



Attachment 04.01.03
Nominated cost pass
through events



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1. Introduction

1.1 Overview

Distribution Network Service Providers (DNSPs) are exposed to unpredictable and high cost events that are beyond their control. To ensure DNSPs are able to recover the legitimate costs of these events, the National Electricity Rules (NER) includes a cost pass through mechanism.

There are a number of pass through events prescribed in the NER which apply to all DNSPs. DNSPs may also nominate additional events for approval as part of the regulatory determination process. This enables DNSPs to tailor pass through events to their unique operating circumstances and network characteristics at the start of each regulatory control period.

If a cost pass through event occurs during the regulatory control period, and it materially increases or decreases a DNSP's costs, the DNSP may apply to the Australian Energy Regulator (AER) to pass these costs or reductions onto customers. If approved, this is done by way of an adjustment to the Annual Revenue Requirement during the annual pricing proposal process.¹

This attachment sets out Ergon Energy's nominated cost pass through events for the regulatory control period commencing on 1 July 2015 and ending on 30 June 2020, and our assessment of how each event meets the nominated pass through event considerations outlined in the NER. It also highlights the impacts on customers if these events are approved by the AER.

1.2 Pass through events

Clause 6.6.1 of the NER define a number of prescribed pass through events which will apply to Ergon Energy in the next regulatory control period. These are:

- a regulatory change event
- a service standard event
- a tax change event
- a retailer insolvency event.²

In addition to the prescribed pass through events, a DNSP's building block proposal may include a proposal as to the events that should be defined as pass through events.³

Ergon Energy proposes the following events should be approved by the AER as pass through events in the next regulatory control period:

- natural disaster event
- insurance cap event
- insurance event
- retail separation event
- isolated network separation event.

Further details on these proposed pass through events are provided in the following chapters.

¹ Refer to the C_i component of the Standard Control Services formula.

² Definitions are provided in Chapter 10 of the NER.

³ NER, clause 6.5.10(a).

Ergon Energy considers that the cost pass through mechanism is the most prudent and efficient option for managing risks associated with these events as they:

- are uncontrollable and have a low probability of occurrence, such that it is difficult to accurately quantify an allowance for inclusion in the capital and operating expenditure forecasts
- cannot be effectively insured, either through commercial insurance or self-insurance
- are likely to have a material impact on the costs of providing direct control services.

1.3 Nominated pass through event considerations

The cost pass through mechanism is a 'last resort' mechanism; it is only to be used in situations where commercial insurance and self-insurance are not available on a reasonable basis, or the DNSP is unable to mitigate or avoid the event without creating unacceptable risks. As such, the NER sets out nominated pass through event considerations which Ergon Energy must have regard for when proposing additional events.⁴ The AER must also take these considerations into account when deciding whether to accept or reject our nominated pass through events.

The nominated pass through event considerations are:

- whether the event proposed is an event covered by a category of pass through event specified in the NER
- 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, and
 - the potential cost to the relevant service provider would not have a significant impact on the service provider's ability to provide network services
- any other matter the AER considers relevant and which the AER has notified Network Service Providers (NSPs) is a nominated pass through event consideration.⁵

Ergon Energy has had regard for these considerations for each of our nominated pass through events.

1.4 Application to all direct control services

Ergon Energy proposes that the prescribed and nominated pass through events should apply to all direct control services (i.e. Standard Control Services and Alternative Control Services). This is consistent with the approach approved by the AER in the current regulatory control period for Ergon Energy.

⁴ As set out in Chapter 10 of the NER.

⁵ The AER has not notified Ergon Energy of any other considerations.

1.5 Customer impacts

There is no immediate cost impact on customers associated with either the prescribed or nominated pass through events. This is because the costs of an event are only recovered from customers if the event occurs during the regulatory control period and the AER approves any subsequent cost pass through application.

Ergon Energy considers that the probability of an event occurring, and meeting the materiality threshold of 1% of the Annual Revenue Requirement for the relevant year (approximately \$15-20 million), is relatively low. In the current regulatory control period, there was only one uncontrollable and unexpected event which met this threshold – Severe Tropical Cyclone Yasi.⁶

Further, we note that the cost pass through application itself is subject to scrutiny and review by the AER.⁷ During this process, the AER may reject the application⁸ or amend the amount proposed to be passed through.

