

12. Pass Through Events

12.1 Introduction

This chapter sets out the nominated and other pass through events proposed by Powerlink for the 2023-27 regulatory period.

The pass through event mechanism in the National Electricity Rules (the Rules) is intended to provide an efficient means for a network service provider to recover the efficient costs of uncontrollable, material events that either cannot be insured or where the establishment of self-insurance is not economically viable.

Key highlights

- We take a holistic approach to identify and manage our risks in the most cost-effective way for customers and Powerlink. We assess if and how risks can be efficiently mitigated through a balance of commercial insurance, self-insurance and pass through events.
- Customers have advised they are concerned about rising insurance costs and the risk of cost pass throughs. We held a deep dive session on insurance in November 2020 to discuss the trade-offs between insurance costs and risk.
- We have committed to engage with customers within period in the event of any material changes in our insurance costs and prior to lodgement of any pass through applications to the Australian Energy Regulator (AER) should they be required.
- Having regard to the current insurance market, we have nominated the following pass through events for the 2023-27 regulatory period:
 - Insurance Coverage event;
 - Insurer Credit Risk event; and
 - Natural Disaster event.
- We have proposed a \$0 network support allowance within our operating expenditure (refer Chapter 6 Forecast Operating Expenditure).
- We have flagged a number of potential areas in which we may need to seek a cost pass through within the next regulatory period.

12.2 Regulatory requirements

The Rules¹ allow for the following pass through events:

1. a regulatory change event;
2. a service standard event;
3. a tax change event;
4. an insurance event;
5. any other event specified in a transmission determination as a pass through event for the determination;
6. an inertia shortfall event; and
7. a fault level shortfall event.

As identified above, the Rules allow a Transmission Network Service Provider (TNSP) to nominate pass through events as part of a Revenue Proposal. We have had regard to the considerations set out in Chapter 10 of the Rules² in the development of our nominated pass through events which are:

- whether the event is a pass through event for a transmission determination specified in clause 6A.7.3(a1)(1) to (4) of the Rules;
- 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;

¹ National Electricity Rules, clause 6A.7.3(a1)

² National Electricity Rules, Chapter 10, definition of nominated pass through event considerations.

- whether the relevant service provider could insure against the event, having regard to:
 - a. the availability (including the extent of availability in terms of liability limits) of insurance against the event on reasonable commercial terms; or
 - b. whether the event can be self-insured on the basis that:
 - i. it is possible to calculate the self-insurance premiums; 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
- any other matter the AER considers relevant and which the AER has notified Network Service Providers (NSPs) is a nominated pass through event consideration.

Pass through events can lead to an increase or decrease in costs (a positive or negative change event). The change in costs must exceed 1% of the Maximum Allowed Revenue (MAR) in the relevant year before a TNSP can seek a determination from the AER to pass through those costs³. For Powerlink, based on the MAR forecast in our Revenue Proposal, this threshold would be approximately \$7.0m.

12.3 Nominated pass through events

We take a holistic approach to the identification and management of our risks. We manage our risk profile with a suite of preventative, detective and mitigation controls. A key component of this strategy is the development and maintenance of an insurance program. To ensure an optimal balance of cover in the most cost-effective way for customers and Powerlink, we consider the complementary nature of commercial insurance coverage, self-insurance and pass through events. This holistic approach has guided the development of our Revenue Proposal.

Among the considerations that we must have regard to under the Rules for our nominated pass through events is the extent to which the event can be insured or self-insured.

We engaged Marsh to provide independent advice on our insurance and risk management approach for the 2023-27 regulatory period, including any risks that may need to be addressed as a nominated pass through event (refer to Appendix 12.01). Our proposed approach to insurance and self-insurance is addressed as part of our operating expenditure forecast (refer Chapter 6 Forecast Operating Expenditure).

Based on Marsh's advice, we propose the following nominated pass through events for the 2023-27 regulatory period:

- Insurance Coverage event;
- Insurer Credit Risk event; and
- Natural Disaster event.

