



**Draft Decision**  
**Endeavour Energy distribution determination**  
**2015–16 to 2018–19**  
**Attachment 15: Cost pass through**

November 2014

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## Note

This attachment forms part of the AER's draft decision on Endeavour Energy's 2015–19 distribution determination. It should be read with other parts of the draft decision.

The draft decision includes the following documents:

Overview

Attachment 1 – Annual revenue requirement

Attachment 2 – Regulatory asset base

Attachment 3 – Rate of return

Attachment 4 – Value of imputation credits

Attachment 5 – Regulatory depreciation

Attachment 6 – Capital expenditure

Attachment 7 – Operating expenditure

Attachment 8 – Corporate income tax

Attachment 9 – Efficiency benefit sharing scheme

Attachment 10 – Capital expenditure sharing scheme

Attachment 11 – Service target performance incentive scheme

Attachment 12 – Demand management incentive scheme

Attachment 13 – Classification of services

Attachment 14 – Control mechanisms

Attachment 15 – Pass through events

Attachment 16 – Alternative control services

Attachment 17 – Negotiated services framework and criteria

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## Shortened forms

Shortened form	Extended form
AARR	aggregate annual revenue requirement
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
ASRR	aggregate service revenue requirement
augex	augmentation expenditure
capex	capital expenditure
CCP	Consumer Challenge Panel
CESS	capital expenditure sharing scheme
CPI	consumer price index
CPI-X	consumer price index minus X
DRP	debt risk premium
DMIA	demand management innovation allowance
DMIS	demand management incentive scheme
distributor	distribution network service provider
DUoS	distribution use of system
EBSS	efficiency benefit sharing scheme
ERP	equity risk premium
expenditure assessment guideline	expenditure forecast assessment guideline for electricity distribution
F&A	framework and approach
MRP	market risk premium

Shortened form	Extended form
NEL	national electricity law
NEM	national electricity market
NEO	national electricity objective
NER	national electricity rules
NSP	network service provider
opex	operating expenditure
PPI	partial performance indicators
PTRM	post-tax revenue model
RAB	regulatory asset base
RBA	Reserve Bank of Australia
repex	replacement expenditure
RFM	roll forward model
RIN	regulatory information notice
RPP	revenue pricing principles
SAIDI	system average interruption duration index
SAIFI	system average interruption frequency index
SLCAPM	Sharpe-Lintner capital asset pricing model
STPIS	service target performance incentive scheme
WACC	weighted average cost of capital

## 15 Pass through events

The pass through mechanism of the 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 unpredictable, high cost events that are not built into our distribution determination. The NER includes the following prescribed pass through events for all DNSPs:

- a regulatory change event
- a service standard event
- a tax change event
- a retailer insolvency event
- in addition to those defined events, an event specified in a determination for a regulatory control period (nominated pass through event).<sup>1</sup>

This chapter sets out our draft decision about which of Endeavour Energy's nominated pass through events we will accept as an additional pass through event for the regulatory control period.

### 15.1 Draft decision

The AER accepts that, in certain circumstances, a pass through of costs may be justifiable. However, the AER does not accept these nominated pass through events as drafted by Endeavour Energy. Instead, the AER substitutes its own definitions for the following events:

- insurance cap event
- terrorism event
- natural disaster event.

We do not accept the proposed insurer's credit risk event as a pass through event.

### 15.2 Endeavour Energy's proposal

Endeavour Energy's proposed nominated pass through events and definitions are set out in Table 15-1.

**Table 15-1 Endeavour Energy's proposed pass through events**

Proposed event	Proposed definition
Insurance cap event	An insurance cap event occurs if: <ol style="list-style-type: none"><li>1. Endeavour Energy makes a claim or claims and receives the benefit of a payment or payments under a relevant insurance policy,</li><li>2. Endeavour Energy incurs costs beyond the relevant policy limit, and</li><li>3. the costs beyond the relevant policy limit materially increase the costs to Endeavour Energy in providing direct control</li></ol>

<sup>1</sup> NER, clause 6.5.10.

For this insurance cap event:

4. the relevant policy limit is the greater of:

- a. Endeavour Energy's actual policy limit at the time of the event that gives, or would have given rise to a claim, and
- b. the policy limit that is explicitly or implicitly commensurate with the allowance for insurance premiums that is included in the forecast operating expenditure allowance approved in the AER's final decision for the regulatory control period in which the insurance policy is issued.

5. A relevant insurance policy is an insurance policy held during the 2015-19 regulatory control period or a previous regulatory control period in which Endeavour Energy was regulated.

