Draft Decision

SPI Electricity Pty Ltd

2011–15 Distribution Determination

Insurance Pass Through Event

Pursuant to Orders of the Australian Competition Tribunal in
Application by United Energy Distribution Pty Limited
[2012] ACompT 8

August 2012

AUSTRALIAN ENERGY REGULATOR

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AER reference: 39804

Amendment record

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1.0	29 August 2012	9

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1 Summary

On 19 November 2010, SPI Electricity Pty Ltd (**SP AusNet**) applied to the Australian Competition Tribunal (**Tribunal**) for review of various parts of its 2011–15 distribution determination.[1] One part of that review concerned the following definition of the insurance pass through event that was included in SP AusNet's 2011–15 distribution determination pursuant to clause 6.12.1(14) of the *National Electricity Rules* (**NER**):

> an insurance event:
>
> An insurance event occurs if:
>
> (a) the DNSP makes a claim on an insurance policy that it holds; and
>
> (b) the DNSP incurs costs beyond the policy limit for the relevant insurance policy; and
>
> (c) the DNSP must bear the costs that are in excess of the policy limit; and
>
> (d) the event materially increases the costs to the DNSP of providing direct control services.
>
> For the purpose of this event, an event is considered to materially increase costs where the event has an impact of one per cent of the smoothed forecast revenue of the regulatory year in which the costs are incurred.
>
> For the purpose of this event, a relevant insurance policy refers to the policy coverage provided through a DNSP ' s forecast operating expenditure allowance for an insured risk, as approved by the AER in its distribution determination and the reasons for the determination.[2]

The reasons for including the insurance pass through event were set out in the AER's final decision for the 2011–15 Victorian distribution determinations (**Final Decision**).[3]

The Tribunal summarised SP AusNet's concern with the insurance pass through event as follows:

> This issue concerns whether the reworked definition of *"insurance event"* in the final decision which included a rider to that definition confining the costs which might be the subject of a pass through payment as a result of the happening of such an event to costs incurred which exceed the level of insurance cover provided by policies the premiums for which were provided for in SP AusNet's forecast opex for the 2011–2015 *regulatory control period* as approved by the AER was an incorrect exercise of discretion or unreasonable in all the circumstances or was arrived at as the result of errors of fact made by the AER. SP AusNet also contended that the decision to include the rider should be set aside because SP AusNet had been denied procedural fairness in the process leading to the final decision. The rider excluded from the scope of the additional nominated *pass through event* concerning insurance (**the insurance event**) events which occurred in a prior regulatory period (ie prior to 1 January 2011) and which were covered by insurance policies which were in place prior to 1 January 2011 but which had expired according to their terms by 1 January 2011, even though the financial impact and losses caused by those events are wholly or partly suffered in the 2011–2015 *regulatory control period*.[4]

On 5 April 2012, the Tribunal ordered that the insurance pass through event decision be remitted to the AER to be remade.[5] At the time of this decision, the Tribunal's reasons remain confidential.[6]

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1 AER, *Final SPI Electricity Pty Ltd, Distribution determination 2011–2015*, October 2010.

2 Ibid., pp. 30 and 31.

3 AER, *Final Decision*, *Victorian electricity distribution network service providers, Distribution determination 2011-15*, 29 October 2010, pp.793–794.

4 *Application by United Energy Distribution Pty Limited* [2012] ACompT 1, [533].

5 *Application by United Energy Distribution Pty Limited (No 2)* [2012] ACompT 8, Order 3 of ACT 7 of 2010.

6 *Application by United Energy Distribution Pty Limited* [2012] ACompT 1, [534]–[539].

For the reasons that follow, the AER has remade this decision by replacing the definition of the insurance pass through event in SP AusNet's 2011–15 distribution determination with the following:

> 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.

This decision revises the definition of an insurance event to include insurance policies that may have been entered into previous regulatory periods. Further, the decision requires the relevant insurance policy was entered into as contemplated by the forecast operating expenditure allowance determined at the time. This is consistent with the revenue and pricing principles (**RPP**), is in the long-term interests of consumers and will contribute to the achievement of the national electricity objective (**NEO**).

2 Reasons

2.1 Approach

A distribution determination is predicated on a number of constituent decisions.[7] One of these constituent decisions is the nomination of the pass through events. This is in addition to a regulatory change event, a service standard event, a tax change event or a terrorism event, which each apply during the regulatory control period (**nominated pass through event**).[8]

The pass through mechanism in Chapter 6 of the NER is designed to allow a distribution network service provider (**DNSP**) to recover the costs it incurs in the provision of standard control services that are material and beyond its control. This is the rationale that underlies each pass through event that is prescribed in the pass through event definition in Chapter 10 of the NER. It is important to recognise that although these costs may be incurred in respect of events that can be foreseen, they are to be distinguished from costs that are within a DNSP's control, the risk of which a DNSP is expected to manage and bear.[9]

The decision to include a nominated pass through event is a discretionary matter for the AER. The NER does not specify any considerations for the AER to take into account. It is a decision that the AER must exercise in a manner that will or is likely to contribute to achievement of the NEO, taking

[7] NER, cl 6.12.1.

[8] NER, cl 6.12.1(14) and the definition of a 'pass through event' in Chapter 10 of the NER.

