



Managing uncertainty

**PAL APP04 - Uncertainty appendix - Jan2020 -
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Regulatory proposal 2021–2026

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1 Summary

We operate in an uncertain environment in which uncontrollable external events can alter the quantity and nature of services required to be provided to our customers. While our expenditure forecasts have been prepared based on the best information currently available for what we will need to do during the 2021–2026 regulatory period, we are unable to predict each and every event that will occur.

The uncertainty regime under the National Electricity Rules (**Rules**) comprises pass through events, capital expenditure reopeners and contingent projects. These mechanisms deal with expenditure that may be required during a regulatory period but which are not able to be predicted with reasonable certainty at the time of preparing or submitting a regulatory proposal to the Australian Energy Regulator (**AER**).

Rather than building up our expenditure forecasts to cover every possible eventuality, we propose nominated pass through events in this regulatory proposal so as to enable us to request extra funding from the AER during the regulatory period if a large unexpected event occurs, or where we are unable to cost an anticipated event given limitations on the works we may be required to undertake. The exclusion of the costs of these uncertain events from our regulatory proposal ensures our customers face the lowest possible prices.

1.1 Pass through events

The pass through mechanism in the Rules 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 the costs of defined unpredictable, high cost events not built into the AER's distribution determination.

In addition to the pass through events specified in the Rules, an event may be defined by the AER in a distribution determination. We propose the following nominated pass through events be accepted by the AER.

Table 1.1 Proposed nominated pass through events

Type of event	Changes from current definition / definition in recent regulatory decisions
An insurer's credit risk event	Consistent with current definition and definition accepted by AER in recent regulatory decisions
An insurance coverage event	Minor amendment from the current 'insurance cap event' having regard to the changes and challenges in the global insurance market that have increased the risk of inability to obtain the full level or scope of cover under relevant insurance policy or policies
Natural disaster event	Minor amendment from current definition; consistent with definition accepted by AER in recent regulatory decisions
A terrorism event	Current definition amended to include specific reference to cyber terrorism
Retailer insolvency event	Minor amendment from current definition having regard to the current definition of the retailer insolvency event in the Rules
Major cyber event	Additional event with definition that addresses AER reservations with this event expressed in recent regulatory decisions
Act of aggression event	Additional event added with definition that addresses AER reservations with this event expressed in recent regulatory decisions
Electric vehicle event	Additional event added to address the uncertainty with electric vehicle uptake

Source: Powercor

Each of these proposed nominated pass through events is consistent with the nominated pass through event considerations. In particular, each event can be clearly identified and defined; is not covered by the pass through

events specified by the Rules; has a low probability of occurrence but the potential to have a significant cost impact; is beyond a distributor's ability to prevent, substantially mitigate, commercially insure or self-insure acting prudently and efficiently; and identifies any additional factors that it is known will be relevant in assessing the amount to be passed through for the purpose of a pass through application for the event.¹

Further, with the exception only of the major cyber event, the act of aggression and the electric vehicle event, each of the proposed nominated pass through events is consistent with the nominated pass through events accepted by the AER in its recent decisions for other service providers.

1.2 Application of cost pass throughs to alternative control services

We also propose the AER apply the pass through provisions for the Rules' specified and nominated pass through events to alternative control services, that the materiality threshold be modified when applied to a cost pass through relating to alternative control services and that an approved pass through amount (or part thereof) that relates to the increased costs of providing alternative control services be recovered through alternative control services pricing, rather than standard control services charges.

1.3 Key documents

The key documents in support of our nominated pass through events are outlined below.

Table 1.2 Key document reference

Document	Reference	Supporting
Insurance Credit Management Policy	PAL ATT056	Insurer's credit risk event
General Assembly Resolution 3314 (XXIX) - Definition of Aggression	PAL ATT063	Act of aggression event
Australian Treaty Series Geneva Conventions, 12 August 1949	PAL ATT058	Act of aggression event
Australian Treaty Series Protocol additional to the Geneva Conventions of 12 August 1949 - Protocol I	PAL ATT060	Act of aggression event
Australian Treaty Series Protocol additional to the Geneva Conventions of 12 August 1949 - Protocol II	PAL ATT061	Act of aggression event
Australian Treaty Series, Protocol additional to the Geneva Conventions of 12 August 1949 - Protocol III	PAL ATT059	Act of aggression event
United Nations - The Prosecutor v Fatmir Limaj, Judgment	PAL ATT062	Act of aggression event
International Criminal Court, Rome Statute of the International Criminal Court	PAL ATT064	Act of aggression event

Source: Powercor

¹ In accordance with clause 6.6.1(j) of the Rules.

2 Nominated pass through events

2.1 Background

The regulatory framework recognises distributors cannot reasonably be expected to forecast costs for all foreseen and unforeseen events over the regulatory period. The regulatory framework addresses this by including a cost pass through mechanism, which allows distributors 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.²

The pass through mechanism provides a means for distributors to recover the efficient costs of events that could not be forecast as part of their regulatory proposals. Without this mechanism, the occurrence of such events would have a significant financial effect on the ability of distributors to invest in and operate their networks.³

The Australian Energy Market Commission (**AEMC**) has recognised that the specification of nominated pass through events is necessary to ensure that distributors are provided with the opportunity to recover their efficient costs where those costs result from unforeseen and uncontrollable events for which insurance is limited or not available on commercial terms and self-insurance is not appropriate.⁴ In the absence of cost pass throughs in these circumstances, the AEMC recognised that efficient investment in, and efficient operation of, a distributor's network would likely be adversely affected over the long term contrary to the National Electricity Objective (**NEO**).⁵ That is, the specification of a nominated pass through event is necessary and contributes to the achievement of the NEO where that event is consistent with the nominated pass through event considerations specified in the Rules.

When determining whether to approve a positive pass through amount, the AER is required to take into account a number of factors, including the efficiency of the distributor's decisions and actions in relation to the risk of the pass through event (including actions taken to reduce the magnitude of the pass through amount).⁶ As such, in relation to each pass through event specified in clause 6.6.1(a1)(1) to (4) of the Rules and nominated in our distribution determination, we retain the incentive to operate efficiently and mitigate our increased costs.

2.2 Rules requirements

The Rules specify the following pass through events:⁷

- regulatory change event
- service standard event
- tax change event
- a retailer insolvency event
- any other event specified in a distribution determination as a pass through event for the determination.

² The pass through mechanism is contained in clause 6.6.1 of the Rules.

³ AEMC, *Rule Determination National Electricity Amendment (Cost pass through arrangements for Network Service Providers) Rule 2012*, 2 August 2012, p. 2 and 9.

⁴ AEMC, *Rule Determination National Electricity Amendment (Cost pass through arrangements for Network Service Providers) Rule 2012*, 2 August 2012, p. 18 to 19.

⁵ AEMC, *Rule Determination National Electricity Amendment (Cost pass through arrangements for Network Service Providers) Rule 2012*, 2 August 2012, p. 18.

⁶ Rules, clause 6.6.1(j).

⁷ Rules, clause 6.6.1.

We can propose events that should be defined as additional pass through events in our distribution determination, having regard to the 'nominated pass through event considerations'.⁸ The AER must take into account these same considerations in deciding whether to accept the pass through events we nominate.⁹

The 'nominated pass through event considerations' are:¹⁰

- whether the event proposed is an event covered by a category of pass through event
- 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:
 - 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
 - the potential cost to the relevant service provider would not have a significant impact on the service provider's ability to provide network services
- any other matter the AER considers relevant and which the AER has notified distributors is a nominated pass through event consideration.

As at the date of this proposal, the AER has not notified us of any other matter that is a nominated pass through event consideration.

In addition, the AER must:

- perform or exercise a function or power under the National Electricity Law (**Law**) or the Rules that relates to the making of a distribution determination in a manner that will or is likely to contribute to the achievement of the NEO¹¹
- in making a distribution determination, if there are two or more decisions that will or are likely to contribute to the achievement of the NEO, the AER must make the decision that it is satisfied will or is likely to contribute to the achievement of the NEO to the greatest degree¹²
- take into account the revenue and pricing principles when exercising a discretion in making those parts of a distribution determination relating to direct control network services.¹³

⁸ Rules, clause 6.5.10(a).

⁹ Rules, clause 6.5.10(b).

¹⁰ Rules, Chapter 10 'nominated pass through considerations'.

¹¹ Law, section 16(1)(a) and section 2(1) definition of 'AER economic regulatory function or power'.

¹² Law, section 16(1)(d) and sections 2(1) and 71A definitions of 'reviewable regulatory decision'.

¹³ Law, section 16(2)(a).

2.3 Our proposed nominated pass through events

The pass through events we nominate for inclusion in our distribution determination are outlined below.

