



Final 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

April 2013

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1 Final Decision

For the reasons outlined below, the AER has maintained its draft decision. We replace 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.

We will make the necessary consequential amendments to SP AusNet's 2011-15 distribution determination to give effect to this decision. We will publish those separately.

This decision addresses a 'gap' in the application of the insurance event. This gap arises given the insurance event in SP AusNet's current determination does not cover the limits for prior policies. The extension of the insurance event definition to prior policies also gives effect to the previous regulatory arrangements administered by the ESCV. Under these previous arrangements were an insurance claim made, SP AusNet could have applied to the ESCV to recover costs above insurance limits.¹

In addressing this gap, this decision allows SP AusNet to apply to the AER to recover costs that exceed the limits of coverage of its relevant insurance policies.

This decision only gives SP AusNet an opportunity to apply to the AER to recover additional costs. It does not mean SP AusNet will automatically receive any additional revenue. We will assess that, should an insurance event occur, and if SP AusNet makes an application. In doing so, we must consider what actions SP AusNet has taken to mitigate or reduce costs. This would include, amongst other factors:

- actions the network business may/may not have taken to reduce the magnitude of the pass through amount; and
- actions or omissions taken by the business which affect the magnitude of the amount involved.²

Should SP AusNet make an application, we would, for example, review any court judgements or litigation settlement involved.

¹ Victorian Electricity Supply Industry Tariff Order cl.3.2

² NER, cl 6.6.1 (j)(3).

It should also be noted this decision is not about whether the AER includes an insurance pass through event in SP AusNet's current determination. The Tribunal's remittal is to determine how to define the event, not whether the event should exist.

2 Introduction

2.1 The issue

A distribution determination is predicated on a number of constituent decisions.³ Nominating pass through events (**nominated pass through event**) is one of these. This is in addition to pass through events that the NER prescribes.⁴

In general, the NER's pass through framework provides a mechanism for a distribution network service provider (DNSP) to apply to the AER to recover certain costs that are material and beyond its control. Although a DNSP may incur these costs in respect of foreseeable events, they are different to costs that a DNSP may control. The regulatory regime⁵ expects a DNSP to manage and bear costs it can control.⁵

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.⁶ 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.⁷

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**).⁸

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

³ NER, cl 6.12.1.

⁴ NER, cl 6.12.1(14) and the definition of a 'pass through event' in Chapter 10 of the NER.

⁵ Australian Energy Market Commission, *National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006, Rule Determination*, 16 November 2006, p. 104.

⁶ AER, *Final SPI Electricity Pty Ltd, Distribution determination 2011–2015*, October 2010.

⁷ *Ibid.*, pp. 30 and 31.

⁸ AER, *Final Decision, Victorian electricity distribution network service providers, Distribution determination 2011-15*, 29 October 2010, pp.793–794.

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*.⁹

On 5 April 2012, the Tribunal remitted that the insurance pass through event decision to the AER to be remade.¹⁰ At the time of the draft decision, the Tribunal's reasons remained confidential.¹¹ The Tribunal on 24 September 2012 released a redacted version of its reasons.

2.2 Scope of AER's decision

Whether the AER includes an insurance pass through event in SP AusNet's current determination is not at issue. The Tribunal's remittal is to determine how to define the event, not whether the event should exist.

2.3 Draft decision

On 29 August 2012, we made a draft decision to revise the definition of an insurance event to include insurance policies that SP AusNet entered into in previous regulatory periods. Further, the decision required that the relevant insurance policy for previous regulatory periods was entered into as contemplated by the forecast operating expenditure allowance determined at the time.

2.4 Summary of submissions and response

The majority of submissions on the draft decision focussed on whether an insurance event should exist, rather than how we should formulate it. We received one submission from the then Victorian Minister for Energy and Resources who submitted that:

As a matter of principle, the Victorian Government would not support any regulatory outcome that resulted in victims of negligence paying for the damage caused by their electricity network where that damage is due to negligence and the network business or a failed to take action expected of it to avoid or reduce that damage.¹²

The Minister submitted that the existing arrangement would preclude such an outcome. But, he considered it important that the AER clarify the existing framework's intent.

The Minister also expressed concern that the insurance event definition may apply to any event which results in a claim on a DNSP's insurance. This occurs regardless of whether the event is beyond the DNSP's control. This could reduce the DNSP's incentives to take out efficient levels of insurance and take efficient steps to minimise the likelihood of an event occurring.¹³

The Hon Lily D'Ambrosio MP, Opposition spokesperson on energy, submitted that the draft decision:

- does not encourage businesses to effectively manage risks

⁹ *Application by United Energy Distribution Pty Limited* [2012] ACompT 1, [533].

¹⁰ *Application by United Energy Distribution Pty Limited (No 2)* [2012] ACompT 8, Order 3 of ACT 7 of 2010.

¹¹ *Application by SPI Electricity Pty Limited* [2013] ACompT 1, [1]-[5].

