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POWERLINK QUEENSLAND REVENUE PROPOSAL

Appendix 12.01 – PUBLIC

Marsh

Nominated Pass Through Events

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January 2021 Insurance Revenue Reset Support Services

Nominated Pass Through Events Powerlink Queensland

Period 2022/2023 to 2026/2027

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NOMINATED PASS THROUGH EVENTS

Introduction

As part of the revenue proposal, Powerlink has the opportunity to nominate reasonable and appropriate nominated pass through events. If one of these nominated pass through events eventuated, the Transmission Network Service Provider (TNSP) has the opportunity to submit an application for cost pass through treatment via consideration by the AER.

Scope

The scope of this report, as set out in our proposal, is for Marsh to analyse and recommend definitions and considerations for suitable nominated pass through events for:

- Non-insurable risk events e.g. very low probability, high impact; and
- Events where it is not possible to calculate a reliable self-insurance forecast.

Background

Clause 6A.7.3(a1) of the Rules provide for the following pass through events for a transmission determination:

- a regulatory change event;
- a service standard event;
- a tax change event;
- an insurance event; and
- any other event specified in a transmission determination as a pass through event for the determination.

The Rules also allow for a TNSP to propose events as part of a Revenue Proposal having regard to the nominated pass through event considerations set out in Chapter 10 of the Rules.

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 6A.7.3(a1)(1) to (4) inclusive (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.
- (e) any other matter the AER considers relevant and which the AER has notified Network Service Providers is a nominated pass through event consideration.

What is pass through?

Cost pass through is a way of addressing unexpected events and is intended to ensure the efficient funding of risks when it is uneconomical for the NSP to obtain insurance cover, or be paid a self-insurance allowance.

The forecast efficient expenditure of NSPs in Australia is regulated by the AER and recovered through their "allowed revenue", set each year. This allowed revenue includes the cost of risk management mechanisms, including commercial insurance and self-insurance.

Currently there are two ways that a NSP may recover the costs incurred as the result of any significant events that were not forecast as part of their allowed revenues:

1. Cost pass through – where expenditure arises in a permitted category of event (prescribed or nominated), the network service provider may apply to the AER to recover this amount from electricity customers in the next year's prices. A cost pass through event nominated at the time of a TNSP's regulatory proposal and approved by the AER only covers that category of event for that regulatory control period.
2. Capital expenditure re-opener – TNSP's can currently propose a capital expenditure re-opener to the AER. This only covers capital expenditure (e.g. the replacement cost of assets Towers and Lines swept away by flooding); it does not enable the recovery of repair costs to any assets which are damaged, but not destroyed.

August 2012 rule change

The aim of these amendments to the National Electricity Rules (NER) was to enable network businesses to recover their efficient costs in the advent of an unexpected event, while ensuring that the prices for consumers are no more than necessary to provide an appropriate level of service.

To achieve this, the AEMC has determined to:

- Provide transmission businesses with the ability to nominate additional pass through events as part of their revenue proposals;
- Include a set of nominated cost pass through event considerations in the NER that the Australian Energy Regulator (AER) must consider when deciding whether to accept the transmission or distribution business' proposed pass through event;
- Remove the terrorism event from the prescribed pass through events under the NER for both transmission and distribution businesses; and

- Provide transitional arrangements for network businesses who have recently completed or are in the middle of their revenue determination with the AER.

Note that the AEMC's policy position remains that cost pass throughs should only be used where other, more suitable, means of addressing these costs are less appropriate.

Recent Determinations

Based on recent determinations we have reviewed, it appears that the AER's starting point for considering pass through events is the provision of appropriate incentives to promote efficient and prudent risk management. The aim is to align the financial risks of providing network services with those best able to manage those risks.

Criteria

We applied the following criteria to identify the events to be nominated for the cost pass through mechanism:

- Quantification of such an event, by attaching likelihood and / or severity, cannot be ascribed by reasonable means and is subject to significant uncertainty.
- Insurance is not available on an efficient and prudent basis.
- Such an event is beyond the control of Powerlink, or Powerlink has taken appropriate and reasonable means in order to prevent or reduce the probability of its occurrence.
- The cost of the event exceeds 1 per cent of the Maximum Allowable Revenue (MAR) for the TNSP for that regulatory year.

