



15 January 2020
Mr Warwick Anderson
Australian Energy Regulator (AER)
GPO Box 250
Melbourne, Vic, 3001

Dear Mr Anderson,

REVISED PROPOSAL: SA POWER NETWORKS (SAPN) – DETERMINATION 2020-25

Endeavour Energy appreciates the opportunity to provide this response to the AER and SAPN. Our submission is made with respect to Attachment 13 of SAPN's revised proposal; pass-through events. We support changes that ensure the principles of appropriate allocation of risk, clarity of regulatory decision making, and the promotion of efficient expenditure are advanced.

What is the role of pass-through events?

The regulatory framework recognises that a distribution network service provider (DNSP), consumers and the AER cannot reasonably be expected to forecast costs for all potential events over the regulatory control period. The regulatory framework addresses this issue by including a cost pass through mechanism, which allows DNSPs to seek the AER's approval to recover (or pass through) the costs (or savings) of: defined; unpredictable; and high cost event(s) for which the distribution determination does not provide a regulatory allowance.

The regulatory framework contains such a mechanism as it is not appropriate to include allowances for every possible risk in a DNSP's regulatory determination due to the difficulties in quantifying an accurate allowance for such events, recognising the likely outcome of materially over or under compensating for these risks. The corollary of this is that it would be contrary to the revenue and pricing principles and the National Electricity Objective to not provide a means for DNSPs to recover the costs from such events, as the financial impacts could be a catastrophic and place the DNSP in financial distress.

Whilst DNSPs have the ability to nominate additional pass through events (in addition to those prescribed in the Rules), this does not necessarily mean that they will be approved by the AER; nor does it mean that pass throughs should be used in place of prudent risk mitigation measures. DNSP's must satisfy the AER that its proposed event meets the Pass-Through Event Considerations (PTE considerations) in the Rules in order for the AER to approve the event as a pass through for the regulatory control period.

The PTE considerations enshrined in the Rules reflect that additional cost pass throughs should only be approved under limited circumstances. Specifically, they should only be approved in circumstances where risks or events have a low probability of occurrence (or are uncertain), have the potential to have a high cost impact and are beyond a network service provider's reasonable control. Further, they should only be approved in circumstances where commercial risk mitigation is not available on a reasonable basis or in situations where the DNSP is unable to mitigate or avoid the event without creating unacceptable risks¹.

Consequently, the PTE considerations help to ensure that nominated cost pass throughs are only approved under appropriate circumstances, so as not to undermine incentives in the regulatory framework for DNSP's to undertake efficient and prudent risk management.

What is the problem to be addressed?

Consistent with the considerations and circumstances outlined above, the AER has accepted an insurance cap event as a nominated pass-through in determinations to date. However, the insurance cap event as currently defined, may not remain fit-for-purpose in light of changing market conditions.

In its revised proposal, SAPN highlight the increasing difficulty networks are experiencing in obtaining a prudent level of insurance coverage at an efficient cost. The increasingly distressed global market for insuring bushfire and other catastrophic risks follows the 2018 and 2019 Californian Bushfires and Victorian bushfire class

¹ AEMC 2012, Cost pass through arrangements for Network Service Providers, Rule Determination, 2 August 2012, p 8.

actions. This trend is expected to materially worsen in light of the current catastrophic bushfires across eastern and southern Australia.

We have faced similar difficulties as SAPN, for our most recent annual insurance placement with several existing insurers have declined to offer terms whilst other providers have indicated they will no longer participate in future years. Sourcing replacement capacity was difficult and expensive requiring a shift (and subsequent delay) in the policy renewal date and establishing relationships with insurers in new markets. Ultimately, our 2019-20 insurance program was placed with over 50 insurers in the Sydney, Singapore, London and European insurance markets at a cost 38% higher than the 2018-19 premium.

What are the regulatory implications?

These changes occurred following the completion of our 2019-24 Determination and were unforeseen at the time of our proposal. This means that while we have, at this stage, maintained our coverage position from our 2018-19 base year we have incurred significantly higher costs in doing so. Between now and our next determination we will need to assess whether the scope and cost of our insurance program remains prudent and efficient in light of the changing market conditions.

For open determinations, like SAPN's, this issue should be addressed via opex step changes (where there is a sufficient degree of predictability to future insurance premium costs) and by ensuring the nominated pass-through event definitions remain appropriate. We note that in managing affordability and given the uncertainty SAPN has committed to its base opex benchmark and will bear the risk that insurance costs will be higher over the period.