We proposed and the AER approved the first two events, Insurance Coverage event and Insurer Credit Risk event, for application in our current regulatory period. We propose that Insurance Coverage events replace our previous term for this type of event (Insurance Cap event) to be consistent with the terminology applied by the AER in its recent regulatory decisions⁴.

On the advice of Marsh, we have also proposed a new, Natural Disaster event. This was recommended given the increase in risk of natural catastrophe events and forecast increase in insurance premiums (refer Chapter 6 Forecast Operating Expenditure). In the current volatile and uncertain insurance market environment, insurance premiums for this class of insurance may become unsustainable over the 2023-27 regulatory period. If this occurs, it may be more prudent and efficient to reduce our premium coverage for some natural disaster events and rely on a Natural Disaster Event nominated pass through instead. This type of nominated pass through is common among other TNSPs and Distribution Network Service Providers (DNSPs) and has been accepted by the AER in recent regulatory decisions⁵.

The sections below set out our proposed definitions and justification for these events. We consider that our nominated pass through events are consistent with the requirements of the Rules⁶.

³ National Electricity Rules, Chapter 10, definition of materially.

⁴ Draft Decisions for United Energy, AusNet Services, Jemena, CitiPower and Powercor, Australian Energy Regulator, September 2020.

⁵ *Ibid.*

⁶ National Electricity Rules, Chapter 10, definition of nominated pass through event considerations.

12.3.1 Insurance Coverage Event

An Insurance Coverage event is proposed to mitigate the risk of liability losses that exceed our insurance coverage. This event covers potential insurance gaps in relation to insurance caps as well as the possibility of withdrawn capacity or uneconomic increases in premiums in the future that could arise from the current and anticipated volatility in the insurance liability market.

Our proposed definition of an Insurance Coverage event is largely consistent with the AER's recent regulatory decisions⁷ with some minor adjustments (underlined below) to capture where insurance coverage may comprise multiple layers and/or insurers.

Table 12.1: Proposed definition of an Insurance Coverage event

<p>An Insurance Coverage Event occurs if:</p> <ol style="list-style-type: none"> 1. Powerlink: <ol style="list-style-type: none"> (a) makes a claim or claims and receives the benefit of a payment or payments under a relevant insurance policy (<u>in whole or in part</u>) or set of insurance policies; or (b) would have been able to make a claim or claims under a relevant insurance policy (<u>in whole or in part</u>) or set of insurance policies but for changed circumstances; and 2. Powerlink incurs costs: <ol style="list-style-type: none"> (a) <u>both within</u> and beyond a relevant policy limit for that policy or set of insurance policies; or (b) that are unrecoverable under that policy or set of insurance policies due to changed circumstances; and <p>The costs referred to in paragraph 2 above materially increase the costs to Powerlink in providing prescribed transmission services.</p> <p>For the purposes of this insurance coverage event:</p> <ul style="list-style-type: none"> • 'changed circumstances' means movements in the relevant insurance liability market that are beyond the control of Powerlink, where those movements mean that it is <u>not</u> possible for Powerlink to take out an insurance policy (<u>in whole or in part</u>) 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: <ul style="list-style-type: none"> o <u>the claimable component up to</u> the limit not been exhausted; or o those costs not been unrecoverable due to changed circumstances. • A relevant insurance policy (<u>in whole or in part</u>) 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 was regulated; and • Powerlink will be deemed to have made a claim on a relevant insurance policy (<u>in whole or in part</u>) or set of insurance policies if the claim is made by a related party of Powerlink in relation to any aspect of Powerlink's network or business; and • Powerlink 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 in relation to any aspect of Powerlink's network or business. <p>Note: In assessing an insurance coverage event through application under Clause 6A.7.3 of the Rules, the AER will have regard to:</p> <ol style="list-style-type: none"> 1. The relevant insurance policy or set of insurance policies for the event; 2. The level of insurance that an efficient and prudent Network Service Provider (NSP) would obtain, or would have sought to obtain, in respect of the event; and 3. Any information provided by Powerlink to the AER about Powerlink's actions and processes.

