



Final guidance note

Guidance note on insurance coverage pass through events

July 2021

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Overview

This final guidance note sets out the Australian Energy Regulator's (AER) expectations about the types of information that should be kept by a Network Service Provider (NSP), and the related processes that should be adopted by the NSP, to facilitate our assessment of a cost pass through application for an insurance coverage event. The insurance coverage pass through event covers general insurance liability risks that an NSP faces, including bushfire risks.

The information proposed in this final guidance note is informed by feedback from stakeholders in response to our Consultation Paper and draft guidance note.

This guidance applies to both electricity and gas, distribution and transmission NSPs.¹ It is intended to help guide electricity and gas NSPs on where our attention would likely be directed to when asked to assess whether an NSP is prudent and efficient in obtaining a given level of insurance cover in the context of an insurance coverage pass through event application. It may be revised over time in light of subsequent experience.

The guidance is intended to assist NSPs by providing guidance on the principles that will influence our assessment of insurance coverage pass through event applications. It outlines six information areas that we view as relevant to assessing whether a NSP has exhausted all reasonable commercial avenues, chosen the most efficient option based on its individual operating environment, and strived to achieve the best allocation of risk with its end users. Some of these include ongoing management of insured risks, including bushfires, and what levels of insurance cover (including associated trade-offs) are consistent with what a prudent and efficient NSP would do. This final guidance takes into account recent changes to conditions in international and domestic insurance liability markets.

The guidance recognises the starting premise that an NSP is responsible for managing its risks, including potential risks associated with catastrophic bushfire and storm events. The guidance provides greater clarity to both the NSPs and energy customers about the cost pass through process.

The principles underlying this guidance rely on established energy regulatory frameworks and good corporate governance and practices. It is not expected to impose additional burden on a NSP above what a prudent and efficient NSP would normally do to manage risks associated with infrequent but high impact events.

¹ NER, cl. 6.5.10(a); 6A.6.9(a); similar arrangements exist for gas network service providers as detailed in the AER's Access Arrangement Guideline March 2009 under the National Gas Law and National Gas Rules framework.

Background

Under the National Electricity Rules (NER), a NSP may propose a nominated pass through event in its revenue proposal.² We must then assess any such proposals and determine whether to accept them. In doing so, under the NER, we must take into account:

- Whether the event is covered by another category of pass through events³
- Whether the nature or type of event can be clearly identified at the time the AER makes its determination
- Whether a prudent NSP could prevent or substantially mitigate the cost impact of the event
- Whether the service provider could insure against the event.⁴

Similar arrangements exist for gas network service providers as detailed in our Access Arrangement Guideline March 2009 under the National Gas Law and National Gas Rules framework.⁵

In the past, we have accepted insurance cap pass through events as nominated pass through events. An insurance cap pass through event allows a NSP to recover material costs that are incurred above its insurance policy limit. In recent decisions,⁶ we renamed the insurance cap event to an insurance coverage event for reasons outlined below. This final guidance note applies to both.

Our acceptance of these events as pass through events is consistent with the Australian Energy Market Commission's (AEMC) final decision on pass through arrangements for NSPs where it stated that the purpose of nominated pass through events is to provide NSPs the opportunity to recover their efficient costs in those limited circumstances where insurance is limited or not available on commercial terms and self-insurance is not appropriate. The AEMC stated that this should be limited to instances where efficient costs are incurred because unforeseen costs arise as a result of events outside a NSP's control.⁷

² NER, cl. 6.5.10(a); 6A.6.9(a).

³ We note that, for transmission networks, there may be a degree of overlap between the prescribed "insurance event" and the insurance coverage (or cap) events that we have accepted as nominated pass through events. We consider there is merit in including the insurance coverage (or cap) pass through event for transmission networks to ensure consistency across the sector and to provide clarity to the industry.

⁴ NER, cl 6.5.10; 6A.6.9 and chapter 10.

⁵ AER, *Access Arrangement Guidelines – section 6.1.3*, March 2009, p. 77; NGR, r. 97.

⁶ AER, *Final Decision – SA Power Networks distribution determination 2020–25 – Attachment 14 – pass through events*, June 2020; AER, *Final Decision – Energex distribution determination 2020–25 – Attachment 14 – pass through events*, June 2020; AER, *Final Decision – Energy Queensland distribution determination 2020–25 – Attachment 14 – pass through events*, June 2020; AER, *Draft Decision – CitiPower 2021–26 – Attachment 15 – pass through events*, September 2020; AER, *Draft Decision – Powercor 2021–26 – Attachment 15 – pass through events*, September 2020; AER, *Draft Decision – United Energy 2021–26 – Attachment 15 – pass through events*, September 2020; AER, *Draft Decision – Jemena 2021–26 – Attachment 15 – pass through events*, September 2020; AER, *Draft Decision – AusNet Services 2021–26 – Attachment 15 – pass through events*, September 2020.

⁷ AEMC 2012, *Cost pass through arrangements for Network Service Providers, Rule Determination*, 2 August 2012.

If an insurance cap pass through event occurs, and a NSP makes a pass through application, the AER commences its assessment process. We must determine the amount the NSP can recover from consumers via the NSP's charges for regulated services. In undertaking this assessment, we must take into account a variety of matters under the NER, including the following:

- Any matters or proposals set out by the NSP
- The change in costs that has occurred, or is likely to occur, as a result of the event
- The efficiency of the NSP's actions in relation to the risk of the event occurring, including the actions taken, or not taken, by the NSP to reduce the magnitude of the costs
- The need to ensure the NSP only recovers any actual or likely incremental costs as a result of the event
- Whether the costs have been, or will be, factored into the NSP's annual revenue requirement
- Any other factors that the AER consider relevant.⁸ In most (if not all) cases, we are likely to consider that the prudence and efficiency (or otherwise) of the NSP's actions in response to the event is a relevant factor.