¹² The Minister for Energy and Resources' submission to the Draft Decision, 12 September 2012, p. 1.

¹³ The Minister for Energy and Resources' submission to the Draft Decision, 12 September 2012, p. 2.

- transfers the risk of an insurance pass through event to households. The businesses may best manage this risk through effective management and oversight of their distribution networks
- creates a situation where households are the insurer of last resort. This is inappropriate and discourages DNSPs bearing risk; and
- leads to a retrospective regulatory decision. It takes into account insurance policies that businesses entered in previous regulatory periods.¹⁴

Amcor submitted that the draft decision does not sufficiently obligate the DNSP to properly administer and manage its business risks.¹⁵ Amcor also submitted that the draft decision does not mirror commercial reality. In fact, it quarantines DNSPs' shareholders from any risk.

SP AusNet also made a submission and supported the draft decision, stating that the decision:

- enhances regulatory certainty
- minimises the costs that customers will pay over the long term and
- provides clarity with respect to the operation of the pass through.¹⁶

In the draft decision, we considered whether the insurance pass through event should cover an insurance policy entered into during a previous regulatory period. In doing so, it was necessary to consider whether the prior level of SP AusNet's insurance coverage was efficient and prudent. We considered that there is no evidence to suggest that the level of coverage was not efficient. This was based on the regulatory regime which applied to SP AusNet at the time. It involved testing any claims against the efficiency and prudence tests, as does the current regime. Neither regime provides certainty or a guarantee that SP AusNet could pass through to consumers, costs in excess of insurance limits. There remains uncertainty about whether SP AusNet could pass through any costs should an insurance event occur. Since it has no guarantee it will obtain a pass-through or allowed to recover excess costs, SP AusNet would have incentives to obtain an efficient level of insurance.

Also Amcor submitted the draft decision does not mirror commercial reality and that it quarantines a DNSP's shareholders from any risk. We do not agree that the draft decision quarantines the shareholders from any risk. DNSPs' shareholders still face risks. Before declaring an 'insurance event', the Rules require that the AER must take into account, amongst other things¹⁷: the efficiency of the network business' decisions and all actions taken in relation to the risk of the event. This includes:

- actions the network business may/may not have taken to reduce the magnitude of the pass through amount; and
- actions or omissions taken by the business which affect the magnitude of the amount involved.¹⁸

A full list of the relevant factors in the Rules that the AER must consider when assessing a pass through application are provided in Appendix A.

¹⁴ The Hon D'Ambrosio MP's submission the Draft Decision, 11 September 2012, p. 1.

¹⁵ Amcor's submission to the Draft Decision, 2 October 2012, p. 1.

¹⁶ SP AusNet's submission the Draft Decision, 12 September 2012, p. 4.

¹⁷ NER, cl 6.6.1 (j)(1)-(8).

¹⁸ NER, cl 6.6.1 (j)(3).

Further, in considering any pass through application we would consider the circumstances surrounding any insurance claim. In particular, any decision on any pass through, would also involve reviewing any relevant court judgements or litigation settlements. We consider these points address the Minister's concerns.

Finally, we agree with the Opposition spokesperson's submission that parties who can best manage risk should do so. This recognises that some parties may better mitigate risk or reduce an event's cost impact. However, this submission is relevant to whether the event (an insurance event) should exist in the first place. This is not a matter within the scope of this remittal decision. As a separate process, we are reviewing the pass through arrangements for an insurance event for upcoming regulatory determinations. As we have previously indicated we intend to consult more widely as part of this review.¹⁹

3 Reasons

3.1 Extending the insurance event definition

As this decision is limited to how to formulate the pass through event, we have considered the following issues raised by submissions:

- whether the decision reflects retrospective decision making by including prior insurance policies in the insurance pass through definition; and
- SP AusNet's proposed amendment to the event definition specified in the draft decision.

These considerations are discussed below.

3.1.1 Prospective application of the pass through event

Some submissions submitted that the draft decision was retrospective in operation given that it proposed to include insurance policies entered into in prior regulatory periods. We do not agree that this decision is in any sense retrospective.

The arrangements under the ESCVs electricity distribution price review (**EDPR**) 2006-10- made an allowance for insurance coverage. During 2006-10, a DNSP could ask the ESCV to reopen the EDPR to seek the recovery of costs in excess of its insurance limits that was beyond its control. The reopener provisions under the ESCV framework operated in a similar way to the NER's pass through provisions.²⁰ This means that had SP AusNet incurred costs in excess of its insurance limits, it could have sought to recover these costs through the ESCV's reopener process. In the absence of an insurance event within SP AusNet's current determination which does not cover the limits for prior policies, SP AusNet would not be able to seek the recovery of the costs in excess of its insurance limits where the costs are incurred in 2011-15. This decision addresses this 'gap' in the application of the insurance event. In addressing this gap, the operation of the insurance event can only be prospective.

¹⁹ AER Decision, Powerlink nominated cost pass through events, Application to amend Powerlink's 2012-17 transmission determination, March 2013, p.6.