⁷ Draft Decisions for United Energy, AusNet Services, Jemena, CitiPower and Powercor; Australian Energy Regulator, September 2020.

Rationale

- An Insurance Coverage event is not covered by any of the categories of pass through events specified in clauses 6A.7.3(a1)(1) to (4) of the Rules.
- We consider that the nature and type of event can be clearly identified at the time the AER's determination is made.
- Events such as floods and cyclones could result in losses that exceed the limit of cover on existing insurances. The occurrence of an insurance coverage event is not foreseeable, has a low probability of occurrence but could potentially result in a high cost impact. We cannot prevent the occurrence of these type of events. While we invest, operate and maintain our network to reasonably withstand such events, we cannot substantially mitigate their cost impact.
- We have insurance coverage based on reasonable commercial terms and set our insurance limits based on credible risk based scenario analysis, worst or maximum foreseeable loss studies and professional insurance broker advice. We consider it would not be efficient to obtain additional insurances beyond these limits of cover.
- We cannot control movements in the insurance liability market, where those movements mean that it is no longer possible to take out an insurance policy (or set of insurance policies) at all, or on reasonable commercial terms. It would also be inefficient to seek an additional self-insurance allowance as such a reserve may need to be maintained for a significant period of time, noting that in practice it may never be required.

12.3.2 Insurer Credit Risk Event

An Insurance Credit Risk event would be triggered where an insurer becomes insolvent and Powerlink is consequently subject to additional costs than allowed under the insurance policy with that insurer. Our proposed definition of an Insurer Credit Risk event is consistent with the AER's recent regulatory decisions⁸.

Table 12.2: Proposed definition of an Insurer Credit Risk event

<p>An Insurer Credit Risk event occurs if:</p> <p>An 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:</p> <ul style="list-style-type: none"> • is subject to a higher or lower claim limit or a higher or lower deductible than would have otherwise applied under the insolvent insurer's policy; or • incurs additional costs associated with funding an insurance claim, which would otherwise have been covered by the insolvent insurer. <p>Note: In assessing an Insurer Credit Risk event pass through application, the AER will have regard to, amongst other things:</p> <ul style="list-style-type: none"> • 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 • 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.

Rationale

- An Insurer Credit Risk event is not covered by any of the categories of pass through events specified in clauses 6A.7.3(a1)(1) to (4) of the Rules.
- We consider that the nature and type of event can be clearly identified at the time the AER's determination is made.
- Given the prudent extent of insurance coverage we have in place, an insurer not being able to pay all, or part, of a large, or catastrophic, event could be financially significant for Powerlink.
- The risk of one of our insurers becoming insolvent is low but not improbable. While we act prudently in selecting an insurance provider, an insurer may still fail. Even though such events are infrequent, we are not able to control whether one or more of our insurers become insolvent.
- To mitigate against a potential Insurer Credit Risk event, we set minimum requirements for the credit rating of participating underwriters and monitor insurer ratings. Marsh provides regular updates on global insurer rankings, and recently provided access to a real time insurer monitor which captures insurer security ratings and movements.
- We diversify our risk through appropriate vertical and horizontal apportionment of our policies across both domestic and international providers. This combination also provides a level of risk mitigation against a potential Insurer Credit Risk event.

⁸ Draft Decisions for United Energy, AusNet Services, Jemena, CitiPower and Powercor, Australian Energy Regulator, September 2020

- We cannot obtain insurance on reasonable commercial terms to cover the occurrence of this type of event. In addition, we are not able to calculate a reasonable self-insurance premium for this event as it would be relative to the claim for a risk that was insured by the insolvent insurer.

12.3.3 Natural Disaster Event

A Natural Disaster event would be triggered where we could not obtain insurance coverage on reasonable commercial terms and the disaster caused a material increase in costs to Powerlink. Our proposed definition of a Natural Disaster event is consistent with the AER's recent regulatory decisions⁹.