The insurance cap pass through event definitions that are currently in a number of NSPs' determinations also note that we will have regard to, amongst other things:

- The relevant insurance policy for the event
- The level of insurance that an efficient and prudent NSP would obtain in respect of the event.

In the 2020–25 Final Determinations for the South Australian and Queensland distributors and the 2021–26 Final Determinations for the Victorian distributors, we took changing insurance market conditions into account. In particular, we took into account changing conditions following bushfire events in Australia and overseas that resulted in bushfire insurance coverage becoming more expensive and difficult to procure. We refined the pass through definition to allow for potential gaps in a NSP's insurance coverage that may occur if it is unable to find suitable insurance providers to fill withdrawn capacity, or if it cannot economically justify higher premiums. At the same time, we sought to preserve appropriate pass through event incentives under a normal operating environment. As a result, the broader coverage of the amended definition applies only under what we defined as 'changed circumstances' where there are movements in the relevant insurance liability market that are beyond the control of a NSP, and those movements mean that it is no longer possible for a NSP to take out an insurance policy or set of insurance policies at all, or on reasonable commercial terms.

These determinations also updated the name of the pass through event. The change from 'insurance cap event' to 'insurance coverage event' recognises that in the future, pass through event applications may relate to costs incurred as a result of potential insurance gaps where a NSP has not been able to efficiently purchase insurance.

In this final guidance note, we have used the term insurance coverage pass through event to include both insurance cap events and insurance coverage events.

⁸ NER cl 6.6.1(j); 6A.7.3(j).

AER guidance

The decision to develop this guidance stemmed from initial representations from a number of NSPs that considered it would be beneficial to provide the broader industry with greater clarity and guidance around the matters we are likely to have regard to in assessing an insurance coverage pass through event. This is particularly the case given we have not had to assess such a pass through event in the past. We agree that there is a need for the regulatory process surrounding an insurance coverage application, including the matters we will have regard to and our assessment approach, to be clear and predictable given the potential material impacts that affect NSPs and energy customers. This is the purpose of this guidance note. This final guidance note follows on from our Consultation Paper and draft guidance note.

1. Stakeholder views from draft guidance note

We received seven submissions in response to our draft guidance note, four from NSPs,⁹ one from a retailer,¹⁰ one from an industry body and one from a public interest advocacy centre. These are summarised in Appendix A. The key themes from these submissions were as follows:

- Submissions were in general agreement with the six information areas outlined in our draft guidance note.¹¹
- Some submissions from NSPs cautioned against placing unrealistic expectations on the modelling or cost benefit analysis¹² required by the NSP to support its cost pass through application.
- Similar to the views outlined in our draft guidance note, there were mixed views from all stakeholders on the practicality of customer engagement around insurance coverage.¹³
- All submissions from NSPs agreed with our position that there would be limited value in establishing an annual information process.¹⁴ One of these submission noted that early engagement with the AER would be appropriate if there are significant shifts in insurance policies and to ensure a 'no surprises' approach.¹⁵

⁹ CitiPower, United Energy, Powercor and SA Power Networks provided a combined submission.

¹⁰ Red and Lumo Energy provided a combined submission.

¹¹ AusNet Services, *Response on Draft Insurance Guideline*, April 2021, p. 1; Ausgrid, *AER insurance coverage draft guidance*, April 2021, pp. 3–4; CitiPower, Powercor, United Energy and SA Power Networks, *Submission to the insurance coverage pass-through event draft decision*, April 2021, p. 1; Energy Networks Australia, *AER Draft Guidance Note - Insurance coverage pass through events*, April 2021, p. 1; Energy Queensland, *Insurance coverage pass through event guidance note*, April 2021, p. 1; Public Interest Advocacy Centre, *Submission to AER insurance pass through guidance*, April 2021, pp. 2–4.

¹² CitiPower, Powercor, United Energy and SA Power Networks, *Submission to the insurance coverage pass-through event draft decision*, April 2021, p. 1; AusNet Services, *Response on Draft Insurance Guideline*, April 2021, p. 1.

¹³ Red and Lumo Energy, *AER draft Guidance Note on cost pass through on insurance coverage pass through events*, April 2021, p. 2; AusNet Services, *Response on Draft Insurance Guideline*, April 2021, p. 1; Ausgrid, *AER insurance coverage draft guidance*, April 2021, p. 4; CitiPower, Powercor, United Energy and SA Power Networks, *Submission to the insurance coverage pass-through event draft decision*, April 2021, p. 1; Energy Networks Australia, *AER Draft Guidance Note - Insurance coverage pass through events*, April 2021, p. 1; Energy Queensland, *Insurance coverage pass through event guidance note*, April 2021, p. 1; Public Interest Advocacy Centre, *Submission to AER insurance pass through guidance*, April 2021, pp. 2–3.

¹⁴ Ausgrid, *AER insurance coverage draft guidance*, April 2021, p. 1; CitiPower, Powercor, United Energy and SA Power Networks, *Submission to the insurance coverage pass-through event draft decision*, April 2021, p. 2; Energy Networks Australia, *AER Draft Guidance Note - Insurance coverage pass through events*, April 2021, p. 2; Energy Queensland, *Insurance coverage pass through event guidance note*, April 2021, p. 1.