Ergon Energy also believes that it is in our customers' interests to pay for these types of events only if and when they happen, rather than through upfront capital and operating expenditure allowances. This is because:

- if the event does not occur or the effects are less costly than expected, customers would be paying higher network prices than needed
- if the impact is worse than anticipated, Ergon Energy's financial viability may be at risk, affecting our ability to provide safe, secure and reliable distribution services to our customers.

⁶ At the direction of the Queensland Government, Ergon Energy did not submit a cost pass through application to recover the costs associated with Severe Tropical Cyclone Yasi. Refer to <http://www.aer.gov.au/node/1458>.

⁷ In accordance with clause 6.6.1 of the NER.

⁸ See, for example, the AER's recent decision to reject ActewAGL's vegetation clearance cost pass through application. The AER was of the view that ActewAGL did not undertake prudent operation risk management. AER (2014), *Final Determination: ActewAGL Distribution cost pass through application, Vegetation management costs for the 2012-13 regulatory year*, July 2014.

2. Natural disaster event

Natural disaster events, such as cyclones, typically result in Ergon Energy incurring substantial costs which are beyond our control. For example, the cost impact on the network of Severe Tropical Cyclone Yasi, which crossed the Queensland coast at Mission Beach as a Category 5 cyclone on 3 February 2011, was in the order of \$100 million.

Costs like this could potentially undermine our financial viability and threaten the security of supply on the network. Therefore, we need an avenue to recover any material increases in costs following a natural disaster. The AER has previously recognised this, approving a natural disaster event for the Victorian DNSPs,⁹ ElectraNet,¹⁰ SPAusNet¹¹ and Aurora Energy.¹²

2.1 Definition

Ergon Energy's proposed definition of a natural disaster event has been adapted from the AER's Final Determination for ElectraNet. The key difference is an explicit reference to cyclones, given the likelihood of this type of disaster occurring in our distribution area.

Consistent with the AER's previous positions,¹³ the cost pass through event will only apply to events that are 'major' and not covered by insurance. Ergon Energy will manage the risk of non-major events, such as lower impact storms, through our approved expenditure program.

Any major cyclone, fire, flood, earthquake or other natural disaster beyond the reasonable control of Ergon Energy that occurs during the *regulatory control period* 2015-20 and *materially* increases the costs to Ergon Energy of providing *direct control services*.

Note:

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

- 1. the insurance premium proposal submitted by Ergon Energy in its Regulatory Proposal**
- 2. the forecast operating expenditure allowance approved in the AER's final decision**
- 3. the reasons for that decision.**

The term 'major' in the above paragraph means an event that is serious and significant.

Ergon Energy notes that there may be some overlap between a 'natural disaster event' and an 'insurance cap event'. The AER also recognised this in its draft determination for Aurora Energy in November 2011, highlighting that it would take this into account when assessing a cost pass through application to ensure there is no double-counting of costs.¹⁴

Ergon Energy agrees with the New South Wales DNSPs' position that third party claims would be covered by the 'insurance cap event' due to their delay in manifesting, while expenditure on restoring the network would be covered by the 'natural disaster event'.¹⁵

⁹ Proposed by the AER. AER (2010), *Final Decision: Victorian Electricity DNSPs Distribution Determination 2011–2015*, October 2010, p746.

¹⁰ AER (2013), *Final Decision: ElectraNet Transmission Determination 2013–14 to 2017–18*, April 2013, pp187-198.

¹¹ AER (2014), *Final Decision: SP AusNet Transmission Determination 2014–15 to 2016–17*, January 2014, p54.

¹² AER (2012), *AER distribution determination: Aurora 2012–13 to 2016–17*, April 2012.

¹³ See, for example, AER (2013), *Final Decision: ElectraNet Transmission Determination 2013–14 to 2017–18*, April 2013.

¹⁴ AER (2011), *Draft Distribution Determination: Aurora Energy Pty Ltd 2012-13 to 2016-17*, November 2011, p287.

