



Consultation Paper

Guidance note on key matters the
AER is likely to have regard to when
assessing an insurance coverage
event application

August 2020

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Overview

This Consultation Paper aims to:

1. Set out the AER's preliminary views on the key elements that will guide the assessment of an insurance cap / coverage pass through event application.
2. Seek comment from Network Service Providers and other stakeholders about these key elements of our proposed assessment approach that will be used to develop a draft and final guidance note.

The AER has historically accepted insurance cap pass through events as nominated pass through events in its revenue determinations and access arrangements¹. In the recent SA Power Networks, Ergon Energy and Energex 2020-25 Final Determinations, we have revised an "insurance cap" event to "insurance coverage" event to more accurately reflect the nature of the provision. For the purpose of this paper, when we use the term insurance coverage event, it covers all existing determinations that contain the insurance cap event.

Insurance coverage pass through events allows a Network Service Provider to recover material costs that are incurred above the Network Service Provider's insurance policy coverage. Consistent with the Australian Energy Market Commission's (AEMC) final decision on pass through arrangements for Network Service Providers, there is a relatively high threshold for these events and it is envisaged that they would generally only occur in circumstances where insurance is limited or not available on commercial terms and self-insurance is not appropriate.² In this way they are used as a last resort. We have not previously had to assess an insurance coverage pass through event.

We note the recent changed insurance market conditions, characterised by rising insurance premiums and withdrawn capacity, and the impact of recent major bushfire events across Australia. This may lead to Network Service Providers experiencing future insurance coverage gaps and the potential for more catastrophic circumstances that are not covered by commercial insurance. In this context, a number of Network Service Providers have sought to refine how the insurance coverage pass through events are defined and for clarification about how the AER would assess an insurance coverage pass through event application.

As noted above, in recent determinations we considered the definitional issues and approved a refined insurance coverage pass through event (discussed in greater detail in the "Background" section). We will continue to examine these definitional issues in future revenue determinations.

Further to these definitional issues, we are seeking to develop a guidance note that will provide Network Service Providers with greater certainty about our assessment process when a Network Service Provider applies to us for such an event. This allows Network Service Providers to be better informed about possible pass through assessment outcomes, including when acquiring insurance in the context of a changing and volatile insurance market. Our intention is that the guidance note be broad enough to cover all possible insurance coverage events.

We consider the primary question centres around our likely assessment approach on how we will identify the level of insurance that an efficient and prudent Network Service Provider would obtain, or would have sought to obtain, in respect of the event. Further, how we will assess the efficiency of the Network Service Provider's actions and decisions in relation to the positive change event. Our view at this stage is that any assessment to be made by us

¹ Applying to both electricity and gas Network Service Providers

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

on a pass through application will rely heavily on the key issues that the AEMC considered as part of its final determination ‘cost pass through arrangements for network service providers’ published on 2 August 2012.

In this regard, a key issue for our assessment is likely to be determining whether the Network Service Providers’ decisions in obtaining a particular level of insurance cover are prudent and efficient, having regard to a number of factors, including its risk tolerance levels, insurance policy structures, past liability claims, mitigation practices, individual operating environments, prevailing insurance market conditions and availability of any other risk-mitigating insurance products. Ultimately, we will need to form a view about whether this results in an efficient allocation of risks between the Network Service Provider and its customers.

This consultation paper commences the process to develop a guidance note and Table 1 sets out our proposed consultation process.

Table 1: Process for developing guidance note and indicative timeline

Key steps	Purpose	Indicative dates
Release consultation paper	Publish the consultation paper seeking submissions	28 August 2020
Submissions on consultation paper	The purpose of this period is to allow adequate consultation to receive views across the industry on matters that should be covered in a final guidance note	30 October 2020
Draft guidance	Publish draft guidance and seek submissions	January 2021
Submissions on draft guidance	Opportunity for Stakeholders to provide feedback on the proposed draft guidance	March / April 2021
Final guidance	Publish final guidance	June 2021

We welcome comments on the above process, including whether there would be value in potential group workshop sessions or one on one meetings. If there is a favourable response to holding these workshops or one to one meetings, some of these can take place in November or December 2020 prior to the release of the draft guidance note.