¹⁵ CitiPower, Powercor, United Energy and SA Power Networks, *Submission to the insurance coverage pass-through event draft decision*, April 2021, p. 2.

- Three submissions supported our position that benchmarking of insurance costs and coverage is not practical, due to individual operating and structural differences as well as the bespoke nature of the liability cover.¹⁶

We have taken these submissions and the information received into account in refining the key matters that we are likely to have regard to when assessing an insurance coverage pass through event. This is in addition to the submissions and information provided in response to the Consultation Paper which have also informed this final guidance note.¹⁷

2. Proposed guiding principles

The proposed guiding principles set out below facilitate greater clarity in our assessment of whether an NSP has acted prudently and efficiently in its actions leading to an insurance coverage pass through event. These are drawn from:

- The policy issues identified by the AEMC at the time it amended the NER to allow for the inclusion of nominated pass through events in revenue determinations;¹⁸ and
- Best practice corporate governance processes that should already be operating within an NSP. These corporate governance processes are expected to be robust and well documented, to support the claim that an NSP has carefully followed its processes (e.g. complying with its risk management policies and strategies) and has a clear rationale in circumstances where it has to depart from them (e.g. explanations on why changes have been made to the allocation of risk between itself and customers and evidence of this being considered by decision makers).

At a high level, the policy issues identified by the AEMC in relation to a cost pass through event include:

1. Efficient allocation of risks between NSPs and end consumers: We agree with the AEMC that NSPs are best placed to manage these risks, having to constantly address them through commercial and self-insurance decisions, mitigation efforts and in extreme circumstances, the need to share some of these risks with consumers. Consistent with this view, we would expect our assessment to consider to what degree the NSP has considered and achieved this and can demonstrate it has arrived at an efficient trade-off between the NSP mitigating its risk through commercial (level of coverage) and/or self-insurance, and end consumers bearing the risk over and above the insurance premiums paid by, or offered to, NSPs.
2. Recovery of efficient costs: Our view is that NSPs should seek, in the first instance, to determine the optimal, most efficient and least cost, way to manage their risks through commercial, and/or self-insurance in combination with other mitigation activities. We would expect our assessment to consider the analysis that the NSPs have undertaken to evaluate the various options available in order to determine the particular insurance structure that provides the least cost option relative to the chosen level of insurance cover and the reasons for any departure from that outcome.

¹⁶ CitiPower, Powercor, United Energy and SA Power Networks, *Submission to the insurance coverage pass-through event draft decision*, April 2021, p. 2; Energy Networks Australia, *AER Draft Guidance Note - Insurance coverage pass through events*, April 2021, p. 2; Energy Queensland, *Insurance coverage pass through event guidance note*, April 2021, p. 1.

¹⁷ See AER, *Draft Guidance Note, Guidance note on insurance coverage pass through events*, February 2021 for full details of the submissions received in relation to the Consultation Paper and how they were taken into account.

¹⁸ AEMC 2012, *Cost pass through arrangements for Network Service Providers, Rule Determination*, 2 August 2012.

3. The extent to which the events are unexpected and outside of the NSPs control: Our view is that NSPs should seek to manage those risks which are within their control and use commercial or self-insurance (e.g. deductible level) for low probability, high severity events beyond their control. We would expect our assessment to consider details of the NSP's ongoing risk management framework, how it is capturing, assessing and responding to changing low probability, high consequence risks and how this has been used to inform a NSPs commercial and self-insurance coverage choices. This may include supporting evidence that the NSP has been taking actions to avoid or mitigate the impact of the event, to the extent possible, such as relevant operating and capital expenditure initiatives. Furthermore, we would consider whether the NSP meets mandatory bushfire-risk standards and requirements (such as those set up by jurisdictional regulators).

In its submission to the draft guidance note, the Public Interest Advocacy Centre raised the possibility of an additional guiding principle requiring NSPs to demonstrate how they have determined and employed the optimal balance between spending to prevent or mitigate the impact of extreme weather events and accepting they might occur and passing through the costs to consumers.¹⁹ We consider that such factors are an aspect of the first guiding principle above – the efficient allocation of risks between NSPs and end consumers. We would take into account, amongst other things, whether the business' actions were consistent with achieving an appropriate balance between spending to prevent or mitigate the impact of extreme weather events and accepting they might occur and potentially passing through the costs to consumers.

Having regard to these matters, our views on the types of information and documentation that NSPs should keep, and about the processes that NSPs should adopt, are set out below.

Taking into account the discussion in our Consultation Paper, draft guidance note and our guiding principles as set out above, we have refined our guidance on key matters and information that we are likely to have regard to when assessing an insurance coverage pass through event.

3. Proposed information that should be provided by the NSP

We anticipate that insurance coverage cost pass through applications will need to be considered on a case by case basis. However, our view is that the information set out below should be a part of NSPs ongoing business considerations and as far as possible be included in any insurance coverage pass through event applications to assist us in making our decision.

It is important to note that no single factor will determine the outcome of our assessment. Amongst other things, and as noted by CitiPower, Powercor and United Energy, there is little uniformity between NSPs.²⁰ We view the information set out below as relevant to assessing whether a NSP has exhausted all reasonable commercial avenues, chosen the most efficient option based on its individual operating environment, and strived to achieve the best allocation of risk with its end users.