¹⁵ See, for example, Ausgrid (2014), *Ausgrid's nominated pass through events (Attachment 4.13 of Regulatory Proposal)*, May 2014, p9.

We also acknowledge there is some overlap with our proposed insurance program (i.e. parametric insurance for cyclones and self-insured bushfire liability claims). The proposed definition states that the AER will have regard to our insurance premium proposal in assessing any natural disaster event cost pass through application. Ergon Energy considers that this will avoid double-counting of costs.

2.2 Nominated pass through event considerations

Ergon Energy’s assessment of the nominated pass through event considerations for a natural disaster event is provided in Table 1.

Table 1: Assessment of nominated pass through event considerations – natural disaster event

Nominated pass through event consideration	Ergon Energy’s assessment
Whether the event proposed is an event covered by the prescribed pass through events	The proposed event is not covered by the prescribed pass through events specified in the NER.
Whether the nature or type of event can be clearly identified at the time of the determination	The nature and type of event can be clearly identified at the time of the determination, as evidenced by the proposed definition and as recognised by the AER in its earlier determinations. ¹⁶
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	<p>The AER has previously noted that an NSP “is limited in its ability to prevent or substantially mitigate the cost impact of a natural disaster...”¹⁷ However, the AER expects NSPs to have prudent preventative measures in place.</p> <p>Ergon Energy has a range of prudent preventative measures in relation to potential natural disasters. The following network maintenance and other reliability improvement programs help minimise our risk exposure:</p> <ul style="list-style-type: none"> • vegetation management – vegetation identified as high risk during our normal maintenance operations, which would not be addressed as part of the current inspection and management cycle, is reviewed and trimmed as a priority before storm season begins • feeder patrols – risk assessments are carried out for of all summer critical feeders and pre-summer line patrols are scheduled, where required • bushfire mitigation program – Ergon Energy identifies asset and vegetation defects within fire prone areas that require fixing before the onset of summer. Feeders passing through areas of high bushfire hazard and those supplying critical infrastructure such as hospitals and pumping stations are also scheduled for additional aerial or ground patrols prior to the start of the fire season. We also have a number of other solutions in place to mitigate the risk such as installing protection systems to minimise the effects of different types of faults, fitting vehicles with fire extinguishers and raising public awareness about bushfire mitigation strategies • thermographic and pole top inspections – timed for inspection and remediation prior to the onset of storm and bushfire seasons • flood mitigation – Ergon Energy requires new bulk supply and zone substations to be built at or above the 0.5% Annual Exceedance Probability (AEP) flood level. If infrastructure is to be located below that level, resilience measures must be taken so that the substation can operate effectively during and immediately after a flood up to the height of the recommended flood level. Where a substation is proposed, but the 0.5% AEP flood level is not presently known, and it is believed that flood risk exists in relation to the proposed site, a hydrological assessment is to be obtained by an external consultant

¹⁶ See, for example, the AER’s Draft Decision for Victorian DNSPs. AER (2010), *Draft Decision: Victorian electricity DNSPs, Distribution Determination 2011–2015*, June 2010, pp716-722.

¹⁷ AER (2012), *Draft Decision: ElectraNet Transmission Determination 2013–14 to 2017–18*, November 2012, p272.

- Remote Observation Automated Modelling Economic Simulation (ROAMES) program – implementation of inspection and analysis products developed from Ergon Energy’s ROAMES program facilitates risk assessment and remediation activities across all of our network area on an annual basis
- Asset Inspection and Defect Management process – aims to identify defects or items expected to fail in the near future. Ergon Energy actively works to replace these assets before they do
- line design standards – poles and towers are designed to cater for Category 3 winds.

Our previous investment under the Cyclone Area Reliability Enhancement program between 2001 and 2014 has also resulted in the undergrounding of key distribution assets in various cyclone-prone areas of North Queensland.

Additionally, Ergon Energy is considering the installation of LV fuses and LV spreaders across the network to reduce LV line failures. These have proven to be effective in the past during cyclones.