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

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

Terrorism event

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

Natural disaster event

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

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

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

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

Insurer's credit risk event

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

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

Source: Endeavour Energy, *Regulatory proposal, Pass Through Events proposal 2014–2019 Regulatory Control Period*, pp. 10–19.



## 15.3 AER's assessment approach

We must decide which of Endeavour Energy's proposed nominated pass through events will apply for the 2015–19 regulatory control period. Pass through events transfer financial risks from the NSPs to consumers. If one of the nominated events occurs, the costs of the event that we assess as meeting the factors set out in the NER are passed through to consumers and network charges increase.<sup>2</sup>

Our approach has been guided by the National Electricity Objective (NEO) and the Revenue and Pricing Principles. It provides the NSP with a reasonable opportunity to recover at least the efficient costs the operator incurs,<sup>3</sup> while also providing effective incentives to promote economic efficiency.<sup>4</sup> It promotes a balance between the economic costs and risks for promoting efficient investment.<sup>5</sup>

The NER includes the following nominated pass through event considerations which we must have regard to when assessing nominated pass through events.<sup>6</sup>

The *nominated pass through event considerations* are:

- (a) 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*);
- (b) whether the nature or type of event can be clearly identified at the time the determination is made for the service provider;
- (c) 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;
- (d) whether the relevant service provider could insure against the event, having regard to:
  - (1) the availability (including the extent of availability in terms of liability limits) of insurance against the event on reasonable commercial terms; or
  - (2) whether the event can be self-insured on the basis that:
    - (i) it is possible to calculate the self-insurance premium; and
    - (ii) the potential cost to the relevant service provider would not have a significant impact on the service provider's ability to provide *network services*; and.
- (e) any other matter the *AER* considers relevant and which the *AER* has notified *Network Service Providers* is a nominated pass through event consideration.

These considerations involve an assessment of the incentives on NSPs to manage their risks efficiently.

For systemic risks, NSPs are compensated through the allowed rate of return. NSPs also face business-specific, or residual, risks. These activities are generally compensated through the opex and capex allowances. Beyond this an NSP may manage other risks through a number of other strategies, including:

- prevention (avoiding the risk)
- mitigation (reducing the negative effect or probability of the risk)

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<sup>2</sup> NER, clauses 6.6.1(d),(g) and (j).

<sup>3</sup> s.7A(2) of the NEL.

<sup>4</sup> s.7A(3) of the NEL.

<sup>5</sup> s.7A(6) of the NEL.

<sup>6</sup> NER, clause 6.5.10(b); NER glossary, definition of 'nominated pass through event considerations'.

- insurance (transferring the risk to another party)
- self-insurance (putting aside funds to manage the likely costs associated with a risky event).

An efficient business will manage its risk by employing the most cost effective combination of these strategies. For example, if a cost is reasonably predictable a business should factor it into its opex and capex proposed expenditure. In addition, an NSP may invest in its networks to mitigate the impact of certain events occurring. Alternatively, if the probability of events occurring can be readily estimated then the event should be insurable.

Pass through events cover those limited circumstances for which the risks cannot be managed efficiently in these ways and for which the NSP should be able to recover its efficient costs.

A factor for us to consider, which is reflected in the pass through event considerations, is who is best placed to manage risk. Generally the party who is in the best position to manage the risk should bear the risk. If the NSP, or customers, are fully exposed to a risk this may lead to adverse outcomes.

For example, where it is not possible for an NSP to insure against a risk, NSPs may need to share that risk with customers, to ensure that the service can continue to be provided if the event happens. The uninsurable risk may be outside the control of the NSP and have a low probability of occurring, but it might also have a significant cost impact. The most efficient and prudent solution to manage that type of risk may be to require customers to accept some of the burden of that risk, by allowing a pass through in the unlikely event that the risk eventuates. On the other hand, if the NSP is able to pass through all the costs of such an event, this may reduce the NSP's incentive to take prudent actions to prevent or mitigate the potential cost impact of the risk. Accordingly, while customers may need to accept some of the burden of the risk, the NSP will need to share some of the risk too. That might be achieved, for example, by making a pass through conditional on the NSP demonstrating that it has acted prudently and efficiently in managing the potential impact of the event.

We consider all of these issues when assessing a nominated pass through event with the aim of achieving the right balance, in the long term interests of consumers, in accordance with the nominated pass through event considerations.