¹⁹ Public Interest Advocacy Centre, *Submission to AER insurance pass through guidance*, April 2021, pp. 1–2.

²⁰ CitiPower Powercor United Energy, *submission to AER consultation on insurance coverage pass-through event*, October 2020, p. 1.

3.1. Historical information and market conditions prior to the event

The purpose of this category of information is for us to understand whether there have been significant changes to an NSP's insurance policy and the rationale for these movements. Further, understanding the prevailing insurance market conditions prior to the occurrence of the cost pass through event will assist in explaining the level and structure of insurance that the NSP had in place at the time the cost pass through event occurred.

Under the current definition of the insurance coverage pass through event, there may also be instances in which we need to be satisfied that there have been 'changed circumstances'.

Information evidencing 'changed circumstances' would include the following:

- If there have been material shifts in a NSP's historical insurance structure such as premiums costs or coverage levels, details of these movements and their key drivers. This would include historical details of any coverage that the NSP no longer obtains, including details of the premium costs offered but deemed inefficient, and details of where, and to what extent coverage that the NSP previously obtained was no longer offered at all.
- If the NSP has incurred historical high severity, low probability losses and claims, supporting evidence to show that identification of the root causes and contributing factors for the occurrence have been identified, how they have been addressed and their impact on insurance premiums.
- A report from the NSP's insurance broker that accurately details the market conditions (such as the level capacity and premium trends) prevailing at the time of the NSP's insurance renewal that is relevant to the year the cost pass through event occurred.
- If there have been material changes in the insurance liability market, NSPs should also consider obtaining an independent review to show how such changes have affected the NSP's coverage and risks.

In the event that NSPs make material changes to their insurance policy or level of coverage that may not be related to market conditions, such information should also be provided along with the reasons for these changes. We would also see value in NSPs providing information on key parameters (such as total premiums, deductible levels and coverage limits) at the start of the regulatory period to serve as a comparison point on how the insurance market may have changed from the NSP's expectations.

3.2. Modelling analysis of possible losses from insured events

The purpose of this category of information is to demonstrate that the NSP has undertaken the relevant options and quantitative analysis that we would expect a prudent NSP to undertake as part of understanding its risk exposure and choice of insurance policy, including the level of coverage. This represents the analysis and information that would support a NSP's application that it has acted prudently and efficiently in respect of the event.

The information that we expect NSPs to provide includes:

- Supporting documentation demonstrating that appropriate risk exposure calculations, such as maximum foreseeable or probable loss assessments, have been carried out. This should include methodology, assumptions and data sets applied in the analysis. Within the context of a hardening insurance liability market, NSPs are encouraged to overlay additional quantitative analysis (for example, weather patterns, location of assets and impacts of bushfire events in other jurisdictions or countries and liabilities of NSPs following these events) to ascertain trade-offs and risk return periods²¹.

²¹ Risk return period is an average time or an estimated average time between events.

- Supporting documentation demonstrating that appropriate financial stress testing (loss scenarios) has been conducted in order to establish a NSP's risk tolerance level. A NSP should outline the methodology used to test the loss scenarios (e.g. Monte Carlo simulations) and explain how risk tolerance levels are linked to its business characteristics (e.g. its financial position).
- Supporting evidence demonstrating that the NSP has calculated and considered the relevant return periods and probability of exceedance²² for potential limits in its selected insurance structure.

3.3. Risk mitigation considerations and actions

The purpose of this category of information is to demonstrate that a NSP has undertaken adequate levels of risk mitigation actions and measures to manage its overall risks with bushfires. We would expect to see information about risk mitigation planning and risk controls. This would demonstrate that, where reasonably possible, mitigations and controls are in place and effective. We also expect to see, in relation to incidents that have actually already occurred, evidence of how the NSP has implemented its risk mitigation policies and procedures. We would also expect to see evidence that, in response to such incidents, additional improvements (including to those policies and procedures) have been considered and / or implemented. For example, as proposed by Ausgrid,²³ this could include information related to a bushfire preparedness program, relevant vegetation management actions and other any technical solutions.

3.4. Customer engagement

The purpose of this category of information is to demonstrate that the NSP has undertaken sufficient targeted effort to familiarise and educate its consumers as far as reasonably possible, and to understand its consumer's preferences (at least at a high level). This is consistent with the need for an NSP to show that its choice for a certain insurance coverage represents an efficient allocation of risks between itself and its customers. One example of this type of customer engagement was AusNet Services' decision to increase its deductible from \$10 million to \$25 million based on customer preferences in order to keep ongoing costs low, with the trade-off being that costs would be higher if an event occurred.²⁴

The information that we expect NSPs to provide includes supporting documentation that demonstrates how the potential customer impacts from cost pass throughs have been considered. This may include the questions put to customers, including stress testing loss scenarios and measuring the bill impact on end consumers, and customer preferences in response to these questions.

In response to our Consultation Paper²⁵ and draft guidance note²⁶ there was some support for customer engagement but also mixed responses in relation to the practicality of undertaking customer engagement. In particular, concerns were raised around the difficulty in having meaningful discussions with consumers on a topic that is highly technical and

²² Probability of exceedance refers to the probability that a certain limit will be exceeded.

²³ Ausgrid, *AER insurance coverage consultation*, October 2020, p.7.

²⁴ AusNet Services, *2021–26 Revised Regulatory Proposal*, December 2020, pp. 88-89.