Finally, Ergon Energy has a Disaster Management Plan and Operational Response Plan which are designed to ensure we respond effectively in the event of a disaster. These established plans are supported by:

- internal staff who can be mobilised from other areas, work additional overtime, have their rosters adjusted and their work reprioritised. Ergon Energy currently has a Natural Disaster Working Arrangements agreement in place with unions covering standard working arrangements for natural disasters
- contractors. Where response capacity exceeds internal capacity, Ergon Energy is able to tap into our active contractor base and the broader contractor market. Contractors can be mobilised or have their work reprioritised, and there are pre-agreed schedules of rates in place for our major lines contractors to cover emergency response type works when needed. Additional contractor capacity has previously been successfully mobilised for major weather events where needed
- other electricity utilities. Ergon Energy has a Memorandum of Understanding in place with Energex to access resources to respond to major weather events. Ergon Energy has previously also shared resources with other interstate utilities to broaden the available resource pool, including labour resources, materials and equipment
- ROAMES’ post disaster response capability which supplies ‘after the event’ asset condition analysis.

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

Traditional insurance for poles and wires assets is generally not available.¹⁸ Further, to obtain traditional insurance at a reasonable cost, a high minimum deductible would need to be taken and, depending on the amount of cover being sought, insurers may not be prepared to offer the total amount. Ergon Energy therefore considers that it would not be efficient or reasonable to obtain traditional commercial insurance to cover the cost of damage to our poles and wires.

In light of this, Ergon Energy has investigated a number of alternative solutions for transferring risk in the next regulatory control period. Following assessment of the options, we have decided to include an allowance for parametric insurance in our Regulatory Proposal which will pay a fixed dollar amount on occurrence of a defined trigger event (refer to Attachment 06.02.03 Parametric Insurance). This insurance will assist in covering our electricity network assets against damage or loss caused by high winds due to major cyclones and the cost of major cyclones not funded through normal capital and operating expenditure allowances.

In addition to the parametric insurance, Ergon Energy has proposed an allowance for property insurance which will cover ‘general assets’ (i.e. not poles, wires and substations) against multi-site natural perils like cyclones.

Ergon Energy considers that our proposed insurance program is appropriate for mitigating the cost impact of natural disasters to the fullest

¹⁸ Aon (2014), *Insurance Premium Forecast: Ergon Energy*, 2014, p14.

extent it is prudent and efficient to do so. While the cost of insuring against major cyclones could exceed the limit of the cover which Ergon Energy proposes to acquire, sourcing higher levels of insurance cover would be inappropriate since the probability of a natural disaster event that meets the materiality threshold is relatively low.

Whether the relevant service provider could insure against the event, having regard to 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 service provider would not have a significant impact on their ability to provide network services

While Ergon Energy has proposed a self-insurance allowance for bushfire liability claims in our Regulatory Proposal, we consider that a self-insurance premium cannot be calculated for natural disaster events more generally. This is because data on insurance premiums is not available due to the lack of a commercial insurance market in this space.

Ergon Energy also believes we would not be a position to effectively self-insure against natural disaster events given the likely cost impacts. For example, the cost impact on the network of Severe Tropical Cyclone Yasi alone was approximately \$100 million.

We note that the AER has also previously concluded that a natural disaster event cannot be self-insured.¹⁹

¹⁹ AER (2012), *Draft Decision: ElectraNet Transmission Determination 2013–14 to 2017–18*, November 2012, p273.

3. Insurance cap event

Like any business, Ergon Energy obtains insurance to mitigate risks we are exposed to. This insurance is typically capped, leaving Ergon Energy exposed to liabilities in excess of our insured limits. While insurance may be available above the cap, Ergon Energy would need to pay higher premiums. This would ultimately result in higher network prices for our customers.

Ergon Energy does not believe this is an appropriate means of addressing our risk exposure; particularly given the low probability of incurring above-cap liabilities. We are therefore proposing an insurance cap event. We note the AER has previously approved similar events for the Victorian DNSPs,²⁰ SPAusNet²¹ and Aurora Energy.²²

3.1 Definition

Ergon Energy's proposed definition for an 'insurance cap event' has been adapted from the AER's Final Determination for SPAusNet. We have changed the 'SPAusNet' references to 'Ergon Energy' and updated the regulatory control period references to 2015-20.