In terms of the insurance cap event definition, we consider it requires either clarification or amendment to maintain its efficacy. Otherwise it could unreasonably confer additional risks on networks and limit their ability to recover their efficient costs.

What is SAPN's proposed solution?

SAPN's revised proposal draws particular attention to the definitions of 'natural disaster event' and 'insurance cap event' which provide that the AER will have regard to '*...the level of insurance that an efficient and prudent NSP would obtain in respect of the event*'. SAPN emphasises that what constitutes 'prudent' and 'efficient':

- should be linked to the actual availability of insurance on reasonable commercial terms;
- cannot rely on what was achievable under historical insurance market conditions as they are not indicative of what is and will be available on reasonable commercial terms; and
- should be independent of the probability of a bushfire occurring and/or the past frequency of bushfire occurrences.

SAPN suggest that the existing insurance cap event definition could be narrowly applied to where a policy limit is exceeded. SAPN proposes that the AER either²:

1. clarify that it will apply the current definition as if it extends to cover the other practical gaps in a NSPs insurance cover (i.e. in addition to a claim exceeding the maximum claim limit); or
2. amend the current wording of the 'insurer cap event' definition to broaden its coverage. Specifically:
 - a) to reflect the layered coverage approach networks employ by referring to insurance 'policies' in the plural rather than the singular³;

² SAPN, 2020-25 Revised Regulatory Proposal – Attachment 13 – Pass through events, 10 December 2019, p. 15

³ SAPN recognise that NER clause 1.7.1(b) will deem that words importing the singular include the plural and vice versa.

- b) to expand the event to costs that fall outside the scope of the cover provided rather than simply the costs beyond the policy limit;
- c) to assess both the level and scope (not just the level) of insurance cover an efficient and prudent NSP would obtain; and
- d) to assess the outcome of the annual consultation process SAPN intend conduct on their annual placement of insurance policies.

Our position

Endeavour Energy is of the view that the definitions of 'natural disaster event' and 'insurance cap event' address those matters of concern raised by SAPN and that a narrow application of these definitions would not be in long term interests of consumers.

Overall however, we are supportive of SAPN's revised proposal which highlights the growing importance of this issue and the potential harm to consumers arising from uncertainty or incongruous application of the definitions in question.

Our preference is for the AER to confirm that the existing definition covers practical gaps in an NSP's insurance coverage and not just exceeding the claim limit. In our view, this aligns with the intent of the event and the PTE considerations. Specifically, the PTE considerations include [emphasis added]⁴:

(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;

In the case of an insurance cap event this consideration (i.e. whether an NSP could have insured against an insurance cap event) would be of limited relevance. It does however, suggest that in assessing insurance coverage regard should be had to its availability on commercial terms and that this assessment should include but not exclusively consider liability limits. A similar principle should apply in assessing (or defining) an insurance cap event so that both scope and liability limits are examined.

A failure to do so could incentivise NSP's to maintain coverage limits that are imprudent and/or inefficient as conditions change. It may also expose NSP's to catastrophic financial risks where they can no longer obtain practical insurance coverage or access to the insurance cap pass-through event which could, in turn, incentivise overly conservative network operation/management decisions to mitigate the exposure. Practical examples⁵ of the customer impact of such outcomes have been seen in recent times and based on our engagement with customers we do not believe that this would be in customers' interests.

If the AER considers that the current definition does not cover the issues raised by SAPN we are supportive of the proposed amendments to the definition in order to expand its coverage. It is important to note that this does not disincentivise NSP's from managing risk prudently and efficiently. Instead, it ensures NSP's have the ability to propose a pass-through event. In doing so, a network would still have to provide evidence supporting the efficiency and prudence of their insurance coverage in accordance with the PTE considerations.

If you wish to discuss this submission further please contact Jon Hocking, Manager Network Regulation at Endeavour Energy or [REDACTED] or via email at [REDACTED]

[REDACTED]
Rod Howard
Deputy Chief Executive Officer

⁴ Refer to 'Nominated pass through event considerations', NER Ch 10.

⁵ <https://www.theguardian.com/us-news/2019/oct/08/california-power-outage-blackout-wildfire-prevention>
<https://edition.cnn.com/2019/10/10/us/pge-power-outages-public-outrage-trnd/index.html>