²⁵ AusNet Services, *AST Response on Insurance Guideline*, October 2020; ENA, *AER insurance coverage pass through event guidance note*, October 2020; Endeavour Energy, *Submission to AER on insurance guidance note*, October 2020; CitiPower Powercor United Energy, *submission to AER consultation on insurance coverage pass-through event*, October 2020.

²⁶ Red and Lumo Energy, *AER draft Guidance Note on cost pass through on insurance coverage pass through events*, April 2021, p. 2; AusNet Services, *Response on Draft Insurance Guideline*, April 2021, p. 1; Ausgrid, *AER insurance coverage draft guidance*, April 2021, p. 4; CitiPower, Powercor, United Energy and SA Power Networks, *Submission to the insurance coverage pass-through event draft decision*, April 2021, p. 1; Energy Networks Australia, *AER Draft Guidance Note - Insurance coverage pass through events*, April 2021, p. 1; Energy Queensland, *Insurance coverage pass through event guidance note*, April 2021, p. 1; Public Interest Advocacy Centre, *Submission to AER insurance pass through guidance*, April 2021, pp. 2–3.

confidential in nature. While we agree, and appreciate, that some information is commercially sensitive, we are also of the view that NSPs could use the opportunity to have discussions that aim to educate its customers or stakeholders on the detailed issues related to insurance coverage. This will enable consumers to provide input on the high level risk and benefit trade-offs that the NSP is considering as part of its insurance policy and coverage decisions. Such discussions could be undertaken during the reset process, or when there are material changes in the insurance market.

3.5. Appropriateness of cover, structure and premiums

This category of information has two purposes. Firstly, to understand the information and the decision making process that the NSP has undertaken in arriving at its insurance coverage. Secondly, to provide confidence and evidence that the chosen cover reflects the decisions a prudent and efficient NSP would make given its operating environment. We expect the NSP to provide documentation which sets out the rationale and decision of the NSP to purchase (or not purchase) a particular insurance cover. It should also demonstrate how all of the above information has been taken into account to reach a decision about the appropriate insurance coverage, structure and premiums.

In our Consultation Paper we raised the concept of the least cost option and that NSPs are expected to determine the optimal and least cost approach to manage their risks through commercial and/or self-insurance.²⁷ At this stage, our view is that NSPs should not be required to choose the least cost option in order to satisfy the cost pass through assessment, rather it should be clear that an NSP has considered this option and if it has chosen to depart from it, then appropriate justification is provided. Evoenergy gave the example in its submission that the least cost option may not be appropriate as low cost insurers are more likely to refuse payout or have unreasonable restriction terms, and therefore the least cost option may not reflect prudent insurance coverage decisions.²⁸

The information that we expect NSPs to provide includes:

- Ideally, an independent report or certification from an insurance expert that the NSP's insurance cover is appropriate based on its operating environment and risk tolerance levels. We note that some submissions raised concerns that a mandatory review from an insurance expert is not practical due to the confidential nature of the process,²⁹ and may compromise the competitive market process.³⁰ While we acknowledge that the level of cover, structure and premium is essentially a Board decision, we consider that, at a minimum, the NSP's insurance broker should provide information about the reasonableness of the NSP's insurance policy based on the market conditions at the time (such as a reasonable range that would allow the board to exercise its discretion). The NSP's insurance brokers report should be at a level of detail that is capable of being reviewed by an independent expert³¹ should we decide to do so at the time of the pass through event application. We also acknowledge that detailed independent analysis may not necessarily be sought annually but rather in years when there are material changes to the insurance market.³²

²⁷ AER, *Insurance coverage pass through event consultation paper*, August 2020, p.9.

²⁸ Evoenergy, *Submission to AER on Insurance Guidance Note*, October 2020, p. 10.

²⁹ SA Power Networks, *Submission on Insurance Coverage Pass Through Event*, October 2020, p. 7–8.

³⁰ CitiPower Powercor and United Energy, *Submission to the AER consultation on insurance coverage pass-through event*, October 2020, p.1.

³¹ The independent expert report would be confidential.

³² AusNet Services, *Response on Draft Insurance Guideline*, April 2021, p. 2.

- Evidence demonstrating that viable alternative insurance coverage options have been considered or implemented by the NSP. For example some of the types of information that could be provided include, using a captive or protected cell company as proposed in one of the submissions,³³ seeking coverage through an aggregated structure, and exploring access to capacity in other insurance markets.

We note the comments raised in submissions to the draft guidance note that some of the detailed analysis required under this category of information may be unrealistic. In particular, these submissions noted that such analysis is usually undertaken by insurers, rather than by NSPs, and that NSPs do not have the actuarial capabilities that would enable them to undertake such analysis. These submissions cautioned against having expectations about the existence of such information that are too high.³⁴ We recognise that NSPs may not have the capabilities internally to undertake the full spectrum of all the numerical analysis set out above. However, we would still expect them to undertake or commission sufficient analysis (e.g. from its insurance brokers or other specialist advisers) to gain an understanding of the material issues to arrive at its decision on its insurance coverage.

Some submissions explained that as NSPs are price takers in the insurance market, detailed modelling analysis of numerous options is unlikely to be possible³⁵ and cautioned against the expectations regarding the availability of detailed cost benefit analysis.³⁶ Our expectations are that NSPs should provide information on the options assessed, including the level of detail that is required for its decision makers to be sufficiently informed. We acknowledge that this may differ between NSPs and in different market conditions.