As a matter of good regulatory practice, an additional factor we take into account is consistency in our approach to assessing nominated pass through events across our determinations where possible.<sup>7</sup>

### 15.3.1 Interrelationships

As we mentioned above, pass through events are not the only mechanism in this determination by which Endeavour Energy can manage its risks. The nominated pass through events are interrelated with other parts of this determination, in particular with the proposed opex and capex allowances and the rate of return. These interrelationships require the AER to balance the incentives in the various parts of its decision.

## 15.4 Reasons for draft decision

This section sets out our reasons for:

- proposing amendments to the insurance cap event, terrorism event and the natural disaster event

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<sup>7</sup> NER, glossary, definition of 'nominated pass through event considerations', paragraph (e).

- not accepting the insurer's credit risk event.

### **Insurance cap event—propose new definition**

We do not accept the proposed definition of an insurance cap event. We have amended the proposed definition to incorporate factors that we will have regard to when assessing a claim for a pass through.

The insurance cap event would allow Endeavour Energy to recover material costs incurred which exceed its insurance claim limit.<sup>8</sup> It is funded through its opex allowance to obtain an appropriate level of insurance for these types of risks. We accept that the insurance cap event would protect it from high cost impact events which would be uneconomical to insure against. We consider consumers benefit 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 cap event occur.

We expect that Endeavour Energy will obtain efficient levels of insurance cover commensurate with its business risk as reflected in its opex allowance and note the following:

- the extent to which Endeavour Energy is able to reasonably prevent costs being incurred which exceed its insurance cap, or take steps to mitigate incurring costs above the cap is limited
- the coverage of insurance should be capped at a level beyond which it is unable or uneconomic to insure, having regard to the cost of premiums and the likelihood of the event.

We note that if a pass through event of this kind were to occur, in assessing Endeavour Energy's application to pass through costs, we will consider the efficiency of Endeavour Energy's decisions and actions. We would consider whether it failed to take reasonable action to reduce the magnitude of the amount being claimed and whether any act or omission it took in response to the event increased the magnitude of the amount claimed.<sup>9</sup> This gives Endeavour Energy an incentive to mitigate the risks associated with the event including through acquiring an appropriate level of insurance and implementing other practical risk minimisation strategies in its operations.

The definition proposed should be amended to clarify some factors to which we will have regard when assessing a claim. Accordingly, we have proposed a new definition as set out at section 15.5.

After making this amendment we consider that including the insurance cap event provides an incentive for Endeavour Energy to obtain an efficient level of insurance.<sup>10</sup>

### **Terrorism event—propose new definition**

We do not accept the proposed definition of a terrorism event. We have amended the proposed definition to incorporate factors that we will have regard to when assessing a claim for a pass through.

For the 2009–14 regulatory control period, this was a prescribed pass through event. A rule change removed the terrorism event from the prescribed list of pass through events. The decision whether to

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<sup>8</sup> Endeavour Energy, *Regulatory proposal, Pass Through Events proposal 2014–2019 Regulatory Control Period*, p. 10.  
<sup>9</sup> Cl.6.6.1(j)(3) of the NER.

<sup>10</sup> We note that we have not explicitly excluded insurance cap events that arise due to a finding of negligence. Negligence suggests the NSP may have some control over the event or some opportunity to limit the magnitude of the event. This may be a factor that we would have regard to in assessing such a pass through application. However, we do not consider it would be appropriate to exclude all events where the suggestion of negligence on behalf of the business has been raised. We further note that unlawful conduct and gross negligence would not be covered by an insurer and that acts or omissions resulting from such unlawful conduct or gross negligence would be relevant considerations when assessing a pass through event application, having regard to the relevant factors set out in the NER.

accept this event is now to be made by us as part of the determination process, considering the circumstances of each network business.<sup>11</sup>

In relation to the this event, we note:

- Endeavour Energy has a range of measures in place to prevent acts of terrorism affecting its operations, or mitigate the impacts of an event should one occur.<sup>12</sup> Endeavour Energy has an ongoing program to meet national and state obligations in relation to infrastructure security. Examples include infrastructure security, participation in joint security risk assessments with the NSW counter terrorism Branch, Ministry for Police and Emergency Services, staff site visits and contracted security service provider visits.<sup>13</sup>
- The commercial market for insurance in Australia is insufficient to cover demand.<sup>14</sup> Endeavour Energy does have commercial insurance which, while not specific to a terrorism event, would be triggered if a terrorism event occurred.<sup>15</sup> However, this may not cover all the costs associated with a terrorism event.
- Endeavour Energy has the option of self-insuring but the relative infrequency and potentially high costs of terrorism events create significant challenges for self-insurance for this type of risk.<sup>16</sup> Further, there is limited data on which to calculate a credible self-insurance premium.<sup>17</sup> Taking out further insurance would likely be inefficient and result in an unnecessary cost increase to customers.