For the events nominated, we note there have been no past incidents of similar type or similar events of such magnitude for Powerlink. However, we do not believe that the occurrence of such an event would necessarily preclude it from being a nominated pass through event as long as it met the above criteria.

In circumstances where these criteria are satisfied, the adoption of the cost pass through mechanism will likely be the most effective approach in achieving an adequate balance between:

- Having the incentive mechanisms in place to ensure that prices for consumers are no more than necessary to provide an appropriate level of service; and
- Still providing Powerlink with a reasonable opportunity to recover efficient costs associated with events that are outside of their reasonable control.

Network businesses should be able to recover the costs associated with events that are outside of their reasonable control.

The pass-through option is an efficient way of dealing with extreme events, which occur infrequently and are extremely difficult to model. The alternative of receiving an annual allowance to be placed in a reserve is problematic as the reserve may need to be maintained for a significant period of time. There is also the possibility that an extreme event may occur well before the reserve has reached the expected size for the event.

It is also worth noting that including a pass through event does not remove regulatory oversight. In relation to each nominated pass through event, Powerlink will retain its incentive to operate efficiently and mitigate its costs.

Nominated Pass Through

For the reasons discussed above, the nominated pass through events promote efficient investment in electricity services, and are in the long-term interests of consumers of electricity,

Accordingly, Powerlink nominate the following additional pass through events:

- Insurance Coverage Event
- Insurer's Credit Risk Default Event
- Natural Disaster Event.

The basis for nominating these events, and the proposed definitions, are set out in the main body of this report.

Risk Mitigation

We note that Powerlink is an efficient and prudent NSP, manages its risk profile ensuring a suite of preventative, detective and mitigating controls are effective in both their design and operation. Risk management is supported by complementary preparedness (including business continuity), recovery (both resumption of key processes and restoration of assets) and response arrangements; in line with best practice as outlined by Emergency Management Australia.

It should also be noted that the interruption or cessation of transmission services, would profoundly impair the electricity market and cause significant economic loss. Consistent with the Security of Critical Infrastructure Act (2018), Powerlink is a critical electricity asset owner. These assets are required therefore to be managed from a risk based as such which includes effective preventative, detective and mitigating (e.g. insurance, self-insurance, and / or regulatory mechanisms) controls.

Risk management is supported by an integrated "Three Lines of Defence" assurance process that provides confidence that controls are designed correctly, fit for purpose and effective in operation.

In the following sections, for each nominated pass through event, we have described the specific risk mitigation controls employed by Powerlink.

1 Nominated Event 1: Insurance Coverage Event

1.1 Definition

We nominate an Insurance Coverage Event as a pass through event for the regulatory period 2022/23 to 2026/27. Our proposed definition of this event is as follows.