3.6. Corporate and risk governance

The purpose of this category of information is to understand the NSP's overarching corporate governance and risk management framework. This will enable us to assess whether the NSP has appropriate processes in place that are utilised to review and manage insurance liability exposure. This will assist an NSP in demonstrating that, consistent with the AEMC's policy approach to nominated pass through events, it has an ongoing and robust risk management framework that captures, assesses and responds to changing low probability high consequence risks, and how this has been used to inform its choice for insurance cover.

The information that we expect NSPs to provide includes:

- Supporting documentation outlining the rationale of the NSP's risk tolerance levels based on empirical evidence and consideration for end customers.
- Supporting documentation that demonstrates regular identification and monitoring of risks and what controls have been implemented – for example, a NSP's risk register that shows evidence of the NSP's risk mitigation planning and decisions.
- Supporting documentation that demonstrates that the relevant risk Committee and or Board within a NSP, have considered the material issues relating to the matters identified under each of the categories of information in the guidance note (as part of the risk Committee's or Board's role in managing risk, including bushfire risk).

CitiPower, Powercor, United Energy and SA Power Networks highlighted in its submission that the information required to be presented at board and executive management levels would be focussed on the key elements and decision points for the insurance cover, and it

³³ Ausgrid, *AER insurance coverage consultation*, October 2020, p.6,

³⁴ AusNet Services, *Response on Draft Insurance Guideline*, April 2021, p. 1; CitiPower, Powercor, United Energy and SA Power Networks, *Submission to the insurance coverage pass-through event draft decision*, April 2021, p. 1.

³⁵ Energy Networks Australia, *AER Draft Guidance Note - Insurance coverage pass through events*, April 2021, p. 1.

³⁶ CitiPower, Powercor, United Energy and SA Power Networks, *Submission to the insurance coverage pass-through event draft decision*, April 2021, p. 1.

would be unreasonable to expect Senior Executives to dive into full details and analysis of numerous options.³⁷ We note the level of detail considered by the board or senior management, may differ between NSPs. However, the NSPs should provide evidence demonstrating that the relevant issues have been considered in a manner that is consistent with the NSP's governance and risk management processes.

4. Annual process for information provision

We have considered the merits of establishing an annual information provision process. As noted in the Consultation Paper this could provide NSPs the opportunity to inform and update us if there are any material changes relating to its insurance position or to enable benchmarking across NSPs.

On balance, we consider that this is not necessary and it would provide only limited value as we are unable to form any ex-ante views (that is, prior to a pass through event actually occurring) based on such information. However, we are open to hearing from stakeholders about changing market conditions, and we do see value in becoming aware of, and understanding material changes within the insurance market, as this may help facilitate our assessment of an insurance coverage cost pass through event if one actually occurs.

This position was supported by four submissions in response to our draft guidance note.³⁸

5. Benchmarking

At this stage we do not intend to benchmark of insurance policies across NSPs.

Various submissions to our Consultation Paper³⁹ made it clear that, due to the fact that each NSP's coverage is bespoke and dependent on their individual operating environments, risk appetite, and network, comparisons, benchmarking across the industry would not provide any meaningful conclusions. This view was further supported by four submissions from NSPs in response to our draft guidance note.⁴⁰

³⁷ CitiPower, Powercor, United Energy and SA Power Networks, *Submission to the insurance coverage pass-through event draft decision*, April 2021, p. 1.

³⁸ Ausgrid, *AER insurance coverage draft guidance*, April 2021, p. 1; CitiPower, Powercor, United Energy and SA Power Networks, *Submission to the insurance coverage pass-through event draft decision*, April 2021, p. 2; Energy Networks Australia, *AER Draft Guidance Note - Insurance coverage pass through events*, April 2021, p. 2; Energy Queensland, *Insurance coverage pass through event guidance note*, April 2021, p. 1.

³⁹ Evoenergy, *Submission to the AER on Insurance Guidance Note*, October 2020; SA Power Networks, *Submission on Insurance Coverage Pass Through Event*, October 2020; AusNet Services, *Response on Insurance Guideline*, October 2020; Ausgrid, *AER insurance coverage consultation*, October 2020; CitiPower Powercor and United Energy, *Submission to the AER consultation on insurance coverage pass-through event*, October 2020; Endeavour Energy, *AER re consultation paper – insurance coverage PTE submission*, October 2020; ENA, *AER insurance coverage pass through event guidance note*, October 2020.

⁴⁰ CitiPower, Powercor, United Energy and SA Power Networks, *Submission to the insurance coverage pass-through event draft decision*, April 2021, p. 2; Energy Networks Australia, *AER Draft Guidance Note - Insurance coverage pass through events*, April 2021, p. 2; Energy Queensland, *Insurance coverage pass through event guidance note*, April 2021, p. 1.

6. Miscellaneous Issues

There were a number of matters raised in the submissions which are not directly related to this guidance note— they are discussed below together with our views.

a. Period for cost recovery

In response to our Consultation Paper, Lumo Energy queried when NSPs should be allowed to recover the positive pass through amounts.⁴¹ Our view is that this issue should be considered on a case by case basis for each pass through application. This is because the impacts on prices could vary depending on the amounts to be recovered. In this regard, NSPs should include options for managing potential price shocks for their customers as part of their applications for such pass throughs. Red and Lumo Energy noted in their joint submission to the draft guidance note, that they supported the requirement for NSPs to demonstrate how they will pass through costs for an insurance coverage event. Red and Lumo Energy submitted that it would be preferable that costs be recovered as part of a NSPs annual pricing proposal in order to avoid consumers being subject to intra-year adjustment and in order to allow retailers to communicate any price changes to consumers.⁴² They also submitted that the AER's Default Market Offer (DMO) should include the costs of all network components, including insurance coverage events.⁴³ We acknowledge these concerns. Our view is these issues are best managed on a case by case basis depending on the size of the cost pass through that the NSP actually seeks in respect of a particular event when the event actually occurs.

