policy or set of insurance policies due to changed circumstances; and</li> </ol> </li> <li>3. The costs referred to in paragraph 2 above materially increase the costs to Ergon Energy in providing direct control services.</li> </ol> <p>For the purposes of this insurance coverage event:</p> <ul style="list-style-type: none"> <li>• 'changed circumstances' means movements in the relevant insurance liability market that are beyond the control of Ergon Energy, where those movements mean that it is no longer possible for Ergon Energy to take out an insurance policy or set of insurance policies at all or on reasonable commercial terms that include some or all of the costs referred to in paragraph 2 above within the scope of that insurance policy or set of insurance policies.</li> <li>• 'costs' means the costs that would have been recovered under the insurance policy or set of insurance policies had:               <ol style="list-style-type: none"> <li>i. the limit not been exhausted; or</li> <li>ii. those costs not been unrecoverable due to changed circumstances.</li> </ol> </li> <li>• A relevant insurance policy or set of insurance policies is an insurance policy or set of insurance policies held during the regulatory control period or a previous regulatory control period in which Ergon Energy was regulated; and</li> <li>• Ergon Energy will be deemed to have made a claim on a relevant insurance policy or set of insurance policies if the claim is made by a related party of Ergon Energy in relation to any aspect of Ergon Energy's network or business; and</li> <li>• Ergon Energy will be deemed to have been able to make a claim on a relevant insurance policy or set of insurance policies if, but for Changed Circumstances, the claim could have been made by a related party of Ergon Energy in relation to any aspect of Ergon Energy's network or business.</li> </ul> <p>Note for the avoidance of doubt, in assessing an insurance coverage event through application under rule 6.6.1(i), the AER will have regard to:</p> <ul style="list-style-type: none"> <li>• The relevant insurance policy or set of insurance policies for the event</li> <li>• The level of insurance that an efficient and prudent DNSP would obtain, or would have sought to obtain, in respect of the event; and</li> <li>• Any information provided by Ergon Energy to the AER about Ergon Energy's actions and processes.</li> </ul>
Insurer credit risk	<p>An insurer credit risk event occurs if:</p> <ul style="list-style-type: none"> <li>• An insurer of Ergon Energy becomes insolvent, and as a result, in respect of an existing or potential claim for a risk that was insured by the insolvent insurer, Ergon Energy:</li> </ul>

Pass through event	Definition
	<ul style="list-style-type: none"> <li>○ is subject to a higher or lower claim limit or a higher or lower deductible than would have otherwise applied under the insolvent insurer's policy; or</li> <li>○ incurs additional costs associated with funding an insurance claim, which would otherwise have been covered by the insolvent insurer.</li> </ul> <p>Note: In assessing an insurer credit risk event pass through application, the AER will have regard to, amongst other things:</p> <ul style="list-style-type: none"> <li>• Ergon Energy's attempts to mitigate and prevent the event from occurring by reviewing and considering the insurers track record, size, credit rating and reputation, and</li> <li>• in the event that a claim would have been made after the insurer became insolvent, whether Ergon Energy had reasonable opportunity to insure the risk with a different insurer.</li> </ul>
Natural disaster	<p>Natural disaster event means any natural disaster including but not limited to cyclone, fire, flood or earthquake that occurs during the 2020–25 regulatory control period that increases the costs to Ergon Energy in providing direct control services, provided the fire, flood or other event was:</p> <ul style="list-style-type: none"> <li>• a consequence of an act or omission that was necessary for the service provider to comply with a regulatory obligation or requirement or with an applicable regulatory instrument; or</li> <li>• not a consequence of any other act or omission of the service provider.</li> </ul> <p>Note: In assessing a natural disaster event pass through application, the AER will have regard to, amongst other things:</p> <ul style="list-style-type: none"> <li>• whether Ergon Energy has insurance against the event,</li> <li>• the level of insurance that an efficient and prudent NSP would obtain in respect of the event.</li> </ul>
Terrorism	<p>Terrorism event means an act (including, but not limited to, the use of force or violence or the threat of force or violence) of any person or group of persons (whether acting alone or on behalf of or in connection with any organisation or government), which:</p> <ul style="list-style-type: none"> <li>• 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</li> <li>• increases the costs to Ergon Energy in providing direct control services.</li> </ul> <p>Note: In assessing a terrorism event pass through application, the AER will have regard to, amongst other things:</p> <ul style="list-style-type: none"> <li>• whether Ergon Energy has insurance against the event, and</li> <li>• the level of insurance that an efficient and prudent NSP would obtain in respect of the event</li> <li>• whether a declaration has been made by a relevant government authority that a terrorism event has occurred.</li> </ul>