An insurance cap event is an event whereby:

1. Ergon Energy:

- (a) makes a claim or claims and receives the benefit of a payment or payments under a relevant insurance policy, or**
- (b) would have been entitled to make a claim or claims or receive the benefit of a payment or payments under a relevant insurance policy but for the application of a relevant policy limit**

2. Ergon Energy incurs costs beyond the relevant policy limit, and those costs would have been recovered under the insurance policy had the limit not been exhausted, and

3. the costs beyond the relevant policy limit *materially* increase the costs to Ergon Energy of providing *direct control services*.

For this insurance cap event:

1. the relevant policy limit is the greater of:

- (a) Ergon Energy's actual policy limit at the time of the event that gives, or would have given, rise to the 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.**

2. a relevant insurance policy is an insurance policy held during the *regulatory control period* 2015-20 or a previous *regulatory control period* in which Ergon Energy was regulated.

Note:

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

- 1. the insurance premium proposal submitted by Ergon Energy in its Regulatory Proposal**
- 2. the forecast operating expenditure allowance approved in the AER's final decision**
- 3. the reasons for that decision.**

²⁰ AER (2010), *Final Decision: Victorian Electricity DNSPs Distribution Determination 2011–2015*, October 2010.

²¹ AER (2014), *Final Decision: SP AusNet Transmission Determination 2014–15 to 2016–17*, January 2014, p54.

²² AER (2012), *Final Distribution Determination: Aurora Energy Pty Ltd 2012-13 to 2016-17*, April 2012, p183.

3.2 Nominated pass through event considerations

Ergon Energy's assessment of the nominated pass through event considerations for an insurance cap event is provided in Table 2.

Table 2: Assessment of nominated pass through event considerations – insurance cap event

Nominated pass through event consideration	Ergon Energy's assessment
Whether the event proposed is an event covered by the prescribed pass through events	The proposed event is not covered by the prescribed pass through events specified in the NER.
Whether the nature or type of event can be clearly identified at the time of the determination	The nature and type of event can be clearly identified at the time of the determination, as evidenced by the proposed definition and as recognised by the AER in previous determinations. ²³
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	Costs incurred beyond the insurance cap would largely be triggered by circumstances beyond a NSP's control and cannot be forecast; therefore a prudent service provider would not be able to prevent this event from occurring or substantially mitigate the cost impact.
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	Ergon Energy considers that including this as a cost pass through event represents the most appropriate means of managing the risks of such an event. This is because it is more efficient to leave uninsured some losses which are above the insurance cap. The costs of taking out higher levels of insurance would be disproportionate to the risk, given the low probability of Ergon Energy incurring above-cap liabilities.
<p>Whether the relevant service provider could insure against the event, having regard to whether the event can be self-insured on the basis that:</p> <ul style="list-style-type: none"> • it is possible to calculate the self-insurance premium • the potential cost to the service provider would not have a significant impact on their ability to provide network services 	It would be difficult to calculate a robust self-insurance premium, particularly given the very low probability of such an event and the lack of a commercial insurance market in this space.

²³ See, for example, AER (2013), *Draft decision: SP AusNet Transmission determination 2014-15 to 2016-17*, August 2013, p224.

4. Insurance event

External insurers may make changes to insurance premiums or deductibles that are beyond the control of the DNSP. This may be due to, for example, recent claims activities, insurer competition and/or market capacity.²⁴ Insurance may also become unavailable to Ergon Energy during the regulatory control period. To mitigate our exposure to this, Ergon Energy is proposing an insurance event.

Ergon Energy notes that an insurance event is currently a prescribed cost pass through event for Transmission Network Service Providers (TNSPs). The AER has also previously approved a comparable event for Victorian DNSPs (an 'insurer credit risk' event).²⁵

4.1 Definition

Ergon Energy's proposed definition for an insurance event has been adapted from the definition of the prescribed 'insurance event' for TNSPs contained in Chapter 10 of the NER. The key differences are:

- 'Ergon Energy' replaces references to the 'TNSP'
- TNSP-specific references have been updated to reflect terminology applicable to DNSPs (e.g. 'annual revenue requirement' replaces 'maximum allowed revenue')
- 'Materially', as defined by the NER, has been used instead of a specific materiality threshold of 1%.