2.3.1 Insurer's credit risk event

This event is contained within our distribution determination for the 2016–2020 regulatory period. This event has also been accepted as a pass through event by the AER in more recent regulatory decisions. We have in place a number of mitigation strategies against one of our insurers becoming insolvent. In particular, we seek to mitigate the risk of any insurers becoming non-viable by regular monitoring and reporting by Jardine Lloyd Thompson of each insurer's Standard & Poor (**S&P**) or equivalent credit rating movements. Our minimum acceptable insurer S&P rating is A minus. If an insurer rating changes below the S&P or equivalent A minus rating, our Risk Management & Compliance Committee has the discretion to:¹⁴

- approve continued use of an insurer that does not have an A minus rating. The decision to do this is only taken after consideration of financial analysis, which includes but is not limited to, size of paid up capital and shareholder funds, amount of gross reinsurance and the quality of the reinsurance.
- move away from an insurer that falls below the A minus rating. In doing so a remedial strategy is prepared and reviewed/approved by our Chief Executive Officer (**CEO**) and this strategy outlines timing associated with moving away from the insurer in question. The objective is to move away from the insurer as quickly as possible.

In addition, for selected key policies such as General Liability insurance, we take out insurance with multiple insurers, therefore spreading the risk and minimising the reliance on any one insurer.

The risk of one of our insurers becoming insolvent is, thus, very low but nonetheless not improbable. Despite acting prudently in selecting an insurance provider, an insurer may still fail. For example, HIH Insurance was placed into liquidation in 2001; similarly AIG faced a liquidity crisis during the global financial crisis. While such events are infrequent, they can occur and the risk of an insurer failing is beyond our control.

In recent regulatory decisions, the AER has concluded in respect of the insurer's credit risk event that a distributor can take some steps to reduce its exposure to this event, but that expenditure beyond a certain level aimed at completely eliminating the risk is likely to be imprudent or inefficient.¹⁵

Proposed definition

We propose that the 'insurer's credit risk event' be defined as:

An insurer's credit risk event occurs if an insurer of Powercor becomes insolvent and as a result, in respect of an existing or potential insurance claim for a risk that was insured by the insolvent insurer, Powercor:

- (a) 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*

¹⁴ PAL ATT056 - Insurance credit management policy - Nov2019 - Public.

¹⁵ See, e.g. AER, Draft Decision Evoenergy Distribution Determination 2019-2024, Attachment 14 - Pass through events, September 2018, p. 14-10 to 14-11; AER, Draft Decision Ausgrid Distribution determination 2019-24, Attachment 14 - Pass through events, November 2018, p. 14-11; AER, Draft Decision Essential Energy Distribution determination 2019–24, Attachment 14 – Pass through events, November 2018, p. 14-11; AER, Draft Decision Endeavour Energy Distribution determination 2019–24 Attachment 14 – Pass through events, November 2018, p. 14-10 to 14-11.

(b) incurs additional costs associated with funding an insurance claim, which would otherwise have been covered by the insolvent insurer.

Note: In assessing an insurer's credit risk event pass through application, the AER will have regard to, amongst other things:

(a) Powercor's attempts to mitigate and prevent the event from occurring by reviewing and considering the insurer's track record, size, credit rating and reputation

(b) in the event that a claim would have been made after the insurance provider became insolvent, whether Powercor had reasonable opportunity to insure the risk with a different provider.

This definition is consistent with our 2016–2020 determination. It is also consistent with the definition accepted by the AER in more recent regulatory decisions.¹⁶

Insurer's credit risk event satisfies nominated pass through event considerations

This event is consistent with the nominated pass through event considerations because:

- the event is not covered by a category of pass through event specified in the Rules.¹⁷
- the nature or type of event can be clearly identified at the time of the determination, as evidenced by the AER having previously included this event in our 2011–2015 and 2016–2020 distribution determinations, and more recent regulatory decisions.
- while we take all prudent steps to assess the viability of actual and potential insurers and to use only those providers that are expected to have the capacity to satisfy any claims under a policy (as discussed above), we could not reasonably prevent the occurrence of an insurer's credit risk event or substantially mitigate the cost impact.¹⁸
- we have not identified insurance for insurer credit risk failure available on reasonable commercial terms. Due to the low probability of the event occurring, it is not possible to calculate a self-insurance premium.

In recent regulatory decisions, the AER has accepted that the insurer credit risk event is not covered by any existing category of pass through event, the nature of the event is clearly identifiable at this time and a prudent service provider could not reasonably prevent an event of that nature or type from occurring or substantially mitigate its cost impact, and could not insure (or self-insure) against the event.¹⁹

We consider the proposed nominated pass through event is consistent with NEO and the revenue and pricing principles, as it ensures we are not placed in a position where we are unable to mitigate or avoid the event or its cost impact without incurring imprudent or inefficient expenditure, and provides a reasonable opportunity to

¹⁶ See, e.g. AER, Draft Decision Evoenergy Distribution Determination 2019-2024, Attachment 14 - Pass through events, September 2018, p. 14-7 and 14-10; AER, Draft Decision Ausgrid Distribution determination 2019-24, Attachment 14 - Pass through events, November 2018, p. 14-13; AER, Draft Decision Essential Energy Distribution determination 2019–24, Attachment 14 – Pass through events, November 2018, p. 14-12; AER, Draft Decision Endeavour Energy Distribution determination 2019–24, Attachment 14 – Pass through events, November 2018, p. 14-11 to 14-12.

¹⁷ Rules, clause 6.6.1(a1)(1) to (4).

¹⁸ AER, Draft decision Victorian electricity distribution network service providers Distribution determination 2011–2015, June 2010, p. 725.

¹⁹ See, e.g. AER, Draft Decision Evoenergy Distribution Determination 2019-2024, Attachment 14 - Pass through events, September 2018, p. 14-10; AER, Draft Decision Ausgrid Distribution determination 2019-24, Attachment 14 - Pass through events, November 2018, p. 14-11; AER, Draft Decision Essential Energy Distribution determination 2019–24, Attachment 14 – Pass through events, November 2018, p. 14-11; AER, Draft Decision Endeavour Energy Distribution determination 2019–24, Attachment 14 – Pass through events, November 2018, p. 14-10.

recover our efficient costs. Further, the inclusion of an insurer's credit risk event means that consumers only bear the risk should such an event occur and satisfy the pass through provisions, rather than funding excessive and potentially unnecessary insurance premiums. The acceptance of the event therefore provides for an appropriate sharing of risk between us and our customers, and is more likely to be in the long-term interests of consumers with respect to price.

2.3.2 Insurance coverage event

The most efficient and appropriate means of managing our exposure to the risk of incurring liabilities and costs beyond our insurance policy limit or scope of cover is via the pass through mechanism.

A similar event, the 'insurance cap event' is contained within our distribution determination for the 2016–2020 regulatory period. We have updated the pass-through event to better reflect the scope of insurance coverage for our liabilities and the recent changes and challenges in the global insurance market. The scope of the cover provided by a relevant insurance policy or policies includes the bands of liability for which Powercor is insured. It does not include:

- any liability beyond the policy limit of the policy or policies or
- any range or band of liability within the policy limit for which Powercor is not insured by the policy or policies.

We have an incentive to choose the most efficient mix of risk mitigation mechanisms for our liabilities insurance coverage. Our level and scope of insurance cover is appropriate, taking into account the probability of an insurance event occurring, the financial consequence of any such event occurring, and the cost and availability of insurance in the global insurance market.

The conditions in the global insurance market have deteriorated significantly since 2016 due to a large number of catastrophic bushfire events, as outlined in a report obtained from Marsh.²⁰ This has had a material impact on our ability to source insurance at efficient prices, resulting in both:

- higher insurance premiums for the same level of cover
- growing risk of inability to source the same level or scope of cover under an insurance policy or program of policies.

We expect the trend in deteriorating global insurance markets will continue over the 2021–2026 regulatory period, further increasing insurance premiums and the risk of inability to obtain the same level or scope of cover.

The probability of an insurance event occurring that results in liability and costs beyond the policy limit, or which otherwise fall outside the scope of the cover provided under the relevant insurance policy or policies is very low, however to manage the risk, we propose to continue to include an 'insurance coverage event'. Our proposed wording for the insurance coverage event captures the risk of inability to obtain the same level or scope of cover under an insurance policy or program of policies that was not previously captured under the 'insurance cap event'.

The proposed 'insurance coverage event' would allow us to recover material costs beyond the policy limit, or which otherwise fall outside the scope of the cover provided under the relevant insurance policy or policies. It would protect us from high cost impact events which would be uneconomical to insure, while benefiting

²⁰ PAL ATT096 - Marsh - Bushfire liability - Oct2019 - Public

consumers because they are not required to fund excessive premiums where insurance, if available, would be uneconomic. Consumers then only bear the risk should an ‘insurance event’ occur. The event therefore provides for an appropriate sharing of risk between us and our customers, and is more likely to be in the long-term interests of consumers with respect to price.