Table 12.3: Proposed definition of a Natural Disaster event

<p>Natural Disaster event means any natural disaster including but not limited to cyclone, fire, flood or earthquake that occurs during the 2023–27 regulatory control period that increases the costs to Powerlink in providing prescribed transmission services, provided the 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 any other act or omission 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> <ul style="list-style-type: none"> • whether Powerlink has insurance against the event; and • the level of insurance that an efficient and prudent NSP would obtain in respect of the event.

Rationale

- A Natural Disaster event is not covered by any of the categories of pass through events specified in clauses 6A.7.3(a1) (1) to (4) of the Rules.
- We consider that the nature and type of event can be clearly identified at the time the AER's determination is made.
- Natural Disaster events, by definition, cannot be prevented or avoided. We employ a range of strategies to minimise and mitigate the exposure of the transmission network to natural disasters. These include a broad range of technical preventative measures, asset monitoring and maintenance activities along with existing insurance cover.
- We currently have insurance in place for towers and lines. However, Marsh have advised that this policy is subject to ongoing review and analysis:

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 ISR¹⁰ 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 analysis¹¹.

- In the volatile and uncertain insurance market environment, insurance premiums for this class of insurance may become unsustainable over the 2023-27 regulatory period. Where insurance becomes unavailable on reasonable commercial terms, it may be more prudent and efficient to reduce or remove the level of insurance coverage. A natural disaster pass through is likely to be the most appropriate way to manage this risk, and is more likely to be in the long-term interests of consumers when considering the trade-off between rising insurance premiums and the likelihood of an event occurring.
- We consider that the treatment of natural disasters as a nominated pass through event represents a more efficient means of managing our risk exposure than self-insurance given the complexity associated with developing credible self-insured risk quantifications for very low probability events and our likely inability to cover the cost impacts of a major natural disaster through a self-insurance allowance.

⁹ Draft Decisions for United Energy, AusNet Services, Jemena, CitiPower and Powercor, Australian Energy Regulator, September 2020.

¹⁰ Industrial Special Risks.

¹¹ Nominated Pass Through Events Powerlink Queensland, Marsh, December 2020, page 9.

12.4 COVID-19

The COVID-19 pandemic has created significant uncertainty and has impacted both domestic and global economies. Marsh has highlighted the unprecedented impact this is having on the global insurance market. At the time of writing our Revenue Proposal, the full extent that COVID-19 claims will have on coverage and pricing of some classes of insurance is still uncertain. This may also impact insurers in terms of maintaining solvency and acceptable financial ratings. We will continue to monitor and actively manage any upward pressure on premiums and ongoing insurance coverage.

While stand-alone pandemic products are available, they are limited and the availability of coverage and limits is insignificant considering the cost. Marsh advise there is little appetite for clients to pursue this option. For certain classes of insurance, the insurance market is introducing communicable disease exclusions that will effectively eliminate coverage over time. Our insurance policies have limited coverage for pandemics and this is expected to continue to reduce with more exclusions from insurers.

From a regulatory perspective, the framework provides some flexibility to enable a TNSP to seek to recover additional costs in such circumstances where these are material. For example, pass through provisions in relation to a regulatory change event or service standard event. The Rules also allow anyone, including industry participants, to request a change to the Rules. Subject to relevant Rules provisions and the Australian Energy Market Commission's (AEMC's) assessment, such a request can be sought as urgent and progressed on an expedited basis.

As many stakeholders will be aware, the AER itself took proactive action in relation to COVID-19 and sought input and feedback from networks and consumer groups on a potential re-opener Rule change to address the consequential cost impacts. As it turns out, based on this feedback, the AER decided not to proceed with the Rule change request.

12.5 Network support pass through

We have identified the potential for future network support arrangements with generators and large loads to form part of an upgraded scheme to extend the power transfer limits between Central Queensland and Southern Queensland. However, at this time, development of the need and full justification has yet to be undertaken. These costs, if they provide a net market benefit, form an efficient use of operating expenditure in place of capital expenditure.

