MOOMBA TO ADELAIDE PIPELINE SYSTEM

PROPOSED ACCESS ARRANGEMENT UNDER THE NATIONAL ACCESS CODE

FINAL DECISION SUBMISSION #6 (FDS6) INSURANCE ISSUES

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1. Introduction

1.1 On 12 September 2001, the Australian Competition and Consumer Commission ("the Regulator") issued its Final Decision in relation to Epic Energy's proposed Access Arrangement for the Moomba to Adelaide Pipeline System ("MAPS").

1.2 In preparing and implementing an access arrangement for a gas transmission pipeline, consideration must be given to all aspects of the service provider's business. In consequence, access arrangement preparation and implementation is an extended process, particularly in the case of a first access arrangement under a new regulatory framework (such as is the case with the MAPS Access Arrangement). During the time in which it takes place, circumstances may change in ways which materially impact on the service provider's business interests, and on service delivery to pipeline users.

1.3 Once an access arrangement is approved, the service provider can, at any time, file a revised access arrangement to take account of changed circumstances. Consistent with this approach it is appropriate that, during a lengthy approval process, the service provider be permitted to update the elements of its proposed access arrangement. The ability to update avoids the need for an immediate refiling once approval occurs. To proceed otherwise would result in unnecessary costs being incurred by the service provider, users and the Regulator.

1.4 Epic Energy also submits that such an approach is consistent with the considerations, factors and principles to be taken into account by the Regulator under section 2.24 of the Code. Not only does it ensure that the legitimate business interests of the service provider and its investment in the pipeline are protected (by having an access arrangement approved based on up-to-date information, and by maximising the opportunity for regulatory certainty during the intended period of the access arrangement); it is also in the public interest, and in the interests of users and prospective users. The benefit of regulatory certainty outweighs the potential risks of higher tariffs (as would be the case as a result of either increased insurance premia, or the additional compensation that a service provider would seek in the event of having to self insure against additional risks).

1.5 In preparing the Access Arrangement for the MAPS, consideration was given to the risks associated with pipeline ownership and operation, and to the cost of insuring those risks. The Access Arrangement was developed on the assumption that, throughout the access arrangement period, Epic Energy would maintain the insurance cover it had previously held for the MAPS. The terms and conditions of access were then drafted on that assumption. That is, the risk weighting between the Service Provider and users reflected, in part, the insurance arrangements in place.

1.6 It is noted that the forecast non-capital costs, from which the MAPS reference tariff was determined, included an amount for insurance premia of about \$250,000 annually. These costs form part of forecast non-capital costs Epic Energy is seeking to recover pursuant to sections 8.36 and 8.37 of the Code.

That is, they are costs that a prudent service provider, acting efficiently and in accordance with good industry practice, would incur in providing a reference service.

1.7 It is also noted that in the Regulator's Final Decision, the forecast non-capital costs proposed by Epic Energy were considered to be reasonable when assessed against widely accepted industry benchmarks.[1]

1.8 As Epic Energy has advised the Regulator, at the end of the 2001 calendar year, key insurance policies expired and had to be renewed. The renewal of the insurance cover however, proved difficult, and costly given recent world events. On classes of insurance relevant to infrastructure assets:

- premia are now significantly higher than they were twelve months ago (when a majority of the policies were last renewed);
- cover is available on less desirable terms than was previously the case; and
- some risks are now much more difficult to insure.

1.9 As Epic Energy completed the renewal of its insurance arrangements before the MAPS Access Arrangement has been implemented, it is seeking changes in the Access Arrangement to reflect:

- changed perceptions of risk, particularly in relation to the threats of sabotage and terrorism;
- the increased costs of insurance; and
- the inability to secure cover for certain classes of risk.

1.10 Given the above, there are now:

- additional risks which now exist but which did not exist at the time that the access arrangement was originally lodged with the Regulator; and
- some additional risks for which insurance is either not available, or is available but at such a high cost that it would be unreasonable and imprudent for Epic Energy to obtain cover.

1.11 As a result, Epic Energy proposes to self insure against these risks.

1.12 Epic Energy considers that it must be compensated for the above changed circumstances (in particular the additional risks for which it must self insure against) over and above that which is proposed in the Regulator's final decision. That compensation should be reflected in the total revenue Epic Energy is allowed to earn for the services provided on the MAPS.

1.13 The circumstances prompting Epic Energy to propose further changes to the MAPS Access Arrangement in relation to insurance are discussed in this submission. Section 2 briefly examines the current state of insurance markets,

[1] Final Decision Access Arrangement proposed by Epic Energy South Australia Pty Ltd for the Moomba to Adelaide Pipeline System, 12 September 2001, page 58.

and section 3 outlines Epic Energy's recent experience in those markets. Section 4 sets out Epic Energy's proposal, and concludes the submission.