Proposed definition

We propose that an ‘insurance coverage event’ is defined as (with minor changes from the 2016–2020 insurance cap event):

An insurance coverage event occurs if:

- (a) Powercor makes a claim or claims and receives the benefit of a payment or payments under a relevant insurance policy or program of insurance policies*
- (b) Powercor incurs costs beyond the policy limit, or which otherwise fall outside the scope of the cover provided, under the relevant insurance policy or policies*
- (c) the costs beyond the policy limit, or otherwise outside the scope of the cover provided, under the relevant insurance policy or policies increase the costs to Powercor in providing direct control services.*

For this insurance coverage event:

- (a) a relevant insurance policy is an insurance policy held during the 2021–2026 regulatory control period or a previous regulatory control period in which Powercor was regulated*
- (b) the scope of the cover provided by a relevant insurance policy or policies includes the bands of liability for which Powercor is insured. It does not include:*
 - (1) any liability beyond the policy limit of the policy or policies or*
 - (2) any range or band of liability within the policy limit for which Powercor is not insured by the policy or policies*
- (c) Powercor will be deemed to have made a claim on a relevant insurance policy if the claim is made by a related party of Powercor in relation to any aspect of the Network or Powercor's business.*

Note in assessing an insurance coverage event pass through application the AER will have regard to:

- (a) the insurance policy or policies for the event*
- (b) the level and scope of insurance cover that would be obtained, and the risks that would be insured against, by an efficient and prudent NSP in respect of the event*
- (c) prevailing conditions in the global insurance market at the time the policy or program of policies was obtained.*

This definition has been amended from our 2016–2020 regulatory determination to reflect changes and challenges in the global insurance market that have increased the risk of inability to obtain the full level or scope of cover under relevant insurance policy or policies.

Insurance cap event satisfies nominated pass through event considerations

This event is consistent with the nominated pass through event considerations because:

- the event is not covered by a category of pass through event specified in the Rules.²¹
- the nature or type of event can be clearly identified at the time of our determination.²²
- the extent to which we can reasonably prevent a claim occurring which exceeds the limits and scope of our insurance cover, or can take steps to mitigate incurring costs beyond the limits and scope of our cover, is limited.
- we have obtained efficient levels of insurance cover which are commensurate with an assessment of our business risk. However, the efficient level and scope of such insurance is typically determined based on global market insurance conditions, with the level and scope of cover beyond the efficient coverage typically requiring exorbitantly higher and uneconomic premiums.
- including an insurance coverage event as a pass through event represents a more appropriate means for managing our risk exposure to such an event than self-insurance given:
 - the complexity associated with developing credible self-insured risk quantifications for very low probability events, such as those that beyond existing liability limits and scope
 - that such an event is likely to be catastrophic in nature and have a significant financial impact on us.

The proposed nominated pass through event is consistent with the NEO and the revenue and pricing principles. This nominated pass through event would protect us from high cost and impact events that are uneconomical and not prudent or efficient to insure against. It ensures we are not placed in a position where we are unable to mitigate or avoid the event or its cost impact without incurring imprudent or inefficient expenditure, and provides a reasonable opportunity to recover our efficient costs.

Consumers benefit from the inclusion of this event because they are not required to fund excessive insurance premiums where insurance is available. Further, consumers only bear the risk should an insurance event occur and satisfy the provisions for the approval of pass through amounts. The event therefore provides for an appropriate sharing of risk between us and our customers, and is more likely to be in the long-term interests of consumers with respect to price.

2.3.3 Natural disaster event

A natural disaster event is contained within our distribution determination for the 2016–2020 regulatory period. This event has also been accepted as a pass through event by the AER in more recent regulatory decisions.²³

The occurrence of natural disasters such as floods, earthquakes, and major storms is entirely beyond our control. The timing of such an event cannot be determined in advance. Costs incurred as a result of a natural disaster depend on several variables, such as the type of event, the magnitude of the event, and the areas of the distributor’s network which are affected (and the extent to which they are affected). Natural disasters are likely to be of a high magnitude or potentially even catastrophic. We are unable to self-insure for these events.

We propose we should continue to have a ‘natural disaster event’ in our distribution determination.

²¹ Rules, clause 6.6.1(a1)(1) to (4).

²² The AER has recognised this in including this event in our 2016–2020 distribution determination.

²³ AER, Draft Decision Evoenergy Distribution Determination 2019–2024, Attachment 14 - Pass through events, September 2018, p. 14-10; AER, Draft Decision Ausgrid Distribution determination 2019–24, Attachment 14 - Pass through events, November 2018, p. 14-11; AER, Draft Decision Essential Energy Distribution determination 2019–24, Attachment 14 – Pass through events, November 2018, p. 14-11; AER, Draft Decision Endeavour Energy Distribution determination 2019–24, Attachment 14 – Pass through events, November 2018, p. 14-10.

Proposed definition

We propose the ‘natural disaster event’ be defined as:

Natural disaster event means any natural disaster including but not limited to cyclone, fire, flood or earthquake that occurs during the 2021–26 regulatory control period that increases the costs to Powercor in providing direct control services, provided the cyclone, fire, flood, earthquake or other event was not directly and solely caused by Powercor’s negligent or unlawful acts or omissions.

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

- (a) whether Powercor has insurance against the event*
- (b) the level of insurance that an efficient and prudent NSP would obtain in respect of the event*
- (c) whether a relevant government authority has made a declaration that a natural disaster has occurred.*

Natural disaster event satisfies nominated pass through event considerations

This event is consistent with the nominated pass through event considerations because:

- the event is not covered by a category of pass through event specified in the Rules.²⁴
- the nature or type of the event can be clearly identified at the time of the determination for the distributor, as evidenced by the fact that the AER included this event in our 2011–2015 and 2016–2020 distribution determinations and more recent regulatory decisions.
- while we have in place a number of preventative measures of the kind detailed below, we cannot reasonably prevent an event of the requisite nature or type from occurring.
 - an ‘Enterprise Risk Management’ approach is used to provide a comprehensive and consistent means to manage and report on business risk exposures through identification of strategic and operational risks, determining accountability for those risks, assessment of controls and the control environment and ensuring that there are adequate resources to manage the risks.
 - we conduct an annual risk profiling exercise which results in a detailed risk register and risk profile. The risk assessment process is the foundation that enables us to maintain a dynamic risk management system tailored to our requirements. Risks in the risk register are clearly defined as to the event, causes and consequences. Controls applying to a particular risk are then rated on their effectiveness and reliance on the control to manage the risk. Each risk is then assessed for its inherent (without controls) and residential (with controls applied) risk rating. The risk rating is then assessed for acceptability and additional actions determined in accordance with the residential risk rating.
 - we have a duty under the *Electricity Safety Act 1998 (Vic)* to design, construct, operate, maintain and decommission its supply network to minimise as far as practicable the hazards and risks to the safety of any person or of damage to the property of any person arising from the supply network, and the bushfire danger arising from the supply network.
 - an electricity safety management scheme (**ESMS**) must be submitted to Energy Safe Victoria (**ESV**) for each of our supply networks under the *Electricity Safety Act 1998 (Vic)*. We must comply with the

²⁴ Rules, clause 6.6.1(a1)(1) to (4).

accepted ESMS, which also must include a plan for the mitigation of bushfire danger in relation to our supply network. The bushfire mitigation strategy plan (**BMP**) is published on our website.²⁵

- in the event of a natural disaster, we have in place a Crisis and Emergency Management System which provides an effective state of readiness to prepare for, respond to and recover from, a range of credible and potential events with the aim of mitigating the effects of the event as far as practicable.
- efficient levels of commercial insurance cover have been obtained through our Industrial Special Risks insurance policy, which is commensurate with an assessment of our business risk arising from natural disasters. However, this insurance would likely not cover all costs associated with a natural disaster event and taking out further insurance would likely be inefficient and result in unnecessary cost increases to customers.
- including natural disasters as a pass through event represents a more efficient means for managing our risk exposure than self-insurance given the complexity associated with developing credible self-insured risk quantifications for very low probability events and our likely inability to pool enough risk to cover the cost impacts of a major natural disaster.

In recent regulatory decisions, the AER has accepted that the natural disaster event is not covered by any existing category of pass through event, the nature of the event is clearly identifiable at this time and a prudent service provider could not reasonably prevent an event of that nature or type from occurring or substantially mitigate its cost impact, and could not insure (or self-insure) against the event.²⁶

The inclusion of a natural disaster pass through event means that consumers only bear the risk should such an event occur and satisfy the provisions for the approval of pass through amounts rather than funding excessive and potentially unnecessary insurance premiums. The event therefore provides for an appropriate sharing of risk between us and our customers, and is more likely to be in the long-term interests of consumers with respect to price.