b. Maximum Probable Loss information

ElectraNet queried whether the AER could assist NSPs to access any information used by underwriters to inform their assessment of NSPs' maximum loss exposures (to the extent that the information is not confidential and/or proprietary).⁴⁴ Our view is that the use and dissemination of such technical and business-specific information is best obtained by the NSPs.

c. Setting the baseline in each reset

AusNet Services queried whether it is appropriate to establish for each reset the five year premium allowance, deductible limit and coverage level as an agreed baseline from which annual movements could be assessed for reasonableness.⁴⁵ Our understanding is that the NSPs set their commercial levels of premium, coverage and deductibles annually through the renewal process. While we understand that forecasting insurance premium costs and coverage levels over a five year period can be difficult, particularly when the market is volatile, we would see value in understanding what assumptions a NSP has built into its regulatory proposal to serve as a reference point if an event was to occur during the regulatory period. As described in Section 4 – Annual process for information provision, we are unable to form pre-emptive positions on cost pass throughs but believe the transparency of sharing such information would be beneficial.

⁴¹ Lumo Energy, *AER Guidance note cost pass throughs*, October 2020.

⁴² Red and Lumo Energy, *AER draft Guidance Note on cost pass through on insurance coverage pass through events*, April 2021, p. 1.

⁴³ Red and Lumo Energy, *AER draft Guidance Note on cost pass through on insurance coverage pass through events*, April 2021, p. 2.

⁴⁴ ElectraNet, *Insurance cost pass through event*, October 2020.

⁴⁵ AusNet Services, *AST Response on Insurance Guidance*, October 2020, p. 5.

Appendix A – summary of submissions to our draft guidance note

Stakeholders	Summary
Red and Lumo Energy	<ul style="list-style-type: none"> Red and Lumo Energy submitted the draft guidance note addressed the risk that an NSP will under insure itself and seek to recover its losses through an insurance coverage application. Red and Lumo considered customer engagement is critical in the AER's assessment of an insurance coverage event application and supported this inclusion in the draft guidance note. They explained it is important for consumers to understand the financial impact that a cost pass through will have. While some stakeholders noted that the complexity of the matters raised in an insurance coverage application is potentially beyond consumers, Red and Lumo Energy did not agree with this position. They noted on many occasions they have witnessed both consumers, consumer representatives and retailers on behalf of their customers successfully contribute to a range of complex matters that the AER has consulted on in the past. They considered complexity should not be a factor in whether or not a matter is transparent and consulted on. Red and Lumo Energy considered retail pricing must include the costs of all network pricing components, including insurance coverage pass through events when the AER sets the Default Market Offer (DMO). Misalignment of dates and timeframes in the DMO Code and the NER could mean that the AER is not always able to include all network costs or the most recent forecasts into the final DMO which can create financial exposure for retailers.
AusNet Services	<ul style="list-style-type: none"> AusNet Services considered overall the draft guidance note sets out a sensible, workable and transparent framework for the assessment of an insurance coverage pass through event. In relation to the modelling analysis of possible losses from insured events, AusNet Services considered the draft guidance note set out unrealistic expectations on the amount and depth of the quantitative analysis required by the NSP to support its understanding of risk exposure and choice of insurance policy. It considered that much of the analysis described is undertaken by the insurers themselves in setting premiums and available cover, not the NSPs which are effectively price takers in current market conditions. NSPs access limited analysis and advice through independent external expert advisors and insurance brokers and do not have those actuarial capabilities internally. In relation to customer engagement, AusNet Services agreed that meaningful customer consultation on risk sharing and cost recovery can be undertaken. It was of the view this consultation is most appropriate during a price review process when the balance of risk sharing between ex-ante or ex-post cost recovery can be dealt with holistically. However, it considered meaningful consultation with-in period is problematic once allowances are set. In relation to independent advice on the appropriateness of cover, AusNet Services agreed that independent advice is an important part of the annual insurance renewal process, however, it noted that it should be recognised that the depth of information and advice listed in the draft guidance note is not necessarily sought annually. Rather, detailed advice and analysis are more comprehensive in years where insurance markets fundamentals are changing. For example, expert advice on coverage levels is not required annually when insurance markets are liquid and operating smoothly.
Ausgrid	<ul style="list-style-type: none"> Ausgrid supported the guiding principles underlying the draft guidance note and agreed that these rely on established regulatory frameworks and good corporate governance and practices. Ausgrid believed that the proposed information requirements should not result in an additional compliance burden on an NSP over and above what a prudent and efficient NSP would normally have done to manage its risks associated with insurance triggering events, such as bushfires. Ausgrid fully supported our draft guidance note to not to benchmark insurance policies across NSPs. Ausgrid supported our draft guidance note to not have an annual information provision process is a sensible outcome given that this information would provide only limited value prior to a pass through event actually occurring. Ausgrid agreed with all six information areas but noted that while customer engagement is desirable, if there are material changes in insurance market conditions, it may be impractical to do so given time constraints.
CitiPower, Powercor, United Energy	<ul style="list-style-type: none"> CPU and SAPN considered the proposed information requirements are generally reasonable and broadly reflect the type of information a prudent network should document and record regarding its insurance coverage and the process of obtaining a policy. Due to the very

Stakeholders Summary

and SA Power Networks – joint submission (CPU and SAPN)

complex nature of the general liability insurance products for electricity networks, it was of the view it is reasonable to expect evidence of a decision-making processes for key elements of the insurance cover and how it relates to the different risk profiles and risk appetites of each business.

