

SPI Electricity Pty Ltd 2011–15 Distribution Determination

Insurance Pass-through Event Response to the AER's August 2012 Draft Decision

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1 Introduction

SP AusNet is pleased to provide its response to the Australian Energy Regulator's (AER) August 2012 Draft Decision on the *Insurance event pass-through*.

In large part, SP AusNet welcomes the AER's decision, with Section 2 setting out the reasons why.

Section 3 proposes a change to the drafting of the *insurance event pass-through* to ensure that the definition more fully covers the range of possible insurance policies.

The AER's Draft Decision is of vital interest to SP AusNet. If its terms should change materially before the Final Decision, SP AusNet would welcome the opportunity to make further submissions.

2 Response to the Draft Decision

SP AusNet concurs with the key findings outlined in the Draft Decision, namely that the Decision:

- Enhances regulatory certainty;
- Minimises the long term costs to consumers;
- Definitions should reference and be consistent with the underlying insurance; and therefore
- Enhances the long term interests of consumers and, therefore, contributes to the achievement of the National Electricity Objective.

2.1 Regulatory consistency over time

The draft decision highlights that the protection being provided to SP AusNet is in effect a continuation of that agreed 2006-10 EDPR Decision made by the Essential Services Commission (ESCV):

“That prior level of insurance was entered into during the 2006–10 regulatory period, which was subject to the incentive arrangements under the ESCV’s electricity distribution pricing review (EDPR). During that time, a DNSP could apply to the ESCV to reopen the EDPR for the purposes of passing costs through to customers the DNSP’s incurred costs for an event that was beyond its control.”

SP AusNet agrees with this characterisation and would, therefore, emphasise that this pass-through arrangement does not provide a new protection to the business but rather honours an existing protection provided by the previous Victorian regime administered by the Essential Services Commission.

For businesses investing in very long term community assets it is particularly important that the regulatory framework offer certainty and that past arrangements and protections are honoured. In contrast, material retrospective changes to previous regulatory contracts damage Australia’s standing in the international investment community and raises the cost of investment funds for Victoria due to sovereign risk concerns. The extra costs this would impose on the Australian community far outweigh the costs of the proposed protections in the unlikely event they are drawn upon.

2.2 Long term cost to consumers

SP AusNet supports the AER’s statement that such protection is in the long term interests of consumers. As outlined in the Draft Decision:

“A DNSP, acting efficiently and prudently in managing its risks, is expected to take out an insurance policy that provides an efficient level of insurance coverage. However, by applying the pass through criteria, the AER can determine whether any excess costs that are not covered under such a policy can be recovered from customers. This may occur in circumstances where a prudent DNSP has obtained an efficient level of insurance policy coverage consistent with the standard expected and approved in its forecast operating expenditure allowance but due to circumstances beyond its control, that

policy coverage does not cover the costs a DNSP incurs once a claim is made on that policy.”

“The kinds of circumstances that may lead to such an excess cannot be self-insured nor could the DNSP have taken actions to reasonably prevent these circumstances from occurring or to substantially mitigate the relevant cost impact. In these circumstances, the DNSP should not bear any excess costs not covered by an insurance policy. A DNSP is not in a position to manage the risk of such circumstances occurring as they are beyond its control. It is therefore a legitimate cost the DNSP incurs in the provision of standard control services that should be recovered from customers by way of a cost pass through. In these circumstances, the pass through of these costs will not undermine the incentives for the DNSP to efficiently and prudently manage the risks that are within its control.”

In particular, SP AusNet would agree that the kinds of circumstances (a claim or claims against an insurance policy) that lead to such an excess cannot be mitigated other than taking out an efficient level of insurance (as defined in the relevant price review decision).

It is also noted that, in the absence of this protection, a business would be required to seek alternative insurance protection. For these types of events, rare and potentially expensive, insurance companies are not in a position to quantify risks. Therefore, in these circumstances insurance is only available at very high premiums – potentially running to hundreds of millions of dollars per year if available at all.

For example, while normal public liability insurance premiums in this area are thousands of dollars per million dollars of cover, the specialist markets that deal in the extra coverage can charge up to hundreds of thousands of dollars per million dollars of cover. Therefore, an additional billion dollars of coverage would cost approximately \$100 million per year.