The proposed nominated pass through event is consistent with the NEO and the revenue and pricing principles because it ensures we are not placed in a position where we are unable to mitigate or avoid the event or its cost impact without incurring imprudent or inefficient expenditure, and provides a reasonable opportunity to recover our efficient costs.

2.3.4 Terrorism event

A terrorism event applied during the 2016–2020 regulatory period pursuant to our distribution determination. This event has also been accepted as a pass through event by the AER in more recent regulatory decisions.²⁷

²⁵ See Powercor, *Bushfire Mitigation Strategy Plan 2014-2019*, 2014, available from <https://www.powercor.com.au/media/2202/powercor-bfm-strategy-plan-2014-2019-issue-2.pdf>.

²⁶ See, e.g. AER, Draft Decision Evoenergy Distribution Determination 2019-2024, Attachment 14 - Pass through events, September 2018, p. 14-10; AER, Draft Decision Ausgrid Distribution determination 2019-24, Attachment 14 - Pass through events, November 2018, p. 14-11; AER, Draft Decision Essential Energy Distribution determination 2019–24, Attachment 14 – Pass through events, November 2018, p. 14-11; AER, Draft Decision Endeavour Energy Distribution determination 2019–24, Attachment 14 – Pass through events, November 2018, p. 14-10.

²⁷ See, eg, AER, Draft Decision Evoenergy Distribution Determination 2019-2024, Attachment 14 - Pass through events, September 2018, p. 14-5; AER, Draft Decision Ausgrid Distribution determination 2019-24, Attachment 14 - Pass through events, November 2018, p. 14-5; AER, Draft Decision Essential Energy Distribution determination 2019–24, Attachment 14 – Pass through events, November 2018, p. 14-5; AER, Draft Decision Endeavour Energy Distribution determination 2019–24, Attachment 14 – Pass through events, November 2018, p. 14-5.

While we have in place systems to mitigate the risk of a terrorism event occurring, we cannot as a prudent and efficient service provider completely eliminate the risk of such an event occurring.

We propose we should continue to have a ‘terrorism event’ in our distribution determination.

Proposed definition

We propose that the event be defined as:

Terrorism event means an act (including, but not limited to, the use of force or violence or the threat of force or violence, attacks or other disruptive activities against critical infrastructure or underlying technology, or the threat of such attacks or disruptive activities, or the deliberate introduction of malware) of any person or group of persons (whether acting alone or on behalf of or in connection with any organisation or government), which:

- (a) 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*
- (b) increases the costs to Powercor in providing direct control services.*

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

- (a) whether Powercor has insurance against the event*
- (b) the level of insurance that an efficient and prudent DNSP would obtain in respect of the event*
- (c) whether a declaration has been made by a relevant government authority that an act of terrorism has occurred.*

This definition has been amended from our 2016–2020 regulatory determination to explicitly reference cyber terrorism. While the AER acknowledged in its final determination in 2016–2020 that if a cyber-attack has the characteristics of an act of terrorism, then we could apply to have those costs passed through,²⁸ amendments are required to provide greater clarity on the regulatory treatment of such events, and to align with recent market and legislative developments aimed at addressing cyber security concerns. These include:

- Commonwealth Attorney General’s Department assessing the risk to the Australian economy from computer intrusion and the spread of malicious code by organised crime as high.²⁹
- establishment of the Critical Infrastructure Centre in January 2017 and the introduction of the Security of Critical Infrastructure Act 2018 aimed at managing the national security risks posed to critical infrastructure from espionage, sabotage and coercion.
- electricity distribution assets being deemed to be critical infrastructure by the Critical Infrastructure Centre and the Security of Critical Infrastructure Act 2018. It was noted that prolonged disruption to Australia’s electricity networks would have a significant impact on communities, businesses and national security

²⁸ Powercor, Final decision, Powercor distribution determination 2016 to 2020, Appendix 15 – Pass through events, May 2016, p. 15-20.

²⁹ Attorney-General’s Department <<https://www.ag.gov.au/RightsAndProtections/CyberSecurity/Pages/default.aspx>>

capabilities. Additionally, it was noted some electricity providers also hold large data sets about customers and their electricity usage, which need to be appropriately protected.³⁰

- the Finkel review recommendation that a stronger risk management framework be implemented, including an annual report on the cyber security preparedness of the National Electricity Market and its participants.³¹
- Australian Cyber Security Centre has noted that the number, type and sophistication of cyber security threats are increasing and that threats to organisations are becoming increasingly sophisticated and targeted.³²

Terrorism event satisfies nominated pass through event considerations

This event is consistent with the nominated pass through event considerations because:

- the event is not covered by another category of pass through event specified in the Rules.³³
- the nature or type of event can be clearly identified at the time of the determination for the distributor, as evidenced by this type of event being previously prescribed in the Rules and included in our 2011–2015 and 2016–2020 distribution determinations and more recent regulatory decisions of the AER.
- our ability to reasonably prevent a terrorism event from occurring or substantially mitigate the cost impact of such an event is limited. While the occurrence of a terrorism event is largely beyond our control, we undertake a range of measures to reduce the likelihood of a terrorism event. We continue to review and assess the level of security at our sites in addition to undertaking security surveys. We also interact with a range of organisations and participates in various groups, including:
 - The Australian Security Intelligence Organisation (**ASIO**) Business Liaison Unit
 - The Australian Cyber Security Centre
 - the Trusted Information Sharing Network (**TISN**) through the Attorney-General's Department
 - the Critical Infrastructure Program for Modelling and Analysis (**CIPMA**), also through the Attorney-General's Department
 - Victorian Energy Security and Continuity Network (**SCN**)
 - AEMO's Victorian Electricity Emergency Committee (**VEEC**)
 - the Distribution Business Information Sharing Security group.
- generally, the commercial market for insurance in Australia is insufficient to cover demand. While the Australian Government found in its 2012 Terrorism Insurance Act Review that the availability for Insurance

³⁰ Australian Government, Security of Critical Infrastructure Bill 2017, Explanatory Memorandum, p. 4. Available from: https://www.aph.gov.au/Parliamentary_Business/Bills_Legislation/Bills_Search_Results/Result?bid=s1118

³¹ Australian Government, Independent Review into the Future Security of the National Electricity Market - Blueprint for the Future, June 2017, p. 22. Available from: <https://www.energy.gov.au/publications/independent-review-future-security-national-electricity-market-blueprint-future>.

³² For example, see Australian Cyber Security Centre, What Executives Should Know About Cyber Security, April 2018 available from: https://www.acsc.gov.au/publications/protect/What_Executives_Should_Know_About_Cyber_Security.pdf.

³³ Rules, clause 6.6.1(a1)(1) to (4).

for terrorism is increasing, it nonetheless concludes that insurance for terrorism events remains insufficiently available at affordable rates:³⁴

...some commercial market capacity for terrorism insurance is re-emerging both internationally and domestically, although it remains insufficient to cover the available demand is concentrated in supporting national pooled arrangements. Furthermore, there is insufficient capacity at reasonable prices for individual risks in Australia with the quantum of commercial market capacity being significantly below the current \$13.4 billion scheme operated by the ARPC [Australian Reinsurance Pool Corporation].

- our Industrial Special Risks insurance policy covers property damage and business interruption for terrorism, however it may not cover all of the impacts of a terrorism event on our network and business. Taking out further insurance would likely be inefficient given prevailing market conditions.
- self-insurance would not be a credible option because the relative infrequency and potentially high costs associated with terrorism events create significant challenges for self-insurance for this type of risk, and there is limited data on which to calculate a credible self-insurance premium.

In recent regulatory decisions, the AER has accepted that the terrorism event is not covered by any existing category of pass through event, the nature of the event is clearly identifiable at this time and a prudent service provider could not reasonably prevent an event of that nature or type from occurring or substantially mitigate its cost impact, and could not insure (or self-insure) against the event.³⁵

The proposed nominated pass through event is consistent with the NEO and the revenue and pricing principles because it ensures that we are not placed in a position where we are unable to mitigate or avoid the event or its cost impact without incurring imprudent or inefficient expenditure, and provides a reasonable opportunity to recover our efficient costs. Further, the inclusion of a terrorism pass through event means consumers only bear the risk should such an event occur and satisfy the provisions for the approval of pass through amounts, rather than funding excessive and potentially unnecessary insurance premiums. The event therefore provides for an appropriate sharing of risk between us and our customers, and is more likely to be in the long-term interests of consumers with respect to price.

2.3.5 Retailer insolvency event

A retailer insolvency event applied during the 2016–2020 regulatory period as a nominated pass through event in our distribution determination.