²⁰ Victorian Electricity Supply Industry Tariff Order cl.3.2.

Accordingly, this decision affords SP AusNet the same opportunity to recover its efficient costs covered by all of its relevant insurance policies.²¹ In particular, only costs above insurance limits on a relevant insurance policy will trigger a pass through event. Such circumstances could only arise in the future.

3.1.2 Proposed amendment to the insurance event definition

SP AusNet proposes that the AER amend the draft decision's definition. SP AusNet proposed to include the plural as well as the singular with regard to claims on the relevant insurance policy. Specifically, it proposed:

An insurance event:

An insurance event occurs if:

- (a) The DNSP makes a claim **or claims** on a relevant insurance policy; and [emphasis added]
- (b)

SP AusNet states that multiple claims are possible and present a risk scenario this protection is seeking to mitigate.²²

SP AusNet's proposal would introduce some practical difficulties. In particular, we consider that where there is a single claim (subject to the remaining conditions), it is clear that a pass through event has occurred. This provides SP AusNet with necessary clarity regarding the period with which it must submit a pass through application.²³ However, if the definition includes a reference to plural claims, the event's timing may be ambiguous. Further, SP AusNet has not explained why multiple claims will present a risk scenario. If there are multiple claims that meet the relevant definition, SP AusNet may submit multiple applications. Accordingly, we do not agree with SP AusNet's proposed amendment to the insurance event definition.

²¹ This is consistent with NEL, ss7, 7A.

²² SP AusNet submission to the Draft Decision, October 2012, p.7.

²³ NER, cl. 6.6.1(c).

Appendix A: Pass through events

Positive pass through

Cl. 6.6 .1 of National Electricity Rules specifies that:

(d) If the AER determines that a *positive change event* has occurred in respect of a statement under paragraph (c), the AER must determine:

- (1) the *approved pass through amount*; and
- (2) the amount of that *approved pass through amount* that should be passed through to *Distribution Network Users* in the *regulatory year* in which, and each *regulatory year* after that in which, the *positive change event* occurred,

taking into account the matters referred to in paragraph (j).

Relevant factors

(j) In making a determination under paragraph (d) or (g) in respect of a *Distribution Network Service Provider*, the AER must take into account:

- (1) the matters and proposals set out in any statement given to the AER by the *Distribution Network Service Provider* under paragraph (c) or (f); and
- (2) in the case of a *positive change event*, the increase in costs in the provision of *direct control services* that, as a result of the *positive change event*, the *Distribution Network Service Provider* has incurred and is likely to incur until:

(i) unless subparagraph(ii) applies – the end of the *regulatory control period* in which the *positive change event* occurred; or

(ii) if the distribution determination for the *regulatory control period* following that in which the *positive change event* occurred does not make any allowance for the recovery of that increase in costs – the end of the *regulatory control period* following that in which the *positive change event* occurred;

(2A) in the case of a *negative change event*, the costs in the provision of *direct control services* that, as a result of the *negative change event*, the *Distribution Network Service Provider* has saved and is likely to save until:

(i) unless subparagraph(ii) applies – the end of the *regulatory control period* in which the *negative change event* occurred;

(ii) if the distribution determination for the *regulatory control period* following that in which the *negative change event* occurred does not make any allowance for the pass through of those cost savings to *Distribution Network Users* – the end of the *regulatory control period* following that in which the *negative change event* occurred;

(3) in the case of a *positive change event*, the efficiency of the *Distribution Network Service Provider's* decisions and actions in relation to the risk of the *positive change event*, including whether the *Distribution Network Service Provider* has failed to take any action that could reasonably be taken to reduce the magnitude of the *eligible pass through amount* in respect of that *positive change event* and whether the *Distribution Network Service Provider* has taken or omitted to take any action where such action or omission has increased the magnitude of the amount in respect of that *positive change event*;

(4) the time cost of money based on the *allowed rate of return* for the *Distribution Network Service Provider* for the *regulatory control period* in which the *pass through event* occurred;

(5) the need to ensure that the *Distribution Network Service Provider* only recovers any actual or likely increment in costs under this paragraph (j) to the extent that such increment is solely as a consequence of a *pass through event*;

- (6) in the case of a *tax change event*, any change in the way another *tax* is calculated, or the removal or imposition of another *tax*, which, in the *AER's* opinion, is complementary to the *tax change event* concerned;
- (7) whether the costs of the *pass through event* have already been factored into the calculation of the *Distribution Network Service Provider's annual revenue requirement* for the *regulatory control period* in which the *pass through event* occurred or will be factored into the calculation of the *Distribution Network Service Provider's annual revenue requirement* for a subsequent *regulatory control period*;
- (7A) the extent to which the costs that the *Distribution Network Service Provider* has incurred and is likely to incur are the subject of a previous determination made by the *AER* under this clause 6.6.1; and
- (8) any other factors that the *AER* considers relevant.