- CPU and SAPN considered it is important there is sufficient flexibility in information requirements to allow for each network's situation and circumstances at the time of obtaining insurance, particularly regarding expectations of options analysis and the level of customer engagement
- CPU and SAPN cautioned against expectations of detailed cost-benefit options analysis for general liability insurance products. It was of the view all electricity networks, regardless of their individual risk profile, are price takers in the tight specialised insurance market. This is particularly evident in the current market where networks are losing coverage while premiums are increasing. As price takers, the options analysis of insurance products would be limited to options presented to each network by insurance providers, and in some cases that may only be one.
- CPU and SAPN recommended the options analysis be focussed on the key elements and decision points in the overall insurance package, for example decisions on deductible options, the top level of cover and gaps in coverage.
- CPU and SAPN cautioned against putting significant weight on customer and stakeholder input for insurance coverage decisions in a given policy year, given the high complexity of the matter, the confidential nature of particular aspects of insurance arrangements and the speed at which insurance offers are undertaken (sometimes within 24-48 hours to the expiry of the policy). However, CPU and SAPN supported the need to better educate its customers and stakeholders on the matters of insurance and seek their high-level input on the typical cost-risk trade-offs of obtaining insurance coverage.
- CPU and SAPN agreed with the AER that there is no merit in establishing an annual information provision process for insurance policies, as the information would not serve a purpose in the AER's decision making.
- CPU and SAPN supported the AER's guidance note to not introduce benchmarking of networks' insurance policies, due to the bespoke nature of general liability insurance products, and heavy dependence on networks' individual operating environments, risk profiles, risk appetites, and similar.

Energy Networks Australia (ENA)

- ENA broadly supported the proposed information set out in the draft guidance note that should be included in an insurance cost pass through event application. However, it considered detailed modelling analysis of numerous options is unlikely to be possible in the specialised insurance market where NSPs are price takers.
- ENA was strongly supportive of the role of consumer engagement in network regulation, and noted that NSPs recognise the need to engage with customers about how risks are appropriately managed, which can take place in the lead up to a NSP submitting its regulatory proposal. However, it considered the insurance market for NSPs is highly complex and is subject to highly confidential and commercially sensitive information. As a result it was of the view this could restrict the ability of NSPs to undertake meaningful consumer engagement about appropriate levels of insurance, and the terms of such cover.
- ENA supported our position that the establishment of a formal annual process for information provision is not necessary. It considered there are material differences between NSPs that would considerably reduce the usefulness of standardised data templates that do not allow for operating context.
- ENA supported our draft guidance note not to benchmark insurance policies across NSPs due to the bespoke nature of insurance arrangements. The decisions around how to manage the risks and costs of possibly catastrophic circumstances, and the prudent and efficient level of insurance cover, would vary materially between NSPs and would involve consideration of the context in which each individual NSP operates. It considered insurance benchmarking therefore would not provide meaningful results.

Energy Queensland (EQ)

- EQ broadly supported the key information requirements outlined in our draft guidance note.
 - EQ also supported our draft guidance note to not establish a formal annual information provision process and pursue benchmarking of insurance policies. EQ considered that a more ad hoc approach to information provision by network businesses will be more useful as market conditions can alter rapidly.
 - EQ considered that benchmarking would be meaningless given the bespoke nature of the insurance policies.
 - EQ raised concerns about the requirement to demonstrate customer engagement as part of an insurance coverage cost pass through event application. EQ stated it unquestionably valued customers input and is committed to ongoing customer engagement but did not believe
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Stakeholders	Summary
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that customer engagement should be a key element in the assessment of insurance coverage cost pass through applications.

Public Interest
Advocacy
Centre (PIAC)

- PIAC considered an additional guiding principle is needed which requires NSPs to demonstrate how they have determined and employed the optimal balance between spending to prevent or mitigate the impact of extreme weather events and accepting these events might occur and passing through the costs to consumers.
 - PIAC agreed that, where it is shown to be part of the most efficient overall decision, NSPs are well placed to manage risks through commercial and self-insurance decisions and mitigation measures. PIAC explained that the balance between sharing risks with consumers, even if in extreme circumstances, or locking in higher costs must be founded on a clear, well-informed and robust understanding of consumers' preferences and interests. .
 - PIAC agreed with all proposed information areas in the draft guidance note.
 - In relation to customer engagement, PIAC noted while some specifics of these discussions might be detailed and technical in nature, this is not a valid reason to avoid having them with consumers. PIAC viewed in addition to discussion at a broader level, it is possible to have detailed and nuanced discussions with consumers and their representatives given adequate time and support to inform participants so they could provide considered feedback. PIAC noted that building (and retaining) this detailed understanding would also become easier as NSPs move towards more regular and deeper engagement with consumers and their representatives as business-as-usual rather than one-off events when preparing a regulatory proposal.
 - In relation to benchmarking, PIAC agreed that the unique characteristics of each NSP would mean using benchmarking to determine insurance coverage cost allowances is not a valid approach. However, examining such information across NSPs, or for the same NSP over time, might still be a useful tool to provide context and help understand where and why businesses differ.
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