There is some uncertainty regarding whether the retailer insolvency event specified in clause 6.6.1(a1)(4) of the Rules applies to Victorian distributors. This is because:

- that pass through event was initially introduced into the Rules through the National Electricity (National Energy Retail Law) Amendment Rule 2012 (**NERL Amendment Rule**)

³⁴ Australian Government, *Terrorism Insurance Act Review: 2012*, p. 2. Available from: http://www.treasury.gov.au/~media/Treasury/Publications%20and%20Media/Publications/2012/Terrorism%20Insurance%20Act%20Review%202012/downloads/Terrorism_Insurance_Act_Review_2012.ashx.

³⁵ See, e.g. AER, Draft Decision Evoenergy Distribution Determination 2019-2024, Attachment 14 - Pass through events, September 2018, p. 14-10 to 14-11; AER, Draft Decision Ausgrid Distribution determination 2019-24, Attachment 14 - Pass through events, November 2018, p. 14-11; AER, Draft Decision Essential Energy Distribution determination 2019–24, Attachment 14 – Pass through events, November 2018, p. 14-11; AER, Draft Decision Endeavour Energy Distribution determination 2019–24, Attachment 14 – Pass through events, November 2018, pp. 14-10 to 14-11.

- the NERL Amendment Rule purports to only apply to jurisdictions that have implemented the National Energy Retail Law³⁶
- the National Energy Customer Framework (**NECF**) (which encompasses the National Energy Retail Law) has not been adopted in Victoria, with the exception of Chapter 5A of the Rules.

The AER has acknowledged that the prescribed retailer insolvency event under the Rules does not apply to Victorian distributors and considered it appropriate to provide equivalent protection to Victorian distributors through a nominated pass through event.³⁷

Proposed definition

We propose that the event be defined as:

Until such time as the National Energy Retail Law set out in the Schedule to the National Energy Retail Law (South Australia) Act 2011 of South Australia is applied as a law of Victoria, retailer insolvency event has the meaning set out in the NER as in force from time to time, except that:

- where used in the definition of 'retailer insolvency event' in the NER, the term 'retailer' means the holder of a licence to sell electricity under the Electricity Industry Act 2000 (Vic)*
- other terms used in the definition of retailer insolvency event in the Rules as a consequence of amendments made to that definition from time to time, which would otherwise take their meaning by reference to provisions of the NER or National Energy Retail Law not in force in Victoria, take their ordinary meaning and natural meaning, or their technical meaning (as the case may be).*

For the purposes of this definition, the terms 'eligible pass through amount' and 'positive change event' where they appear in the NER are modified in respect of this retailer insolvency event in the same manner as those terms are modified in respect of the retailer insolvency event prescribed in the NER from time to time. Other terms defined in the NER for this purpose (including without limitation 'retailer insolvency costs', 'failed retailer' and 'billed but unpaid charges') which would otherwise take their meaning by reference to provisions of the NER or National Energy Retail Law not in force in Victoria, take their ordinary and natural meaning, or their technical meaning (as the case may be).

Note: This retailer insolvency event will cease to apply as a nominated pass through event on commencement of the National Energy Retail Law in Victoria.

This definition has been amended from our 2016–2020 regulatory determination having regard to changes in respect of the retailer insolvency event in the Rules made by the National Electricity Amendment (Retailer-Distributor Credit Support Requirements) Rule 2017. In particular, that Rule brought in:

- changes to the definition of 'positive change event' to allow for the costs arising from a retailer insolvency event to be passed through, without being subject to the materiality threshold that is applied to other cost pass through events

³⁶ Section 2 of the NERL Amendment Rule provides that the Rule comes into operation on the day on which Schedule 1 of the National Energy Retail Law (South Australia) Act 2011 (No 6 of 2011) comes into operation. There is a note to section 2 which states '[t]his Rule does not apply in a participating jurisdiction until the National Energy Retail Law is applied in that jurisdiction as a law of that jurisdiction.'

³⁷ AER, Powercor, Preliminary decision, Powercor distribution determination 2016 to 2020, Appendix 15 – Pass through events, October 2015, p. 15-21; AER, Powercor, Final decision, Powercor distribution determination 2016 to 2020, Appendix 15 – Pass through events, May 2016, pp. 15-20 to 15-22. See also Powercor, Regulatory Proposal 2016-2020 Price Reset, Appendix L Managing uncertainty, April 2015, p. 29-32, which explains why the rationale for the inclusion of the retailer insolvency pass through event in the Rules for distributors in jurisdictions which have adopted the NECF also applies to us.

- the insertion of a new definition of retailer insolvency costs, which specifically includes a distributor's unpaid network charges as a result of a retailer insolvency event.

A rule change proposal in respect of amendments of this nature had been submitted by Council of Australian Governments (CoAG) to the AEMC prior to the 2016–2020 regulatory determination. Accordingly, the definition of retailer insolvency event in the 2016–2020 regulatory determination was formulated to encompass those changes to ensure that the protection afforded to Victorian distributors remains consistent with that available to distributors in NECF jurisdictions.³⁸ However, we have amended that definition having regard to terms brought in by the final Rule that are relevant to the calculation of 'eligible pass through amount' in relation to a positive change event that is a retailer insolvency event under clause 6.6.1(l) of the Rules. In particular, we have amended the definition to provide that "Other terms defined in the NER for this purpose (including without limitation 'retailer insolvency costs', 'failed retailer' and 'billed but unpaid charges') which would otherwise take their meaning by reference to provisions of the NER or National Energy Retail Law not in force in Victoria, take their ordinary and natural meaning, or their technical meaning (as the case may be)." This is because 'failed retailer' which is used in both the definitions of 'retailer insolvency costs' and 'billed but unpaid charges' is defined to take the meaning given to that term in the National Energy Retail Law which is not in force in Victoria.

Retailer failure event satisfies nominated pass through event considerations

This event is consistent with the nominated pass through event considerations because:

- it may not be covered by a category of pass through event specified in the Rules.³⁹ There is some uncertainty over whether the retailer insolvency event specified in the Rules applies to Victorian distributors. It is, however, appropriate to provide equivalent protection to Victorian distributors through a nominated pass through event.
- the nature or type of event can be clearly identified at the time of the determination for the distributor as it is based on the retailer insolvency event in the Rules.⁴⁰
- similar to distributors in jurisdictions which have wholly adopted the NECF, we are unable to manage the risk of retailers defaulting on payment of our network charges and as such are unable to reasonably prevent a retailer failure event from occurring or substantially mitigate the cost impact of such an event.
- due to the low probability, but potentially high cost, of a retailer failure event occurring, it is inefficient for us to insure (either externally or self-insure) against this event.

The proposed nominated pass through event is consistent with the NEO and the revenue and pricing principles because it provides us with a reasonable opportunity to recover our efficient costs and avoids placing us in a position where it incurs costs that we are unable to avoid, recover or mitigate. The existing credit support arrangements for us for failure of a retailer do not recover the full amount of the outstanding debt to us and this shortfall in cost recovery can be significant. The costs to us of a retailer failure which fall within the proposed definition of the retailer insolvency event and satisfy the provisions for the approval of pass through amounts should be borne by consumers because:

- the costs of retail contestability should be borne by the beneficiaries of that contestability, that is, by consumers

³⁸ Powercor, Revised Regulatory Proposal 2016-2020, p. 421-422; AER, Powercor, Final decision, Powercor distribution determination 2016 to 2020, Appendix 15 – Pass through events, May 2016, pp. 15-21 to 15-22.

³⁹ Rules, clause 6.6.1(a1)(1) to (4).

⁴⁰ Rules, chapter 6.

- consumers are the most appropriate party to bear the costs of the financial failure of a retailer because we are unable to manage the risk of a retailer failure, and they are also better placed to bear these costs as they can be spread across a diversified consumer base.

The event therefore provides for an appropriate sharing of risk between us and our customers, and is more likely to be in the long-term interests of consumers with respect to price.

2.3.6 Major cyber event

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

Existing insurance policies do not cover the cost of non-physical losses and such policies are not currently available.

We propose the addition of a 'major cyber event' in our distribution determination for the 2021–2026 regulatory period.

Proposed definition

We propose the definition of a 'major cyber event' is as follow:

Major cyber event' means any significant interruption to the technology systems or assets used by Powercor to provide direct control services occurring during the 2021–2026 regulatory control period that materially increases the costs to Powercor in providing direct control services, provided that:

- (a) *the interruption was caused by an act of a third party*
- (b) *the event does not constitute a 'terrorism event'.*

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

- (a) *whether Powercor has insurance against the event*
- (b) *the level of insurance that an efficient and prudent DNSP would obtain in respect of the event*
- (c) *whether the steps taken by Powercor to prevent the event from occurring are consistent with the steps that an efficient and prudent DNSP would have taken in the circumstances to prevent the occurrence of the event*
- (d) *whether the steps taken by Powercor to mitigate the cost impact of the event are consistent with the steps that an efficient and prudent DNSP would have taken in the circumstances to mitigate the cost impact of the event.*

To address the potential for overlap between a 'major cyber event' and 'terrorism event', paragraph (b) of our proposed 'major cyber event' explicitly excludes an event that would already be covered by the definition of 'terrorism event'.