We consider that there may be some overlap between an insurance cap event and the terrorism event, but accept the need to have both because Endeavour Energy may incur costs which an insurance policy would not ordinarily cover. The amendment to the pass through event definition will assist in avoiding the overlap.

We also consider that a terrorism event should be more clearly defined so that the event can be clearly identified and assessed.<sup>18</sup> We note that Endeavour Energy's opex allowance includes funding for insurance and self-insurance yet it may have an incentive to keep that allowance (and not insure the risk) while managing this risk through the pass through mechanism. We consider that this disincentive to insure against terrorism can be reduced by clarifying the pass through event definition. Accordingly, we have proposed a new definition as set out at section 15.5.

## Natural disaster event—propose new definition

We do not accept the proposed definition of a natural disaster event because it does not sufficiently describe whether a provider could mitigate the cost impact of the event<sup>19</sup> and whether the provider could insure against the event.<sup>20</sup> We have amended the proposed definition to incorporate factors that we will have regard to when assessing a claim for a pass through.

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<sup>11</sup> Under the transitional rules, the terrorism event is a prescribed pass through event for the transitional regulatory control period: NER, clause 11.49.2.

<sup>12</sup> NER, glossary, definition of 'nominated pass through event considerations', paragraph (c).

<sup>13</sup> Endeavour Energy, *Regulatory proposal, Pass Through Events proposal 2014–2019 Regulatory Control Period*, p. 17.

<sup>14</sup> Australian Government, *Terrorism Insurance Act Review*, May 2012 as cited in Endeavour Energy, *Regulatory proposal, Pass Through Events proposal 2014–2019 Regulatory Control Period*, p. 18.

<sup>15</sup> NER, glossary, definition of 'nominated pass through event considerations', paragraph (d)(1).

<sup>16</sup> Endeavour Energy, *Regulatory proposal, Pass Through Events proposal 2014–2019 Regulatory Control Period*, p. 18.

<sup>17</sup> NER, glossary, definition of 'nominated pass through event considerations', paragraph (d)(2).

<sup>18</sup> NER, glossary, definition of 'nominated pass through event considerations', paragraph (b).

<sup>19</sup> NER, glossary, definition of 'nominated pass through event considerations', paragraph (c).

<sup>20</sup> NER, glossary, definition of 'nominated pass through event considerations', paragraph (d).

We consider that there may be some overlap between an insurance cap event and a natural disaster event, but accept the need to have both because the NSP may incur costs which an insurance policy would not ordinarily cover.

In relation to this event, we note:

- Endeavour Energy has a range of measures in place to mitigate the impacts of an event should one occur.<sup>21</sup>
- Endeavour Energy currently has an appropriate level of commercial insurance for natural disasters.<sup>22</sup> This would not likely cover all the costs associated with a natural disaster event, however taking out further insurance would likely be inefficient and result in an unnecessary cost increase to customers.<sup>23</sup>
- Endeavour Energy has not included a self insurance amount in its opex proposal as, in the event of a major natural disaster, it would be unlikely to be in a position to pool enough risk to cover the cost impacts from such an event.<sup>24</sup>

However the definition of the event as proposed is not sufficiently clear. We consider that a natural disaster event should be more clearly defined so that the event can be clearly identified and assessed. We also note that Endeavour Energy's opex allowance includes funding for insurance yet it may have an incentive to keep that allowance (and not insure the risk) while managing this risk through the pass through mechanism. We consider that this disincentive to insure natural disasters can be reduced by clarifying the natural disaster event. Accordingly, we have proposed a new definition as set out at section 15.5.

After making this amendment, we consider that including the natural disaster event will provide an incentive for Endeavour Energy to mitigate the potential impact of natural disaster events.

### **Insurer's credit risk event—do not accept**

We do not accept the insurer's credit risk event as a pass through event because a prudent service provider could reasonably prevent an event of that nature from occurring.<sup>25</sup>

The proposed insurer's credit risk event is an event for which an insurance allowance is provided but as a result of the insolvency of an insurance provider:<sup>26</sup>

- the cost of the insurance premium materially changes from the allowance
- the business incurs a materially higher or lower deductible (excess)
- the claim limit is materially higher or lower.