Under the Rules¹², a TNSP can seek a determination from the AER to pass through any differences in costs between the amount included in the annual revenue requirement and actual efficient costs associated with network support events.

Given the uncertainty around the costs associated with the potential need identified above and other needs that could arise during the next regulatory period, we have proposed a \$0 network support allowance for the 2023-27 regulatory period. If network support is required and can be justified within period, we will seek a network support pass through from the AER at that time (refer Chapter 6 Forecast Operating Expenditure).

12.6 Potential pass through events in the 2023-27 regulatory period

Pass through events are typically uncontrollable, material and uncertain (as to if, or when, they will occur and/or their total cost).

Customers have advised they are concerned about increases in insurance premiums and the risk of cost pass throughs. We held a deep dive session on insurance in November 2020 and discussed the trade-off between certainty of insurance costs and the uncertainty of pass through risk.

In light of customer concerns and volatility in the insurance market, we have committed to engage with customers in the event of any material changes in our insurance costs within period and prior to lodgement of any pass through applications to the AER should they be required.

As many stakeholders are aware, at any one time there are numerous external consultations associated with Rule changes and reviews underway that may have cost consequences for networks and ultimately, consumers. Typically, stakeholders such as the AEMC, AER and networks will seek to address obligations and cost recovery in the context of each consultation, which may include cost pass through arrangements.

To be open and transparent, we have identified several potential pass through events that may eventuate in the next regulatory period that relate to the provision of prescribed transmission services. While not an exhaustive list, these events or drivers are shown in Table 12.4.

¹² National Electricity Rules, clause 6A.7.2.

If these or any other events occur during the 2023-27 regulatory period we will assess the most efficient way to manage these costs, which may result in a cost pass through application to the AER. Whether these events will occur or would qualify as a pass through event under the Rules is not known at this time.

Table 12.4: Potential cost pass through events in 2023-27 regulatory period

Pass through event	Description
Cyber security	<p>In December 2020, the Federal Government introduced the <i>Security Legislation Amendment (Critical Infrastructure) Bill 2020</i> to Parliament. If passed, this legislation would establish a new security and resilience regulatory regime on operators of critical infrastructure and we anticipate there would be elevated security obligations and standards on critical infrastructure owners and operators such as Powerlink.</p> <p>We considered an operating expenditure step change for a potential uplift in costs related to this requirement. We have decided not to pursue this and to aim to absorb these costs within our proposed operating expenditure forecast (refer Chapter 6 Forecast Operating Expenditure). However, if these costs are material, we may need to consider a cost pass through arrangement within period.</p>
Transmission Ring-Fencing	<p>The AER's Electricity Transmission Ring-Fencing Guideline Review⁽¹⁾ may result in additional costs for Powerlink. The quantum of these costs will depend on the nature and extent of the changes proposed and will need to be assessed after publication of the AER's Draft Guideline, indicatively scheduled for release in September 2021.</p>
Inertia shortfall and fault level shortfall events	<p>The change in generation mix presents particular challenges for the network (refer Chapter 2 Business and Operating Environment).</p> <p>In its 2020 System Strength and Inertia Report, the Australian Energy Market Operator (AEMO) concluded that fault level and inertia shortfalls are not yet considered likely for Queensland in the next five years, but shortfall risks are increasing. Changes to the operating patterns of large synchronous generators could result in either or both types of shortfall being declared during the 2023-27 regulatory period.</p> <p>AEMO declared a fault level shortfall event in North Queensland in April 2020 and we are required to meet this shortfall by August 2021. We have sought potential non-network solutions and have started to implement arrangements to meet this need. An application to the AER to approve the pass through of these network support costs will be made after the end of 2020/21.</p>

(1) Electricity Transmission Ring-Fencing Guideline Review Discussion Paper, Australian Energy Regulator, November 2019.

12.7 Summary

We have nominated three cost pass through events for inclusion in our transmission determination, consistent with the Rules.

We have also proposed a \$0 network support allowance and will manage any network support costs which may arise during the 2023-27 regulatory period by seeking a network support pass through from the AER if required.