Major cyber events nominated pass through event considerations

This event is consistent with the nominated pass through event considerations because:

- a major cyber event is not already covered by any of the categories of pass through events specified in the Rules or the proposed terrorism event⁴¹
- this type of event can be and is clearly identified
- a 'major cyber event' is beyond our control—we cannot prevent this type of event from occurring and cannot substantially mitigate the cost impacts of this type of event (both prior to and after the occurrence of this type of event)
- we cannot obtain appropriate insurances on reasonable commercial terms covering the full range of costs that could potentially be incurred as a result of the occurrence of this type of event
- the occurrence of a particular major cyber event is not foreseeable, has a low probability of occurrence but has a high consequence or magnitude, with the result that it cannot be self-insured.

In recent regulatory decisions, the AER has disallowed the inclusion of a 'major cyber event' as a nominated pass through event primarily because it was not satisfied that a distributor could not reasonably prevent or substantially mitigate the cost impact of such an event, or insure or self-insure against such an event.⁴² It reasoned therefore that major cyber events that are not in the nature of cyber-terrorism 'are standard business risks which the DNSP should manage' and allowing a 'major cyber event' would reduce the DNSP's incentive to do so.

The types of interruptions intended to be covered by a 'major cyber event' share the same characteristics as the type of events covered by terrorism events and natural disaster events (i.e. events that cannot be fully addressed even if we take all reasonable available actions to prevent the occurrence of the event and to mitigate the costs associated with the occurrence of the event).

The AER noted in recent distribution determinations, a major cyber event could be classified as a terrorism event, presumably because these types of events result from the acts of a third party which a distributor has little or no capability to prevent.⁴³ However, it is unclear why a major interruption caused by an act of a third party which a distributor has little or no capability to prevent but was not motivated by the terrorism criteria should be treated any differently.

As already noted, a 'major cyber event' cannot be insured on reasonable commercial terms. The Policy Schedule to our Industrial Special Risks Policy expressly excludes risks of this kind.⁴⁴

A 'major cyber event' cannot be self-insured. As such an event has a low probability of occurrence but a high consequence or magnitude, it is not possible to develop credible self-insured risk quantifications or thus calculate the required self-insurance premium and, in any event, we would be unable to self-insure the potential cost of such an event without this having a significant impact on our ability to provide network services.

Further and in any event, the reservations expressed by the AER in respect of a 'major cyber event' in recent regulatory decisions have been addressed in our proposed definition of that event, by including the assessment factors in the definition. This gives the AER the ability to consider our ability to prevent or substantially mitigate

⁴¹ Rules, clause 6.6.1(a1) to (4).

⁴² See, e.g., AER, Draft decision Essential Energy Distribution determination 2019–24, Attachment 14 – Pass through events, November 2018, pp. 14-13 to 14-14. See also, AER's decision not to allow Ausgrid's amendment to the definition of 'Terrorism' to explicitly refer to attacks on technology: AER, Draft Decision Ausgrid Distribution determination 2019-24, Attachment 14 - Pass through events, November 2018, pp. 14-11 to 14-12.

⁴³ AER, Draft decision Essential Energy distribution determination 2019–24, Attachment 14 – Pass through events, pp. 14-13 to 14-14.

⁴⁴ Property Exclusions, item 12 at 29; Perils Exclusions, items 5(a) and 6 at 31-32

the cost impact of such an event, or insure or self-insure against such an event, acting efficiently and prudently, when assessing a pass through application for a 'major cyber event'.

The proposed nominated pass through event is consistent with the NEO and the revenue and pricing principles because it ensures that we are not placed in a position where we are unable to mitigate or avoid the event or its cost impact without incurring imprudent or inefficient expenditure, and provides a reasonable opportunity to recover our efficient costs. Further, the inclusion of a major cyber pass through event means consumers only bear the risk should such an event occur and satisfy the provisions for the approval of pass through amounts, rather than funding excessive and potentially unnecessary insurance premiums. The event therefore provides for an appropriate sharing of risk between us and our customers, and is more likely to be in the long-term interests of consumers with respect to price.

2.3.7 Act of aggression

We consider the approval of an act of aggression event cost pass through as necessary, as it captures a key category of uncertain, potential high cost impact events outside our control. Such an event could have the potential to result in us incurring substantial costs and interruption to the provision of our direct control services.

While we have in place systems to mitigate the risk associated with an act of aggression event occurring, we cannot as a prudent and efficient service provider completely eliminate the risk of such an event occurring.

We propose we should have an act of aggression in our distribution determination for the 2021–2026 regulatory period.

Proposed definition

We propose that an act of aggression be described as:

Act of aggression event means:

- (a) an event that constitutes an international armed conflict (within the meaning given to that term by the Geneva Conventions and associated Protocols) involving Australia;*
- (b) an event that constitutes a non-international armed conflict (within the meaning given to that term by the Geneva Conventions and associated Protocols) occurring in Australia; or*
- (c) an act of aggression (within the meaning given to that term by United Nations General Assembly resolution 3314 (XXIX) of 14 December 1974) against Australia,*

which occurs during the 2021–2026 regulatory control period and materially increases the costs to Powercor in providing direct control services.

Note: In assessing an act of aggression event pass through application, the AER will have regard to, amongst other things:

- (a) whether Powercor has insurance against the event*
- (b) the level of insurance that an efficient and prudent distributor would obtain in respect of the event*

Act of aggression events nominated pass through event considerations

This event is consistent with the nominated pass through event considerations because:

- our proposed event is not already covered by any of the categories of pass through events specified in the Rules or proposed additional events.⁴⁵
- this type of event can be and is clearly identified.
- our proposed act of aggression event is beyond our control. We cannot prevent this type of event from occurring and cannot substantially mitigate the cost impacts of this type of event (both prior to and after the occurrence of this type of event).
- act of aggression type risks (e.g. war) are a standard exclusion from commercial insurance policies. Consequently, obtaining insurance cover for this type of risk on commercial grounds is difficult, or impossible.
- the occurrence of a particular act of aggression event is not foreseeable, has a low probability of occurrence but a high consequence or magnitude. The low probability of occurrence, and resultant lack of data on which to base a reliable calculation of a self-insurance premium, and significant magnitude of the cost impact means our proposed war event cannot be credibly self-insured.

The AER, in its draft decision on Essential Energy's distribution determination for 2019–24 disallowed Essential Energy's proposal of a 'war event' on the basis that:

- the war event proposed by Essential Energy is not of a nature or type that can be clearly identified at the time the determination is made, contrary to nominated pass through event consideration (b)
- as a consequence, Essential Energy had not demonstrated that a prudent service provider could not substantially mitigate the cost impact of such an event, or insure (or self-insure) against the event, contrary to nominated pass through event considerations (c) and (d).

The AER reasoned that these conclusions follow from:

- the breadth of the definition of Essential Energy's proposed war event
- the uncertainty as to the costs Essential Energy's proposed war event was intended to cover or the drivers of change of those costs
- the fact that, in contrast to natural disaster and terrorism events, acts of war besides a physical invasion of Australia are unlikely to directly impact on a distributor's physical assets
- the difficulty of proving a nexus between Essential Energy's proposed war event and the change of costs claimed such that the AER anticipated it could not be satisfied that 'such costs occur solely as a consequence of the positive change event' for the purpose of clause 6.6.1(c)(6)(ii) of the Rules.

We consider our proposed act of aggression event (which differs materially from that proposed by Essential Energy) is of a nature or type that can be clearly identified. As there is no single, accepted meaning of the term 'war' in domestic or international law, we have defined our proposed act of aggression event by reference to the terms 'international armed conflict', 'non-international armed conflict', 'aggression' and 'act of aggression', each of which has a clear, identifiable meaning in international law.

The terms 'international armed conflict' and 'non-international armed conflict' are defined in the Geneva Conventions. The Geneva Conventions comprise four treaties and three additional Protocols, which together

⁴⁵ Rules, clause 6.6.1(a1) to (4).

establish the standards of international law for humanitarian treatment in war. The Geneva Conventions have been universally ratified and all of the Protocols to the Conventions have been similarly ratified by Australia.

The applicability of the Geneva Conventions is spelt out in Common Articles 2 and 3, which relate to international armed conflicts and non-international armed conflicts respectively. They apply at times of war and armed conflict to governments who have ratified their terms.