[9] Australian Energy Market Commission, *National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006, Rule Determination*, 16 November 2006, , p. 104.

into account the RPP.[10] In explaining how it decided to include a nominated pass through event in SP AusNet's distribution determination, in the Final Decision the AER set out the following criteria which it developed having regarding to the NEO and the RPP (**pass through criteria**):

- the event is not already provided for:
  - in the defined event definitions in the NER (and does not conflict or undermine the events defined in the NER)
  - through the opex allowance (e.g. the insurance or self-insurance components)
  - through the WACC (events which affect the market generally and not just the provider are systematic and already compensated through the WACC), or
  - through any other mechanism or allowance
- the event is foreseeable - in that the nature or type of the event can be clearly identified
- the event is uncontrollable-in that a prudent service provider through its actions could not have reasonably prevented the event from occurring or substantially mitigated the costs impact of the event
- the event cannot be self-insured because the self-insurance premium cannot be calculated or the potential loss to the relevant DNSP is catastrophic
- the party who is in the best position to manage the risk is bearing the risk
- the passing through of the costs associated with the event would not undermine the incentive arrangements within the regulatory control period.[11]

2.2 Reconsideration of the insurance pass through event

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.

[10] NEL, s 16.

[11] AER, *Final Decision*, *Victorian electricity distribution network service providers, Distribution determination 2011-15*, 29 October 2010, p. 745.

The Tribunal has ordered that the decision to include the insurance pass through event be remitted to the AER for it to be remade. In remaking this decision, the AER has revised the definition of the insurance pass through event to take into account SP AusNet's concern that the existing definition excludes insurance policies that may have been entered into previous regulatory periods and to ensure that it only allows SP AusNet to seek the recovery of any excess costs not covered by an efficient insurance policy from consumers in the specific set of circumstances discussed above.

This has resulted in the following two revisions to the definition to:

- include efficient insurance policies entered into in previous regulatory periods and
- require that the relevant insurance policy was entered into as contemplated by the forecast operating expenditure allowance determined at the time.

These revisions are discussed in turn below.

2.2.1 Efficient insurance policies entered into in previous regulatory periods

The insurance pass through event definition included in SP AusNet's 2011–15 distribution determination excluded insurance policies entered into in previous regulatory periods. This drafting of this event reflected the AER's intention to ensure that costs were not passed through to customers in circumstances where those costs should have been covered under insurance policies for which a DNSP was compensated (i.e. insurance premiums allowed) in the approved forecast operating expenditure allowance for the 2011–15 regulatory control period.[12]

SP AusNet has identified that this form of drafting has the effect of precluding it from making a cost pass through application for costs associated with an event that occurred in a previous regulatory period. The AER recognises that in circumstances where an insurance claim is invoked under a prior insurance policy and SP AusNet incurs an excess loss on this policy, the insurance pass through event would not be triggered.

In determining whether the insurance pass through event should cover an insurance policy entered into during a previous regulatory period, it is necessary to consider whether the prior level of SP AusNet's insurance coverage was efficient and prudent. 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. Significantly, the reopening of the EDPR is subject to a number of conditions. Whether a DNSP would have been successful in this regard is uncertain. In the case of SP AusNet, notwithstanding the availability of this option, the uncertainty suggests that SP AusNet would have likely sought an efficient and prudent level of insurance. In addition, the efficient forecast operating expenditure for the 2006–10 regulatory period determined in the EDPR included a level of insurance coverage.

Accordingly, the insurance pass through event definition will be revised to include insurance policies entered into in previous regulatory periods.

[12] Ibid, pp. 793 and 794.

2.2.2 The connection of the relevant insurance policy limit to the approved forecast operating expenditure allowance

The Final Decision permitted a step change in forecast operating expenditure to allow SP AusNet increased insurance coverage (and as a result higher forecast insurance premiums) during the 2011–15 regulatory control period. However, the AER also noted it ultimately cannot compel a DNSP to actually seek increased insurance coverage.

This raises the risk that a DNSP might under-insure by obtaining a level of insurance cover lower than that contemplated in the forecast operating expenditure allowance determined in its distribution determination, and then pass through any costs that exceed its insurance cap. In these circumstances, customers are effectively paying twice – for the premiums of an efficient level of insurance as reflected in the forecast operating expenditure and through the cost pass through mechanism for costs that should have been otherwise covered by that efficient level of insurance.

Accordingly, to address this risk, the definition of the insurance pass through event was amended in the Final Decision to ensure that only costs arising from an efficient insurance policy as contemplated in the forecast operating expenditure allowance could be recovered, should an insurance pass through event be triggered. This ensures consumers pay for the premium as contemplated in the forecast operating expenditure allowance and beyond this may only pay for any excess loss incurred by the DNSP that would otherwise be considered an efficient cost.

This issue remains relevant in this decision and the AER has attempted to address this in terms of the conditions that apply to the relevant trigger.

3 Draft Decision

The definition of the insurance pass through event contained in Chapter 4 of *SPI Electricity Pty Ltd, Distribution Determination 2011–2015*, October 2010 will be replaced with the following:

> 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.

This decision allows SP AusNet to seek to recover any costs that exceed the level of coverage provided to it through an efficient insurance policy that are beyond its control. This includes costs incurred under a previous insurance policy that is efficient and prudent by reason that such coverage was obtained consistently with the operating expenditure allowance approved by the AER or the previous regulator, the Essential Services Commission of Victoria. For the reasons discussed above, this decision is consistent with the RPP as it will continue to provide SP AusNet with a reasonable opportunity to recover at least its efficient costs in providing direct control network services and effective incentives to promote economic efficiency with respect to direct control network services. It is also in the long term interests of consumers, and will contribute to the achievement of the NEO.[13]

[13] NEL, ss 7, 7A and 16.