Figure 1-1 – Proposed Definition for Insurance Coverage Event

AN INSURANCE COVERAGE EVENT OCCURS IF:	
1.	Powerlink <ol style="list-style-type: none">makes a claim or claims and receives the benefit of a payment or payments under a relevant insurance policy (in whole or in part – noting that an element of a policy may be retained by the insured) or set of insurance policies; or;would have been able to make a claim or claims under a relevant insurance policy (in whole or in part) or set of insurance policies but for changes circumstances; and
2.	Powerlink incurs costs <ol style="list-style-type: none">both within (where Powerlink retains elements of a policy e.g. effectively self-insures) and beyond the relevant policy limit for that policy or set of insurance policies; orthat are unrecoverable under that policy or set of insurance policies due to changed circumstances; and
3.	The costs referred to in paragraph 2 above materially increase the costs to Powerlink in providing prescribed transmission services.
For the purposes of this Insurance Coverage Event:	
<ul style="list-style-type: none">‘changed circumstances’ means movements in the relevant insurance market that are beyond the control of Powerlink Queensland, where those movements mean that it is not possible for Powerlink Queensland to take out an insurance policy (in whole or in part) or set of insurance policies at all or on reasonable commercial terms that include some or all of the costs referred to in paragraph 2 above within the scope of that insurance policy or set of insurance policies.‘costs’ means the costs that would have been recovered under the insurance policy or set of insurance policies had:<ol style="list-style-type: none">the claimable component up to the limit not been exhausted, orthose costs not been recoverable due to changed circumstancesA relevant insurance policy (in whole or in part) or set of insurance policies is an insurance policy or set of insurance policies held during the regulatory control period or a previous regulatory control period in which Powerlink Queensland was regulated, andPowerlink Queensland will be deemed to have made a claim on a relevant insurance policy or set of insurance policies if the claim is made by a related party of Powerlink Queensland in relation to any aspect of Powerlink Queensland’s network or business; andPowerlink Queensland will be deemed to have been able to make a claim on a relevant insurance policy or set of insurance policies if, but for Changed Circumstances, the claim could have been made by a related party of Powerlink Queensland in relation to any aspect of Powerlink Queensland’s network or business.	

Note for the avoidance of doubt, in assessing an insurance coverage event through application under rule 6A.7.3, the AER will have regard to:

- i) the relevant insurance policy or set of insurance policies for the event;
- ii) the level of insurance that an efficient and prudent NSP would obtain, or would have sought to obtain, in respect of the event; and
- iii) any information provided by Powerlink Queensland to the AER about Powerlink Queensland's actions and processes

1.2 Rationale

Powerlink has a range of insurance policies in place, aligned to its risk profile. [REDACTED]

This pass through event is proposed on the basis that it is not always efficient for TNSPs to fully insure against high impact, low probability events. This is because commercial insurance for these events may be unavailable, or may be available at a prohibitively high cost. It is also unlikely to be efficient to receive an additional annual self-insurance allowance to be placed in a reserve as the reserve may need to be maintained, theoretically, for a significant period of time, noting that an extreme event may occur well before the reserve has reached the expected size for the event.

The AER has previously determined that an insured event where costs are incurred beyond the insurance cap would largely be triggered by circumstances beyond the NSP's control, could not be forecast and would likely incur costs of a high magnitude. The AER considered that a combination of self-insurance (for costs above the insurance cap but below a specified threshold) and pass throughs should compensate for such an event.

1.3 Risk Mitigation

It is important to consider the complementary nature of commercial insurance coverage, self-insurance and pass through events to ensure optimal blend of cover.

Powerlink, as an efficient and prudent NSP, sets its insurance limits based on credible risk based scenario analysis, worst or maximum foreseeable loss (MFL) studies e.g. credible bushfire and loss of supply liability events, asset replacement values, industry benchmarks and professional Broker advice.

2 Nominated Event 2: Insurer Credit Risk Event

2.1 Definition

We nominate Insurer Credit Risk as a pass through event for the regulatory period 2022/23 to 2026/27. Our proposed definition of this event is as follows.

Figure 2-1 – Proposed definition for an Insurer Credit Risk Event

AN INSURER CREDIT RISK EVENT OCCURS IF	
A nominated insurer of Powerlink becomes insolvent, and as a result, in respect of an existing, or potential claim for a risk that was insured by the insolvent insurer, Powerlink:	
i)	is subject to a materially higher or lower claim limit or a higher or lower deductible than would have otherwise applied under the insolvent insurer’s policy; or
ii)	incurs additional costs associated with funding an insurance claim, which would otherwise have been covered by the insolvent insurer. This could include loss of premiums paid to insolvent insurer and the costs of premiums to reinstate coverage.
Note: In assessing an insurer’s credit risk event pass through application, the AER will have regard to amongst other things:	
a)	Powerlink’s attempts to mitigate and prevent the event from occurring by reviewing and considering the insurer’s track record, size, credit rating and reputation; and
b)	in the event that a claim would have been covered by the insolvent insurer’s policy, whether Powerlink had reasonable opportunity to insure the risk with a different provider.