If the regulator is not prepared to effectively insure the business for the potential loss above the current insurance cap, the business must take out much higher levels of cover even though the likelihood of the event the business is seeking to cover is once in fifty or a hundred years.

In this instance, consumers would pay considerably more over 100 years (up to \$10 billion) in extra electricity charges than if pass-through protection was provided to the business for an unlikely one in a hundred year pay out.

It is for this reason that this type of community insurance of community infrastructure is in fact the norm throughout Australia and the developed world, even though not always explicit. For example, Australian taxpayers have effectively insured Queensland residents for their infrastructure and (some) property damage during the recent floods. Likewise, historically Victorian taxpayers stood behind the State Electricity Commission of Victoria in essentially the same manner and circumstances.

2.3 The link to insurance

For the pass-through to be operated effectively, clarity for both the AER and the business is essential. The most effective way to gain this clarity is to reference both the underlying insurance and the relevant regulatory decision. This prevents both the

business underinsuring and transferring risk to customers or needing to seek expensive coverage and recovering these higher costs annually from customers.

As a major function of public liability insurance is to indemnify the insured against its negligence, it is right that SP AusNet's pass-through amount is not reduced or denied on the basis that SP AusNet had been negligent, even if that were to be the finding of a court, as this would undermine the objective of the insurance event pass-through.

However, it is important to note that, the pass-through protection would apply only insofar as the underlying insurance protection would apply. If the company was found to have acted in such way that its insurance protections were voided (for example, insurance does not cover illegal or reckless behaviour by the business) the pass-through protection itself would not apply, leaving any impact solely and wholly with the business.

2.4 Conclusion

For the reasons outlined above, the Draft Decision;

- Honours previous regulatory agreements;
- Minimises the costs that customers will pay over the long term;
- Provides clarity with respect to operation of the pass-through.

Therefore, the Draft Decision enhances the achievement of the National Electricity Objective.

3 Proposed minor changes to the definition

While SP AusNet welcomes and supports the Draft Decision some minor drafting changes would clarify the operation of the pass-through provision. These minor drafting changes are explained below.

The current definition is:

“an insurance event:

An insurance event occurs if:

- (a) the DNSP makes a claim on a relevant insurance policy; and*
- (b) the DNSP incurs costs beyond the relevant policy limit; and*
- (c) the costs beyond the relevant policy limit materially increase the costs to the DNSP of providing direct control services.*

For the purposes of this insurance event:

- (d) the relevant policy limit is the greater of the DNSP’s actual policy limit at the time of the event that gives rise to the claim and its policy limit at the time of making of the 2011–15 distribution determination by the AER or, if the policy coverage was for coverage during the 2006–10 electricity distribution pricing review, by the ESCV, with reference to the forecast operating expenditure allowance approved in those determinations;*
- (e) a relevant insurance policy is an insurance policy held during the 2006–10 regulatory period or the 2011–15 regulatory control period;*
- (f) the costs beyond the relevant policy limit materially increase the costs where those costs would increase the smoothed forecast revenue of the regulatory year in which the costs are incurred by at least 1 per cent.”*

SP AusNet proposes that the definition be amended to include the plural as well as singular with regards to claims on the relevant insurance policy. Multiple claims are possible and present a risk scenario this protection is seeking to mitigate.

This would result in the following alternative drafting:

“an insurance event:

An insurance event occurs if:

- (a) the DNSP makes a claim **or claims** on a relevant insurance policy; and*
- (b) the DNSP incurs costs beyond the relevant policy limit; and*
- (c) the costs beyond the relevant policy limit materially increase the costs to the DNSP of providing direct control services.*

For the purposes of this insurance event:

- (d) the relevant policy limit is the greater of the DNSP’s actual policy limit at the time of the event that gives rise to the claim and its policy limit at the time of making of the 2011–15 distribution determination by the AER or, if the policy coverage was for coverage during the 2006–10 electricity distribution pricing review, by the ESCV, with reference to the forecast operating expenditure allowance approved in those determinations;*

Proposed changes to the definition

- (e) *a relevant insurance policy is an insurance policy held during the 2006–10 regulatory period or the 2011–15 regulatory control period;*
- (f) *the costs beyond the relevant policy limit materially increase the costs where those costs would increase the smoothed forecast revenue of the regulatory year in which the costs are incurred by at least 1 per cent.”*