Pursuant to the Geneva Conventions and the accompanying Protocols, an 'international armed conflict' includes:

- all cases of declared war or any other armed conflict which may arise between two or more of the 'High Contracting Parties' (which, given the universal ratification of the Geneva Conventions, can be taken to refer to any and all United Nations member states), even if the state of war is not recognised by one of them⁴⁶
- all cases of partial or total occupation of the territory of a High Contracting Party. Even if the said occupation meets with no armed resistance⁴⁷
- armed conflicts in which peoples are fighting against colonial domination, alien occupation or racist regimes in the exercise of their right to self-determination (wars of national liberation).⁴⁸

A 'non-international armed conflict' means 'an armed conflict not of an international character occurring in the territory of one of the High Contracting Parties [between] each Party to the conflict'⁴⁹ and extends to an armed conflict which takes place 'in the territory of a High Contracting Party between its armed forces and dissident armed forces or other organized armed groups which, under responsible command, exercise such control over a part of its territory as to enable them to carry out sustained and concerted military operations and to implement this Protocol'.⁵⁰

Article 3 establishes two criteria to distinguish non-international armed conflicts from lower forms of violence. First, the level of violence has to be of a certain intensity, for example when the State cannot contain the situation with regular police forces.⁵¹ Secondly, the non-state Party must possess organised armed forces (being under a structure of command and able to sustain military operations).⁵²

'War crimes' are defined in the Rome Statute of the International Criminal Court by reference to the Geneva Conventions and the terms 'international armed conflict' and 'non-international armed conflict' defined in Articles 2 and 3 of those Conventions.⁵³

The terms 'aggression' and 'act of aggression' are defined in United Nations General Assembly Resolution 3314 (XXIX) (Definition of Aggression), which was adopted by the United Nations General Assembly on 14 December 1974. 'Aggression' is defined in Resolution 3314 to mean 'the use of armed force by a State against the sovereignty, territorial integrity or political independence of another State, or in any other manner inconsistent

⁴⁶ PAL ATT058, Common Article 2 of Geneva Conventions.

⁴⁷ PAL ATT058, Common Article 2 of Geneva Conventions.

⁴⁸ PAL ATT060, Additional Protocol I to the Geneva Conventions.

⁴⁹ PAL ATT058, Common Article 3 of Geneva Conventions.

⁵⁰ PAL ATT061, Additional Protocol II, Art 1(1). This understanding develops and supplements common Article 3 without modifying it: Additional Protocol II, art. 1, para. 1.

⁵¹ See further PAL ATT062, ICTY, *The Prosecutor v Fatmir Limaj*, Judgment, IT-03-66-T, 30 November 2005, para. 135-170.

⁵² See further PAL ATT062, ICTY, *The Prosecutor v Fatmir Limaj*, Judgment, IT-03-66-T, 30 November 2005, para. 94-134.

⁵³ PAL ATT064, Rome Statute of the International Criminal Court, Article 8.

with the Charter of the United Nations'.⁵⁴ Resolution 3314 provides that any of the following acts, regardless of a declaration of war, qualifies as an 'act of aggression':

- *an invasion or attack by the armed forces of a State of the territory of another State;*
- *any military occupation resulting from such invasion or attack;*
- *any annexation by the use of force of the territory of another State or part thereof;*
- *bombardment by the armed forces of a State against the territory of another State;*
- *the use of weapons by a State against the territory of another State;*
- *the blockade of the ports or coasts of a State by the armed forces of another State;*
- *an attack by the armed forces of a State on the land, sea or air forces, or marine and air fleets of another State;*
- *the use of armed forces of one State which are within the territory of another State with the agreement of the receiving State, in contravention of the conditions provided for in the agreement or any extension of their presence in such territory beyond the termination of the agreement;*
- *the action of a State in allowing its territory, which it has placed at the disposal of another State, to be used by that other State for perpetrating an act of aggression against a third State;*
- *the sending by or on behalf of a State of armed bands, groups, irregulars or mercenaries, which carry out acts of armed force against another State of such gravity as to amount to the acts listed above, or its substantial involvement therein.*

The definition of 'act of aggression' in Resolution 3314 is incorporated by the Rome Statute of the International Criminal Court in defining the 'crime of aggression'. The Rome Statute defines the 'crime of aggression' as 'the planning, preparation, initiation or execution, by a person in a position effectively to exercise control over or to direct the political or military action of a State, of an act of aggression which, by its character, gravity and scale, constitutes a manifest violation of the Charter of the United Nations'.⁵⁵ For the purpose of this definition, the Rome Statute incorporates the Resolution 3314 definition of 'aggression' verbatim, and provides, in essence, that any of the acts listed in Resolution 3314 shall, in accordance with Resolution 3314, qualify as an 'act of aggression' for the purposes of the international 'crime of aggression'.

The definition in international law, and use in defining the international crime of war and international crime of aggression, of the terms 'international armed conflict', 'non-international armed conflict', 'aggression' and 'act of aggression' demonstrates that our proposed 'war event', which is defined by reference to those same terms, is of a nature or type that is capable of being clearly identified.

The basis on which the AER maintains that it cannot be satisfied that a prudent service provider could not substantially mitigate the cost impact of a 'war event' (or in our case an act of aggression event), or insure (or self-insure) against such an event, contrary to nominated pass through event considerations (c) and (d), is unclear.

⁵⁴ PAL ATT063, Article 1 of UN General Assembly, Definition of Aggression, 14 December 1974, A/RES/3314.

⁵⁵ PAL ATT064, Rome Statute of the International Criminal Court, Article 8 bis.

As already explained, such risks are a standard exclusion from commercial insurance policies; obtaining insurance cover for this type of risk on reasonable commercial terms is difficult, if not impossible. The Policy Schedule to our Industrial Special Risks Policy expressly excludes:

- liability for loss, destruction of or damage to property 'directly or indirectly occasioned by or happening through or connected with war, invasion, act of foreign enemy, hostilities (whether war be declared or not), civil war, rebellion, revolution, insurrection, military or usurped power' (at 30, item 1(a) of Peril Exclusions); and
- liability for loss, damage, cost or expense of whatsoever nature 'directly or indirectly caused by, resulting from or in connection with any of the following regardless of any other cause or event contributing concurrently or in any other sequence to the loss: (a) war, invasion, acts of foreign enemies, hostilities or warlike operations (whether war be declared or not), civil war, rebellion, revolution, insurrection, civil commotion assuming the proportions of or amounting to an uprising, military or usurped power ... This Exclusion also excludes loss, damage, cost or expense of whatsoever nature directly or indirectly caused by, resulting from or in connection with any action taken in controlling, preventing, suppressing or in any way relating to (a)...' (at 32, item 9 of Peril Exclusions).

A war event cannot be credibly self-insured given its low probability, high cost magnitude nature. It is not apparent why the AER considers it more difficult to satisfy itself that a prudent service provider could not substantially mitigate the cost impact of or insure (or self-insure) against the proposed 'act of aggression event' than it is to establish this matter in respect of a natural disaster or terrorism event.

Our proposed act of aggression event is not overly broad. As our proposed event is defined by reference to the international law definitions of the terms 'international armed conflict', 'non-international armed conflict' and 'act of aggression', it mirrors the breadth of those defined terms and is thus of an appropriate breadth. Further, it is similar in breadth to the definitions of natural disaster and terrorism events accepted by the AER in recent regulatory decisions.

The kinds of costs our proposed act of aggression event is intended to cover, and the drivers of the change in costs, are apparent from the definition of that event. The kinds of cost increases the event is intended to cover are the costs of damage to property, and increased input costs due to supply chain disruptions, resulting from an armed conflict involving or occurring in, or act of aggression against, Australia. The drivers for such a change in costs are identifiable from the definitions of those terms in international law, being the use of armed force against, invasion, attack, military occupation, the bombardment of, or the use of weapons against, Australia or the blockade of the ports or coasts of Australia.

We do not accept that, as the AER has suggested, acts of war that have the potential to directly impact a distributor's physical assets are limited to physical invasions of Australia. It is readily apparent that the bombardment or attack of, or use of weapons against, Australia, for example, has real potential to impact a distributor's physical assets.

The basis on which the AER asserts that it will be more difficult to establish a nexus between the change in a distributor's costs and an act of war or aggression than to establish such a nexus in respect of a terrorism event or natural disaster event is unclear. Presumably, if detonation of a bomb were to destroy a distributor's physical assets, this nexus would be fairly self-evident. Similarly, if the blockading of an Australian port were to disrupt supply to a distributor of equipment or materials, resulting in the adoption of more costly supply solutions, the nexus between the act of aggression and the change in the distributor's costs should be readily capable of establishment.

For these reasons, we consider that the proposed nominated pass through event is consistent with the NEO and the revenue and pricing principles because it ensures that we are not placed in a position where we are unable to mitigate or avoid the event without creating unacceptable risks, and provides a reasonable opportunity to

recover our efficient costs. Further, the inclusion of an act of aggression pass through event means consumers only bear the risk should such an event occur and satisfy the provisions for the approval of pass through amounts in the Rules, rather than, for example, funding excessive and potentially unnecessary insurance premiums.⁵⁶ The event therefore provides for an appropriate sharing of risk between us and our customers, and is more likely to be in the long-term interests of consumers with respect to price.