2. State of insurance markets

2.1 Epic Energy's brokers have advised that renewal of the company's insurance cover for the 2002 insurance period proved to be extremely difficult as a result of a number of specific events which occurred during 2001. These events were:

- the destruction of the World Trade Center in New York, on 11 September, which has led to reduced capacity, worldwide, in both the reinsurance and the direct insurance markets;
- difficulties experienced in renegotiation of direct underwriters' reinsurance treaties, many of which expired on 31 December 2001, because the extent of losses across all classes of insurance resulting from the attack on the World Trade Center have not yet been fully quantified;
- the Petrobras oil platform collapse and sinking off the Brazilian coast, and the Total Fina plant explosion in France, both of which caused significant losses to underwriters providing cover for energy infrastructure; and
- in Australia, the collapse of HIH Insurance.

2.2 Insurance markets are now responding to these events:

- premia are increasing for all classes of cover;
- there is reduced capacity, resulting in the rationing of cover for certain classes of risk; and
- there have been some insolvencies among insurers, more are expected, and businesses requiring insurance are now facing the need to obtain replacement cover.

2.3 The views of Epic Energy's brokers are supported by numerous, recent reports in the financial press on the current state of insurance markets. The *Australian Financial Review*, for example, reported on 21 January 2002, that insurance costs for businesses have risen by up to 100 per cent during the month.

2.4 The *Financial Review* also noted that the insurance industry was still negotiating with the Commonwealth Government over the issue of terrorism insurance:

"*The industry wants the Government to set up a system so businesses can be covered for terrorist attacks after reinsurers pulled out of the market at the beginning of the year*."[2]

2.5 Insurance cover for sabotage and terrorism has been (and continues to be) an important issue for Epic Energy, given that the strategic nature of its assets make them prime targets for such action.

[2] "Big firms face 100% increases in costs", Australian Financial Review, 21 January 2002, page 4.

3. Epic Energy's insurance cover

3.1 Epic Energy's insurance broker has negotiated for the company renewals for all of its industrial special risks and motor vehicle insurance cover, as well as its cover for non-owned aviation liabilities, marine transit, corporate travel, journey, public and products liability, directors and officers and professional indemnity. The policies that have been granted for the above risks involve significantly higher premia, higher deductibles and more onerous terms and conditions than was previously the case in 2001.

3.2 This section of this submission therefore provides specific examples of risks for which cover is either now available on significantly less desirable terms than was previously the case, or for which cover is proving difficult to secure. The next section of the submission outlines Epic Energy's proposal for dealing with these types of risks in the MAPS Access Arrangement.

Industrial Special Risks Cover (Property Damage Cover)

3.3 A key component of Epic Energy's insurance portfolio is a property (known as "industrial special risks") policy. It has, in previous years, provided cover of A$100 million for property damage and $150 million for business interruption losses.

3.4 The policy has generally used the standard industry wording, referred to as "Mark IV". However, in the policy secured for 2002, the following amendments have been made to the standard industry wording so as to tighten the terms and conditions of cover:

- the deductible aggregations that existed in previous years have been removed, and the low deductibles for burglary and personal effects have been deleted; and
- the sublimit for business interruption claims relating to a suppliers' premises has been reduced from $75 million to $25 million.

3.5 It should be noted that the policy has not provided for business interruption losses on the MAPS due to the nature of the existing contracts. Having said that however, this position may change should contracts securing the majority of the pipeline's capacity once these existing contracts end, adopt the terms and conditions of the access arrangement.

3.6 The most significant change to the level of cover offered is in respect of sabotage and terrorism. In previous years, the industrial special risks policy extended to cover acts of sabotage and terrorism. This will not be the case in 2002. Furthermore, Epic Energy's brokers have indicated that an industrial special risks policy is unlikely to provide cover for sabotage and terrorism in the remaining years of the access arrangement period. A separate policy of insurance would therefore need to be put in place for sabotage and terrorism risks if cover were to be maintained at 2001 levels.

3.7 Enquiries in the London market produced an indication of cover for property damage as a result of an act of sabotage or terrorism (but not for business interruption, for which, as noted above, Epic Energy currently has a $150 million limit for its assets other than the MAPS) at a sharply increased premium, and without a copy of the policy wording. Inclusion of sabotage and terrorism cover for business interruption risk was expected to further raise the premium.

3.8 Epic Energy's broker has now indicated that even with a substantially reduced limit for property damage and business interruption, the premium will not be significantly reduced.

3.9 Furthermore, current indications are that the policy wording would be substantially different from that which applied under the comparable provisions of Epic Energy's previous industrial special risks policy in 2001. The main differences relate to the ambiguous definition of an act of terrorism, the broadening of the exclusions clauses, and the tightening of the clauses relating to onus of proof.