## 14.2 Ergon Energy’s revised proposal

Ergon Energy's revised proposal adopted our draft decision for the four nominated pass through events; insurance cap, insurer credit, risk natural disaster and terrorism. These were the same four initially proposed by Ergon Energy and our draft decision

accepted these, but with amended definitions so that the pass through events that apply to Ergon Energy were consistent with recent decisions for other network service providers.

### 14.3 Assessment approach

The NER sets out how we must assess nominated pass through events, and how we must assess an application from a service provider to pass through changes in costs where an event occurs.<sup>3</sup>

Our assessment approach is guided by the National Electricity Objective (NEO) and the Revenue and Pricing Principles (RPPs).<sup>4</sup> One of the RPPs is that the service provider should have a reasonable opportunity to recover at least the efficient costs of providing services and complying with regulatory obligations.<sup>5</sup> The NEO and the RPPs also reflect the importance of incentives to promote economic efficiency,<sup>6</sup> and balance the risks of under and over investment.<sup>7</sup>

In the context of pass through events, we have particular regard to the impact on price, quality, reliability and security of supply that may arise as a result of any change in the efficient operation of, and ability and incentive of, a service provider to invest in its network. This is a similar approach to that taken by the Australian Energy Market Commission (AEMC) when considering pass through event rule changes.<sup>8</sup>

In determining whether we accept a nominated pass through event, we must take into account the 'nominated pass through event considerations' as defined, which are as follows:<sup>9</sup>

- 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) (in the case of a distribution determination) or clause 6A.7.3(a1)(1) to (4) (in the case of a transmission determination);
- whether the nature or type of event can be clearly identified at the time the determination is made for the service provider;
- 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;
- whether the relevant service provider could insure against the event, having regard to:

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<sup>3</sup> NER, cl. 6.5.10(b), 6.6.1.

<sup>4</sup> NEL, ss. 7 and 7A.

<sup>5</sup> NEL, s. 7A(2).

<sup>6</sup> NEL, s. 7A(3).

<sup>7</sup> NEL, s. 7A(6).

<sup>8</sup> AEMC 2012, *Cost pass through arrangements for Network Service Providers, Rule Determination*, 2 August 2012, p. 6.

<sup>9</sup> NER, Chapter 10, definition of nominated pass through event considerations.



- the availability (including the extent of availability in terms of liability limits) of insurance against the event on reasonable commercial terms; or
- whether the event can be self-insured on the basis that:
  - it is possible to calculate the self-insurance premium; and
  - 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
- any other matter the AER considers relevant and which the AER has notified network service providers is a nominated pass through event consideration.