2.3.8 Electric vehicle uptake event

The increase of electric vehicles (**EVs**) penetration is expected to drive new distributed load and generation centres across the network. EVs will have requirement to draw electricity from the network for charging, and potentially export energy into the network.

There is potential for new electricity demand peaks to arise, given that the increased consumption of electricity is expected to be materially higher with the introduction of EVs than that experienced historically. Eventually, networks will be required to invest in order to ensure that they can safely and reliably meet the increase in demand required to support electric vehicle charging.

The rise of EVs could be accelerated if there is a change in government policy. The 2019 Senate Inquiry recommended the Australian Government encourage EVs including developing standards and regulations in regards to charging infrastructure and electricity grid integration.⁵⁷ While an EV uptake from legislative changes may be covered by the regulatory change cost pass through event set out in the Rules, it does not cover the introduction or announcement of new policies. Therefore where there is a change in policy announcement but there is no subsequent passage of law or regulations or other regulatory instrument there is a risk the costs of such an event would not be covered by existing arrangements.

The significant uncertainty that exists with respect to the cost impacts and timing of EV uptake mean that it is in the long-term interests of our consumers that we recover the prudent and efficient costs of the event through pass through arrangements, rather than forecasting a material step up in EV penetration in demand forecasts and subsequently expenditure forecasts.

Nominating a risk as a cost pass through event is the most appropriate treatment for low likelihood, high consequence risks that cannot be efficiently managed using alternative measures, or for risks with a high likelihood of occurrence but where substantial uncertainty exists with respect to cost impacts and timing, such as an accelerated uptake of EVs.

Proposed definition

An electric vehicle event occurs if a government announcement directly related to increased electric vehicle uptake occurs during the 2021–2026 regulatory period that materially increases localised electricity demand

Note: In assessing an electric vehicle risk event pass through application, the AER will have regard to, amongst other things:

- (a) Powercor's attempts to mitigate the impact of the event on localised electricity demand*
- (b) whether the event already satisfies a regulatory change event in the Rules*

⁵⁶ Rules, clause 6.6.1.

⁵⁷ The Senate, Select Committee on Electric Vehicles Report, January 2019.

Electric vehicle event satisfies nominated pass through event considerations

This event is consistent with the nominated pass through event considerations because:

- the event is not covered by a category of pass through event specified in the Rules.⁵⁸
- the nature or type of event can be clearly identified at the time of our determination.
- the extent to which we can reasonably prevent a the impact on electricity demand, or can take steps to mitigate incurring costs, is limited as it is driven by customer preferences.⁵⁹
- we have forecast efficiently for EV uptake assuming there is no step change driven by a government announcement. However, an EV government announcement may materially increase network costs.
- including an electric vehicle event as a pass through event represents a more appropriate means for managing our risk exposure to such an event than forecasting it given the difficulty predicting government policy announcements

The proposed nominated pass through event is consistent with the NEO and the revenue and pricing principles. This nominated pass through event prevent consumers bearing the costs of higher investment needs in the 2021–2026 regulatory period that would arise from foresting a material step up in EVs. The event therefore provides for an appropriate sharing of risk between us and our customers, and is more likely to be in the long-term interests of consumers with respect to price.

2.3.9 End of metering derogation event

In our distribution determination for the 2016–2020 regulatory period, we submitted an 'end of metering derogation event' to be triggered upon a decision to introduce metering contestability. The event would have allowed us to pass through costs associated with the end of the Victorian derogation from the metering provisions (under chapter 7 of the Rules) and the introduction of metering contestability.

The AER rejected the additional proposed pass through event as it 'would likely be covered under the regulatory change event or a service standard event, depending on the final form the framework takes'.⁶⁰ The AER also noted that it does not 'consider the prescribed regulatory change and service standard necessarily preclude recovery of costs incurred under a change in obligations that has been made (for example, in a final rule change determination) if the date from which Powercor must comply with the changed obligation has been clearly specified.'⁶¹

On the basis that the AER considers this event would be covered by a regulatory change or service standard event, we have not included an 'end of metering derogation event' in our distribution determination for the 2021–2026 regulatory period. We request the AER to confirm this event would already be captured consistent with its last Victorian determination.

⁵⁸ Rules, clause 6.6.1(a1)(1) to (4).

⁵⁹ EVs differ from other distributed energy resources in that the need for transportation plays a fundamental role in customers' lifestyle choices compared to solar or in home batteries where electricity is typically still available if these devices cannot be used.

⁶⁰ AER, Preliminary decision Powercor distribution determination, Attachment 15 - Pass through events, October 2015, p. 22.

⁶¹ AER, Preliminary decision Powercor distribution determination, Attachment 15 - Pass through events, October 2015, p. 22.

3 Cost pass throughs for alternative control services

The Rules allow for the cost pass through arrangements to apply to direct control services, namely standard and alternative control services.⁶²

While clause 6.6.1 is contained in Part C of Chapter 6, which relates to building block determinations for standard control services, clause 6.2.6(c) of the Rules provides that the control mechanism for alternative control services may utilise elements of Part C of Chapter 6 (with or without modification). Below that clause, an example is given that the 'distribution determination might provide for the application of clause 6.6.1 to pass through events with necessary adaptations and specified modifications'. In addition, the definitions of the pass through events specified in clause 6.6.1(a1)(1) to (4) of the Rules refer to direct control services and thus allow the pass through provisions to apply to both standard control services and alternative control services.

In our 2016–2020 determination, the AER accepted that the pass through provisions and pass through events specified in clause 6.6.1(a1)(1) to (4) apply, and the approved nominated pass through events should extend, to alternative control services.⁶³ It provided for the recovery of an approved pass through amount through charges for standard control services via the control mechanism for standard control services regardless of whether that approved pass through amount included increased costs of providing alternative control services.⁶⁴

We request the AER to again confirm that the cost impacts of defined and nominated pass through events on the provision of alternative control services may be recovered under the pass through provisions. We also request:

- a modification to the materiality threshold for pass through events that result in increased costs for alternative control services; and
- the control mechanism(s) for our alternative control services provide for the recovery of an approved pass through amount (or part thereof) that relates to the increased costs of providing alternative control service, such that the alternative control services cost impact is recovered from alternative control services customers through alternative control pricing rather than from standard control services customers through standard control services charges.

3.1 Modification to materiality threshold

The Rules currently provide:

For the purposes of the application of clause 6.6.1, an event results in a Distribution Network Service Provider incurring materially higher or materially lower costs if the change in costs (as opposed to the revenue impact) that the Distribution Network Service Provider has incurred and is likely to incur in any regulatory year of a regulatory control period, as a result of that event, exceeds 1% of the annual revenue requirement for the Distribution Network Service Provider for that regulatory year.

This materiality threshold is not appropriate for assessing the materiality of the cost impact of a pass through event where that cost impact relates to the provision of alternative control services as the reference to annual revenue requirement relates to the revenue amount in respect of standard control services. We propose that

⁶² Rules, clause 6.6.1

⁶³ AER, Powercor, Preliminary decision, Powercor distribution determination 2016 to 2020, Attachment 15 - Pass through events, October 2015, pp 15-6 and 15-12; Powercor, Final decision, Powercor distribution determination 2016 to 2020, Attachment 15 - Pass through events, May 2016, p. 15-9.

⁶⁴ AER, Powercor, Preliminary decision, Powercor distribution determination 2016 to 2020, Attachment 15 - Pass through events, October 2015, p. 15-13 to 15-14.

the AER assess the materiality of pass through applications as one per cent of the revenue for the impacted alternative control service rather than one per cent of the annual revenue requirement.

3.2 Recovery of approved pass through amounts

The AER is required to make a constituent decision on the form of the control mechanisms for alternative control services and the formulae that give effect to those control mechanisms.⁶⁵ That decision may include a decision on the formulae to enable cost pass throughs for alternative control services.

The AER decided in our 2016–2020 determination that we may recover the full amount of an approved pass through via standard control services.⁶⁶ The AER considered that customers are no worse off under that approach because most, if not all, alternative control customers are also standard control customers.⁶⁷ We consider that a more cost reflective basis would be to recover an approved pass through amount (or that part thereof) that relates to the increase in costs of providing alternative control services via an adjustment to alternative control prices.

⁶⁵ Rules, clause 6.12.1(12).

⁶⁶ AER, Powercor, Preliminary decision, Powercor distribution determination 2016 to 2020, Attachment 15 - Pass through events, October 2015, p. 15-13 to 15-14.

⁶⁷ AER, Powercor, Preliminary decision, Powercor distribution determination 2016 to 2020, Attachment 15 - Pass through events, October 2015, p. 15-14.