3.10 The definition of an act of terrorism is now limited to include "*an act, including the:*

- *use of force or violence … committed for political, religious or ideological purposes;*
- *intention to influence any government and/or to put the public in fear".*

However, the phrase "*political, religious or ideological purposes*" in itself is not defined. Given recent events, this wording could prove significant.

3.11 Some examples of the broadening of the exclusions clauses are as follows. Protection will not be afforded against loss or damage:

- caused by seizure or illegal occupation;
- caused by confiscation or any order of public or government authority which deprives Epic Energy of the use or value of its property;
- arising indirectly or directly from the discharge of pollutants or contaminants which includes contaminants of a toxic or hazardous substance which endangers or threatens to endanger the health, safety or welfare of persons or the environment;
- caused by chemical or biological release or exposure of any kind (this would cover such instances as anthrax outbreaks); or
- caused by attacks by electronic means (e.g. by computer hacking or viruses).

3.12 Examples of how the insured now has a heavier burden of proof are as follows:

- notification to the broker/underwriter within 72 hours of knowledge of the occurrence of an event for which there is insurance cover;
- signed/sworn proof of loss within 60 days after occurrence of loss (unless this period is extended by the underwriter's written agreement);

- the insured must prove that none of the policy limitation/exclusions apply; and
- the insured must prove the quantum of loss.

4. Epic Energy's proposal

4.1 As mentioned above, both the level of insurance cover that can be provided for the MAPS, and the cost of providing that cover, are now substantially different from those in previous years, and substantially different from those assumed for development of the MAPS Access Arrangement.

4.2 Consideration must be given to the fact that cover for some risks is either not now available, or is only available on terms and at a cost for which it would be imprudent or unreasonable for Epic Energy to effect a policy of insurance. The way in which Epic Energy proposes to deal with these issues in the MAPS Access Arrangement is set out in this section of this submission.

4.3 As a preliminary matter, Epic Energy is of the view that it is reasonable for it to make provision for risks such as sabotage and terrorism because:

- such risks were able to be insured against in previous years, and earlier forecasts of the costs have been accepted by the Regulator as part of the Service Provider's non-capital costs; and
- acts of sabotage and terrorism are now perceived to be a greater risk than in previous years, and a prudent pipeline operator would insure against such risk if an acceptable policy and premium could be obtained.

4.4 Epic Energy understands that most risks are ultimately insurable. However, the costs of insuring some risks may be so high that it would not be prudent to obtain cover in the market. This is a particular issue for a pipeline service provider which can include in the non-capital costs of an access arrangement only those costs which would be incurred by a prudent service provider, acting efficiently, in accordance with accepted and good industry practice, and to achieve the lowest sustainable cost of delivering a reference service (Code, section 8.37). Good industry practice includes not obtaining cover when less well defined risks can only be insured at prices which involve payment of substantial contingency margins to insurers.

4.5 Epic Energy is therefore proposing to:

- leave the amount allowed for insurance in the non-capital costs of the MAPS Access Arrangement unchanged (at approximately $250,000 per annum);
- seek similar insurance cover to that which it had previously, even though risks have increased and higher premia are now being sought by insurers for reduced levels of cover;
- self insure for those risks for which insurance is now significantly more costly and cannot be obtained within the current allowance in the forecast non-capital costs; and
- self insure for those risks for which cover is now difficult to obtain given current conditions in insurance markets.

4.6 Those risks which are now significantly more costly to insure include the risks of sabotage and terrorism. Epic Energy proposes to self insure for sabotage and terrorism to the extent that its required level of cover can no longer be obtained with the provision for insurance included in the non-capital costs of the MAPS Access Arrangement.

4.7 Epic Energy is of the view that a prudent service provider would self insure rather than incur the additional costs of obtaining cover against the risks of sabotage and terrorism through the insurance market. This view is supported by recent experience in the London market. Epic Energy's brokers have indicated a take-up rate, by their energy and utility industry clients, of only about 15% for the more costly sabotage and terrorism insurance now available, a cover which even then, does not provide complete coverage.

4.8 Due to the recent and widespread change in the insurance market as a result of such events as September 11, 2001, no accepted regulatory approach has been developed (as far as Epic Energy is aware) as to the appropriate mechanism to be used to compensate a service provider for this additional self insurance.

4.9 However, the risks for which insurance cover is now either significantly more costly, or more difficult to obtain in current market conditions, are not, at present, risks measured by the asset betas which have been used in determining costs of capital for gas transmission pipelines. Furthermore, whether they are diversifiable risks, or whether they are non-diversifiable and hence should be reflected in beta, is not entirely clear. At least a part of these risks may, in the future, be found to be non-diversifiable because, for example, acts of terrorism have the effect of depressing the level of activity throughout the economy. For the present, although they are clearly risks which will have an adverse impact on the entire business of a service provider if they materialize, the risks for which insurance cover is now either significantly more costly, or more difficult to obtain in current market conditions, are best characterized as asymmetric, diversifiable risks.