An event for which the risk of its occurrence is the subject of insurance taken out by or for Ergon Energy, for which an allowance is provided in Ergon Energy's *annual revenue requirement* and in respect of which:

- 1. the cost of the premium paid or required to be paid by Ergon Energy in the *regulatory year* in which the cost of the premium changes is *materially* higher or lower than the premium that is provided for in the *annual revenue requirement* for that *regulatory year*, or**
- 2. the risk eventuates and, as a consequence, Ergon Energy incurs or will incur all or part of a deductible where the amount so incurred or to be so incurred in a *regulatory year* is *materially* higher or lower than the allowance for the deductible (if any) that is provided for in the *annual revenue requirement* for that *regulatory year*, or**
- 3. insurance becomes unavailable to Ergon Energy, or**
- 4. insurance becomes available to Ergon Energy on terms materially different to those existing at the time the *distribution determination* was made (other than as a result of any act or omission of Ergon Energy which is inconsistent with good electricity industry practice).**

4.2 Nominated pass through event considerations

Ergon Energy's assessment of the nominated pass through event considerations for an insurance event is provided in Table 3.

²⁴ AER (2014), *Insurance Premium Forecast: Ergon Energy*, 2014, p3.

²⁵ AER (2010), *Final decision: Victorian electricity distribution network service providers, Distribution determination 2011–2015*, October 2015, p797.

Table 3: Assessment of nominated pass through event considerations – insurance event

Nominated pass through event consideration	Ergon Energy's assessment
Whether the event proposed is an event covered by the prescribed pass through events	The proposed event is not covered by the prescribed pass through events specified in the NER for DNSPs.
Whether the nature or type of event can be clearly identified at the time of the determination	The nature and type of event can be clearly identified at the time of the determination, as evidenced by the proposed definition.
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	By virtue of the fact that an insurance event is included as a prescribed cost pass through event for TNSPs, Ergon Energy considers that a prudent service operator could not reasonably prevent an event of this 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	Given the nature of this event, it is not possible to obtain commercial insurance.
<p>Whether the relevant service provider could insure against the event, having regard to whether the event can be self-insured on the basis that:</p> <ul style="list-style-type: none"> • it is possible to calculate the self-insurance premium • the potential cost to the service provider would not have a significant impact on their ability to provide network services 	<p>Ergon Energy considers it would be difficult to calculate a robust self-insurance premium since data on insurance premiums is not available due to the lack of a commercial insurance market in this space.</p> <p>Further, a lack of insurance potentially exposes Ergon Energy to significant losses if insurance coverage changes and an event occurs that Ergon Energy would otherwise have been insured for.</p>

5. Retail separation event

In 2012, the Queensland Government commissioned the Interdepartmental Committee on Electricity Sector Reform (IDC) to identify issues with delivering electricity in a cost-effective manner and provide solutions to address rising electricity costs in Queensland. The IDC was supported by an Independent Review Panel on Network Costs.

In May 2013, the IDC released its report to the Queensland Government outlining its short- and long-term recommendations to reform the Queensland electricity sector. Among other things, the IDC recommended that the government:

- consider options to align Ergon Energy's retail business, Ergon Energy Queensland Pty Ltd (EEQ), with a government-owned generator (in conjunction with a longer term structural reform objective for EEQ)
- investigate options for the long term future of EEQ, including the feasibility of creating a vertically-integrated entity
- publicly consult on the merits of continued government ownership of energy assets for generation and retail.²⁶

The Queensland Government accepted in principle the first two recommendations, and accepted the third recommendation.²⁷ However, the Queensland Government emphasised that it would seek a mandate from the Queensland people before divesting itself of any government business, and tasked the Queensland Commission of Audit Taskforce with progressing work on this.