2.2 Rationale

As outlined in Section 1.2 above, Powerlink has significant insurance coverage in place and hence an insurer not being able to pay all, or part, of a large, or catastrophic, event could be financially significant for Powerlink.

Recent catastrophic events including COVID-19, are likely to impact insurers in terms of ongoing claims and could also be a key factor for insurers in maintaining solvency and acceptable financial ratings.

Although Powerlink has mitigated this risk to the best of its ability, the insolvency of one or more of the insurers on their programme is out of their control. Hence, we believe that a pass through mechanism is currently the most appropriate regulatory approach for addressing the costs arising from a nominated insurer of Powerlink’s becoming insolvent.

2.3 Risk Mitigation

Powerlink as an efficient and prudent NSP, sets minimum requirements for the grading of participating underwriters at A- with A.M. Best and / or BBB+ with Standard and Poor’s. This standard is currently reflected in all major policies. In addition Marsh provides regular updates on Global insurer rankings, and recently issued a hyperlink to a real time ‘insurer monitor’ which captures insurer security ratings and movements. Powerlink, as an efficient and prudent NSP, ensures these requirements are met and manages the risk through appropriate vertical and horizontal apportionment across its policies both domestically and internationally. As outlined, this is supported by appropriate due diligence activities by Powerlink and Marsh.

3 Nominated Event 3: Natural Disaster Event

3.1 Definition

We nominate that a Natural Disaster Event be included as a pass through event for the regulatory period 2022/23 to 2026/27. Our proposed definition of this event is as follows.

Figure 3-1 – Proposed definition for an Natural Disaster Event

A NATURAL DISASTER EVENT OCCURS IF:
<p>Natural Disaster Event means any natural disaster including but not limited to cyclone, fire, flood, or earthquake that occurs during the 2022/23 to 2026/27 regulatory control period that increases costs to Powerlink in providing prescribed transmission services, provided the cyclone, fire, flood or other event was:</p> <ul style="list-style-type: none">• a consequence of an act or omission that was necessary for the service provider to comply with a regulatory obligation or requirement or with an applicable regulatory instrument; or• not a consequence of the acts or omissions of the service provider. <p>Note: In assessing a Natural Disaster Event pass through application, the AER will have regard to, amongst other things:</p> <ol style="list-style-type: none">i) Whether Powerlink has insurance against the event; andii) The level of insurance that an efficient and prudent NSP would obtain in respect of the event.

3.2 Rationale

The above definition of a Natural Disaster Event is consistent with the wording contained in prior pass through nominations.

The increasing number of Natural Catastrophe events and focus around effects of climate change does present greater concern with natural catastrophe risks moving forward and in particular in Queensland as it relates to Flood and Cyclone

Powerlink has been subjected to claims from Flood and Cyclone in the past, however the levels of insurance were sufficient and the policies did respond under those particular circumstances.

Whilst insurance is in place, in its current structure for Towers & Lines, the extensive transmission network does present a material risk for damage caused by Cyclone and Floods.

Additionally, with the Towers & Lines insurance:

- there is a lack of general appetite with only a select group of insurers capable of underwriting this cover,
- competition is minimal, and
- there are limited alternative options outside current markets (unlike the ISR policy, replacement capacity is not readily available).

Therefore, given the specialised nature of Towers & Lines insurance and the relatively small number of insurers willing to place such a policy, the continuity, terms and structure of this policy is subject to ongoing review and analysis.

3.3 Risk Mitigation

Natural Disaster events, by definition, cannot be prevented or avoided. Powerlink employs a range of strategies across the entire asset lifecycle to minimise and mitigate the exposure of the transmission network to Natural Disasters. These include a broad range of technical preventative measures including minimum design standards to withstand seismic, flood and cyclonic events; and continuous asset monitoring and maintenance activities along with insurance cover.

4 Reliance's and Limitations

We have relied on the accuracy and completeness of the data and other information (qualitative, quantitative, written and verbal) provided to us by Powerlink for the purpose of this advice.

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