4.10 Compensation for these asymmetric, diversifiable risks could be via the use of higher non-capital costs in the determination of the MAPS reference tariff. Quantification of the cost increase is, however, difficult given the current practice of insurers either not to cover particular risks, or to quote cover for more restricted sets of risk events than was previously the case. Given the uncertainty in the costs of insurance, Epic Energy proposes following normal commercial practice and allowing for the additional risk by including an asymmetric risk premium in the rate of return on equity used in determining the MAPS reference tariff, rather than by increasing the forecast non-capital costs for the Pipeline.

4.11 This is, at least in part, consistent with the approach recommended by the Regulator in its Final Decision for the Victorian Gas Transmission Access Arrangements, and in its Final Decision in respect of the Access Arrangement for the Central West Pipeline.

4.12 In its decision on the Victorian Access Arrangements, the Regulator:

- recognised the issue of risks which were excessively costly to insure, or for which cover was difficult to obtain (and referred to these as "potentially insurable risks");
- acknowledged that potentially insurable risks were difficult to quantify; and
- proposed that, were it appropriate to do so, such risks be taken account by making an adjustment through the rate of return on equity.[3]

4.13 In its Final Decision for the Access Arrangement for the Central West Pipeline, the Regulator:

- again recognised that there were risks against which a service provider might self insure (but noted that a business would normally be expected to take out appropriate insurance to reduce these risks to a manageable level, that the costs of this insurance would be included in the determination of total revenue, and that this would reduce the need for a specific self insurance allowance);
- reiterated the difficulty of identifying and quantifying the risks for which self insurance was sought; and
- proposed accommodation of those risks exacerbated by systematic influences and against which the service provider sought to self insure through a higher rate return on equity.[4]

4.14 In the cases of the Victorian Gas Transmission System and the Central West Pipeline, the Regulator recognised risks against which the service provider sought to self insure, and provided compensation through a higher rate of return on equity delivered via a higher asset beta. Epic Energy concurs with the Regulator's approach, but is concerned that it is compromised by the difficulty of quantifying, with any degree of credibility, the required increase in the asset beta. Furthermore, Epic Energy is not, at this time, convinced that the risks against which it is seeking to self insure are the non-diversifiable risks captured by beta. In these circumstances, the better approach is compensation through a rate of return on equity determined as the sum of the return obtained from the Capital Asset Pricing Model and an appropriate asymmetric risk premium.

4.15 During 2001, and especially after the events of 11 September, the risks of sabotage, terrorism and similar activities have increased. These risks are even more real for public utility infrastructure. Epic Energy has worked with its insurance broker to identify the additional risks which now exist but which did not exist at the time the Access Arrangement for the MAPS was originally lodged with the Regulator. Epic Energy has also worked with its broker to ascertain the extent of those risks for which insurance is not available, or is

[3] Final Decision Access Arrangement by Transmission Pipelines Australia Pty Ltd and Transmission Pipelines Australia (Assets) Pty Ltd for the Principal Transmission System, Access Arrangement by Transmission Pipelines Australia Pty Ltd and Transmission Pipelines Australia (Assets) Pty Ltd for the Western Transmission System, and Access Arrangement by Victorian Energy Networks Corporation for the Principal Transmission System, 6 October 1998, page 60.

[4] Final Decision Access Arrangement by AGL Pipelines (NSW) Pty Ltd for the Central West Pipeline, 30 June 2000, page 30.

available but at such a high cost that it would be unreasonable or imprudent to obtain cover. The extent of the risks in each of these two classes was discussed in section 3 of this submission.

4.16 Enquiries have been made in the London market for the particular case of insurance cover for sabotage and terrorism. Indications are that such cover is available but at a substantially increased premium, and on restricted terms and conditions. The premium for restricted sabotage and terrorism cover could be in the order of $500,000, an amount nearly double the premium Epic Energy must now pay for industrial and special risks cover (excluding cover for risks associated with sabotage and terrorism).

4.17 On the basis of the (largely qualitative) information it has on the risks for which insurance is not available, or which is available but at such a high cost that it would be unreasonable or imprudent to obtain cover, and from discussions it has held with its insurance broker and with other parties concerned with this issue, Epic Energy has concluded that an appropriate asymmetric risk premium for self insurance is at least 0.6%. Epic Energy proposes increasing the rate of return on equity used in determining the total revenue, and hence the reference tariff, for the MAPS, by at least 0.6% to compensate for risks for which insurance is not now available, or is available but at such a high cost that it would be unreasonable or imprudent to obtain cover.