The Queensland Government undertook extensive public consultation through the Strong Choices initiative, which was launched in April 2014. The draft outcomes of the consultation and the Commission of Audit's review were set out in *The Strongest & Smartest Choice* plan released by the Queensland Government in June 2014. The Queensland Government stated its intention sell Ergon Energy's retail assets:

“Based on expert and independent advice, together with the outcomes of the community consultation undertaken as part of the Strong Choices consultation, the Government proposes the sale of the retail assets of Ergon Energy Queensland”.²⁸

In its *Final Plan - The Strongest & Smartest Choice*²⁹, the Queensland Government amended its position to offer the assets of EEQ for lease with the Queensland generation assets. However, a final decision, including timing of the sale process, will not be known until after the next State election.

Currently, the same resources, systems and processes may be employed to service the retail and distribution arms of the business. Therefore, if EEQ separates from Ergon Energy, the costs of providing direct control services will increase due to loss of synergies. There will be a direct impact

²⁶ IDC (2013), *Report to government, Interdepartmental Committee on Electricity Sector Reform*, May 2013. Refer to recommendations 5.5.4, 5.5.5 and 6.2.1.

²⁷ Queensland Government (2013), *Queensland Government response to the Interdepartmental Committee on Electricity Sector Reform*.

²⁸ Queensland Government (2014), *The Strongest & Smartest Choice – Queensland Plan for Secure Finances and a Strong Economy*, p33.

²⁹ Queensland Government (2014), *Final Plan - The Strongest & Smartest Choice – Queensland Plan for Secure Finances and a Strong Economy*, p30.

on our operational and fixed support costs, such as our call centre, finance, human resources, IT, property and management. We are therefore proposing a retail separation event to recover any material costs incurred if a separation commences during the next regulatory control period.

We note the AER has previously approved a retail (separation) project event for the NSW DNSPs.³⁰

5.1 Definition

Ergon Energy proposes to adopt the definition previously approved by the AER for the NSW DNSPs, updated for Ergon Energy-specific references.³¹

Any legislative or administrative act of the Queensland Government to separate the retail electricity business of Ergon Energy in whole or in part from the electricity distribution function of Ergon Energy (including by way of a sale of the retail business), which materially changes the costs to Ergon Energy of providing direct control services in the regulatory control period 2015-20.

5.2 Nominated pass through event considerations

Ergon Energy's assessment of the nominated pass through event considerations for a retail separation event is provided in Table 4.

Table 4: Assessment of nominated pass through event considerations – retail separation event

Nominated pass through event consideration	Ergon Energy's assessment
Whether the event proposed is an event covered by the prescribed pass through events	<p>The proposed event is not covered by the prescribed pass through events specified in the NER. In particular, Ergon Energy considers that the prescribed regulatory change event would not encompass a retail separation event.</p> <p>A regulatory change event is limited in its application to a regulatory obligation or requirement, as defined under section 2D of the National Electricity Law. Ergon Energy believes that any separation of EEQ would not fall within this limited definition, as it is likely to be an administration decision made by the Queensland Government.</p> <p>In the event the decision is covered by a regulatory obligation or requirement, Ergon Energy would seek to recover any material increase in costs associated with the separation through the prescribed regulatory change event (rather than this event).</p>
Whether the nature or type of event can be clearly identified at the time of the determination	The nature and type of event can be clearly identified at the time of the determination, as evidenced by the proposed definition.
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	A prudent service provider could not reasonably prevent an event of this nature or type from occurring or substantially mitigate the cost impact of such an event. The AER has previously stated that it is an uncontrollable event. ³²
Whether the relevant service provider could insure against the event, having regard to the availability (including the extent of availability in terms of liability	It is not possible to obtain commercial insurance for this type of event. We note that the AER has previously recognised that it is an uninsurable event. ³³

³⁰ AER (2009), *Final decision: New South Wales Distribution Determination 2009-10 to 2013-14*, 28 April 2009, p283.

³¹ AER (2009), *Final decision: New South Wales Distribution Determination 2009-10 to 2013-14*, 28 April 2009, p283.

³² AER (2009), *Final decision: New South Wales Distribution Determination 2009-10 to 2013-14*, 28 April 2009, p283.