The AEMC described the purpose of the nominated pass through event considerations as:

to incorporate and reflect the essential components of a cost pass through regime in the NER. It was intended that in order for appropriate incentives to be maintained, any nominated pass through event should only be accepted when event avoidance, mitigation, commercial insurance and self-insurance are unavailable.<sup>10</sup>

that a pass through event should only be accepted when it is the least inefficient option and event avoidance, mitigation, commercial insurance and self-insurance are found to be inappropriate. That is, it is included after ascertaining the most efficient allocation of risks between a service provider and end customers.<sup>11</sup>

This protects the incentive regime under the NER by limiting erosion of a service provider's incentives to use market based mechanisms to mitigate the cost impacts that would arise.<sup>12</sup> This promotes the efficient investment in, and efficient operation and use of, network services for the long term interests of consumers with respect to price.<sup>13</sup>

As a matter of good regulatory practice, we also take into account the desirability of consistency in our approach to assessing nominated pass through events across our electricity determinations and gas access arrangements.<sup>14</sup>

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<sup>10</sup> AEMC 2012, *Cost pass through arrangements for Network Service Providers, Rule Determination*, 2 August 2012, p. 19.

<sup>11</sup> AEMC 2012, *Cost pass through arrangements for Network Service Providers, Rule Determination*, 2 August 2012, p. 20.

<sup>12</sup> AEMC 2012, *Cost pass through arrangements for Network Service Providers, Rule Determination*, 2 August 2012, p. 8.

<sup>13</sup> AEMC 2012, *Cost pass through arrangements for Network Service Providers, Rule Determination*, 2 August 2012, p. 8.

<sup>14</sup> AEMC 2012, *Cost pass through arrangements for Network Service Providers, Rule Determination*, 2 August 2012, p. 18.

## 14.4 Interrelationships

As discussed in our draft decision, the pass through mechanism is not the only way service providers can manage their risks under a distribution or transmission determination. It is interrelated with other parts of this determination, in particular with Ergon Energy's forecast operating and capital expenditure and the rate of return included in our revenue determination. We must specify and take account of these interrelationships.<sup>15</sup> This requires us to balance the incentives in the various parts of our decision.

## 14.5 Reasons for final decision

We approve the insurer credit risk, natural disaster and terrorism nominated pass through events in Ergon Energy's revised proposal for the final decision.

We also approve an insurance coverage event, previously referred to as an insurance cap event. This reflects further amendments to this nominated pass through event that take into account potential changes in insurance liability market conditions that may lead to unfavourable changes to Ergon Energy's insurance policy. These amendments were proposed by SA Power Networks, for whom we made a distribution determination concurrently with Ergon Energy. We assessed SA Power Networks' proposed expansion of the insurance cap event and considered them appropriate for network service providers. We therefore decided to include these amendments for other distributors. We consulted with Ergon Energy about these changes and it stated it was comfortable with adopting them. These amendments reflect:

- the use of multiple insurance policies by distribution network service providers;
- a refined definition of the pass through event that recognises the potential for unfavourable changes to Ergon Energy's insurance policy (including insurance coverage gaps, negative impact on deductibles or reinstatements rights). These may occur if Ergon Energy is unable to find suitable insurance providers to fill withdrawn capacity, faces unavoidable impacts for its deductible schedules or reinstatement rights on economically justifiable higher premiums; and
- the amended definition of the pass through event allows for these unfavourable changes under 'changed circumstances'. Our definition of 'changed circumstances' is as follows:

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

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<sup>15</sup> NEL, s. 16(1)(c).

Our final decision acknowledges the challenges that Ergon Energy may face with changing market conditions within the bushfire insurance market but seeks to preserve appropriate pass through event incentives under a normal operating environment.

Our final decision also updates the name of the pass through event. This name change - from 'insurance cap event' to 'insurance coverage event' recognises that in the future potential insurance gaps may not only relate to any insurance caps.

Further, we consider it reasonable to provide Ergon Energy, and the broader industry, with greater clarity and guidance around the matters we are likely to have regard to in assessing any insurance cap pass through event that occurs. We propose to release a consultation paper to begin this process shortly.

## Shortened forms

Shortened form	Extended form
AEMC	Australian Energy Market Commission
AER	Australian Energy Regulator
distributor	distribution network service provider
NEL	national electricity law
NEO	national electricity objective
NER	national electricity rules
NSP	network service provider
opex	operating expenditure
RPP	revenue and pricing principles

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