A key consideration is whether a prudent service provider could reasonably prevent an insurer's credit risk event occurring.<sup>27</sup> We consider that a prudent service provider would use an insurance provider that has the capacity to satisfy any claims under a policy. NSPs can assess the viability of an insurer by reviewing its track record, size, credit rating and reputation. If we allow an insurer's credit risk event

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<sup>21</sup> NER, glossary, definition of 'nominated pass through event considerations', paragraph (c).

<sup>22</sup> NER, glossary, definition of 'nominated pass through event considerations', paragraph (d)(1).

<sup>23</sup> Endeavour Energy, *Regulatory proposal, Pass Through Events proposal 2014–2019 Regulatory Control Period*, p. 16.

<sup>24</sup> NER, glossary, definition of 'nominated pass through event considerations', paragraph (d)(2).

<sup>25</sup> NER, glossary, definition of 'nominated pass through event considerations', paragraph (c).

<sup>26</sup> Endeavour Energy, *Regulatory proposal, Pass Through Events proposal 2014–2019 Regulatory Control Period*, p. 19.

<sup>27</sup> NER, glossary, definition of 'nominated pass through event considerations', paragraph (c).

we may encourage NSPs to obtain insurance from providers who are not capable of paying large claims or to not monitor or review the viability of their insurance provider. Under this scenario, in the event that the insurance provider fails and a claim is made, the NSP may simply seek a pass through of the costs.

We also do not consider there is sufficient reason why Endeavour Energy will incur a higher or lower deductible, or why the insurance premium should vary materially, as a consequence of an insurer becoming insolvent.

Including the insurance credit risk event removes the incentive for Endeavour Energy to obtain insurance from a reputable provider who is able to pay a claim. We consider Endeavour Energy is able to take steps to mitigate or prevent this event from occurring. Accordingly, we do not accept the insurer's credit risk event.

## 15.5 Revisions

We propose an amendment to the definition of the insurance cap event.

An insurance cap event occurs if:

1. Endeavour Energy makes a claim or claims and receives the benefit of a payment or payments under a relevant insurance policy,
2. Endeavour Energy incurs costs beyond the relevant policy limit, and
3. the costs beyond the relevant policy limit materially increase the costs to Endeavour Energy in providing direct control services

For this insurance cap event:

4. the relevant policy limit is the greater of:
  - a. Endeavour Energy's actual policy limit at the time of the event that gives, or would have given rise to a claim, and
  - b. the policy limit that is explicitly or implicitly commensurate with the allowance for insurance premiums that is included in the forecast operating expenditure allowance approved in the AER's final decision for the regulatory control period in which the insurance policy is issued.
5. A relevant insurance policy is an insurance policy held during the 2015-19 regulatory control period or a previous regulatory control period in which Endeavour Energy was regulated.

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

- i. the insurance policy for the event, and
- ii. the level of insurance that an efficient and prudent NSP would obtain in respect of the event
- iii. the extent to which a prudent provider could reasonably mitigate the impact of the event.

We propose an amendment to the definition of the terrorism event.

A terrorism event occurs if:

An act (including, but not limited to, the use of force or violence or the threat of force or violence) of any person or group of persons (whether acting alone or on behalf of or in connection with any organisation or government), which from its nature or context is done for, or in connection with, political, religious, ideological, ethnic or similar purposes or

reasons (including the intention to influence or intimidate any government and/or put the public, or any section of the public, in fear) and which materially increases the costs to Endeavour Energy in providing direct control services.

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

- i. whether Endeavour Energy has insurance against the event,
- ii. the level of insurance that an efficient and prudent NSP would obtain in respect of the event, and
- iii. whether a declaration has been made by a relevant government authority that a terrorism event has occurred
- iv. the extent to which a prudent provider could reasonably mitigate the impact of the event.

We propose an amendment to the definition of the natural disaster event.

A natural disaster event occurs if:

Any major fire, flood, earthquake or other natural disaster occurs during the 2015-19 regulatory control period and materially increases the costs to Endeavour Energy in providing direct control services, provided the fire, flood or other event was not a consequence of the acts or omissions of the service provider

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

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

- i. whether Endeavour Energy has insurance against the event,
- ii. the level of insurance that an efficient and prudent NSP would obtain in respect of the event,
- iii. whether a relevant government authority has made a declaration that a natural disaster has occurred, and
- iv. the extent to which a prudent NSP could reasonably mitigate the impact of the event.

We do not accept the insurer's credit risk event.