³³ AER (2009), *Final decision: New South Wales Distribution Determination 2009-10 to 2013-14*, 28 April 2009, p283.

limits) of insurance against the event on reasonable commercial terms

Whether the relevant service provider could insure against the event, having regard to 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 service provider would not have a significant impact on their ability to provide network services

Ergon Energy considers that it would be inefficient to self-insure given the uncertainties surrounding the event. Firstly, the Queensland Government has not yet made a formal decision to proceed with the separation as it is seeking a mandate from the Queensland people. If it does proceed, a timeframe for implementation has not been communicated. Secondly, a state election will be held in the first half of 2015. The outcome of this election may impact the occurrence of the event.

Finally, we consider that it would be difficult to calculate a robust self-insurance premium since data on insurance premiums is not available due to the lack of a commercial insurance market in this space.

6. Isolated network separation event

Ergon Energy currently owns and operates energy systems that supply 39 isolated communities in Western Queensland, Gulf of Carpentaria, Cape York and various Torres Strait Islands (i.e. the isolated network). These systems are not connected to main electricity grid. Instead, they typically consist of centralised generation, predominantly diesel, and distribution networks.

In its report, the IDC recommended that the government initiate an open tender or call for expressions of interest to supply the isolated systems to promote greater cost efficiency.³⁴ The Queensland Government accepted in principle this recommendation. However, it indicated that a final decision would not be made until consultation about the likely effect on Ergon Energy employees takes place. A final decision on this is not yet known.

Currently, the same resources, systems and processes may be employed to service the isolated network function and the grid-connected network function of the business. If a separation occurs, the costs of providing direct control services may increase due to loss of synergies. There will be a direct impact on our operational and fixed support costs, such as our call centre, finance, human resources, IT, property and management. We are therefore proposing an isolated network separation event to recover any material costs incurred if the separation proceeds.

6.1 Definition

Similar to the retail separation event nominated in Section 5.1 above, Ergon Energy proposes the following definition:

Any legislative or administrative act of the Queensland Government to separate the isolated network function of Ergon Energy in whole or in part from the grid-connected electricity distribution function of Ergon Energy, which *materially* changes the costs to Ergon Energy of providing *direct control services* in the *regulatory control period 2015-20*.

6.2 Nominated pass through event considerations

Ergon Energy's assessment of the nominated pass through event considerations for an isolated network separation event is provided in Table 5.

Table 5: Assessment of nominated pass through event considerations – isolated network separation event

Nominated pass through event consideration	Ergon Energy's assessment
Whether the event proposed is an event covered by the prescribed pass through events	<p>The proposed event is not covered by the prescribed pass through events specified in the NER. In particular, Ergon Energy considers that the prescribed regulatory change event would not encompass an isolated network separation event.</p> <p>For the same reasons identified above for the retail separation event, Ergon Energy considers that an isolated network separation event is unlikely to fall within the definition of a regulatory change event.</p> <p>In the event the decision is covered by a regulatory obligation or requirement, Ergon Energy would seek to recover any material increase in costs associated with the separation through the prescribed regulatory change event (rather than this event).</p>

³⁴ IDC (2013), *Report to government, Interdepartmental Committee on Electricity Sector Reform*, May 2013. Refer to recommendation 5.5.7.

Nominated pass through event consideration	Ergon Energy's assessment
Whether the nature or type of event can be clearly identified at the time of the determination	The nature and type of event can be clearly identified at the time of the determination, as evidenced by the proposed definition.
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	A prudent service provider could not reasonably prevent an event of this nature or type from occurring or substantially mitigate the cost impact of such an event. Given the similarities with the proposed retail separation event, Ergon Energy considers that this type of event is also 'uncontrollable'.
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	There is no commercial insurance available for this type of event.
<p>Whether the relevant service provider could insure against the event, having regard to whether the event can be self-insured on the basis that:</p> <ul style="list-style-type: none"> • it is possible to calculate the self-insurance premium • the potential cost to the service provider would not have a significant impact on their ability to provide network services 	<p>Like the retail separation event, Ergon Energy considers that it would be inefficient to self-insure given the uncertainties surrounding the event (i.e. there is no formal decision or timeframe as yet and the upcoming state election may impact the occurrence of the event).</p> <p>Further, we consider that it would be difficult to calculate a robust self-insurance premium since data on insurance premiums is not available due to the lack of a commercial insurance market in this space.</p>