How to make a submission

Interested parties are invited to make submissions on this consultation paper by 30 October 2020. In providing responses, please explain your reasons, including supporting evidence and data where possible.

You do not need to comment on all issues in your feedback and we invite you to respond to the questions that are relevant to you and your circumstances.

We prefer that all submissions are in Microsoft Word or another text readable document format. Any submissions that include data should be provided in Microsoft Excel format. Submissions should be emailed to: AERInquiry@aer.gov.au with the subject heading "Attention: General Manager – Transmission and Gas – Submission on assessing an insurance coverage pass through event"

Alternatively, submissions can be send to:

Sebastian Roberts
General Manager
Transmission and Gas
Australian Energy Regulatory
GPO Box 520
Melbourne VIC 3001

We prefer that all submissions be publicly available to facilitate an informed and transparent consultative process. Submissions will be treated as public documents unless otherwise requested. Parties wishing to submit confidential information should:

- Clearly identify the information or data that is subject to the confidentiality claim
- Provide a non-confidential version of the submission in a form suitable for publication if applicable.

All non-confidential submissions will be placed on our website. For further information regarding our use and disclosure of information provided to us, see the ACCC/AER Information Policy (October 2008), which is available on our website.

1. Background

Under the National Electricity Rules (NER), a Network Service Provider may propose a nominated pass through event in its revenue proposal.³ The AER must then assess any such proposals and determine whether to accept them. In doing so, under the NER it must take into account:

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

In the past, the AER has accepted insurance cap pass through events as nominated pass through events. An insurance cap pass through event allows a Network Service Provider to recover material costs that are incurred above their insurance policy limit.

We note this is consistent with the Australian Energy Market Commission's (AEMC) final decision on pass through arrangements for Network Service Providers where it stated that the purpose of nominated pass through events is to provide Network Service Providers 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. This should however, be limited to instances where efficient costs are incurred because unforeseen costs arise as a result of events outside a Network Service Provider's control.⁵

Although there are minor variances in the wording for the insurance cap pass through event definitions between Network Service Providers, in general an insurance cap pass through event occurs if:

1. The Network Service Provider makes a claim or claims and receives the benefit of a payment or payments under a relevant insurance policy
2. The Network Service Provider incurs costs beyond the relevant policy limit, and
3. The costs beyond the relevant policy limit materially increase the costs to the Network Service Provider in providing direct control services.

If an insurance cap pass through event occurs, and a Network Service Provider makes an application, the AER commences its assessment process. The AER must determine the amount of a Network Service Provider's material costs above the limit of the Network Service Provider's insurance cover at the prevailing time that can be recovered from consumers via the Network Service Provider's charges for regulated services. In undertaking this assessment, the AER must take into account a variety of matters under the NER, including the following:

- Any matters or proposals made by the Network Service Provider
- The change in costs as a result of the event
- The efficiency of the Network Service Providers actions in relation to the event, including the actions taken, or not taken, by the Network Service Provider to reduce the costs

³ 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.

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

⁵ AEMC 2012, *Cost pass through arrangements for Network Service Providers, Rule Determination*, 2 August 2012.

- The need to ensure the Network Service Provider only recovers any actual or likely incremental costs
- Whether the costs have been, or will be, factored into the Network Service Providers annual revenue requirement.⁶

The nominated insurance cap pass through event definitions that are currently in most Network Service Provider's determinations also note that the AER will have regard to, amongst other things:

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

In the recent SA Power Networks, Ergon Energy and Energex 2020-25 Final Determinations, we took into account the changing insurance market conditions. In particular, the 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 Network Service Provider's insurance coverage that may occur if it is unable to find suitable insurance providers to fill withdrawn capacity, or 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 definition applies only under what we defined as 'changed circumstances' where movements in the relevant insurance liability market that are beyond the control of a Network Service Provider, and those movements mean that it is no longer possible for a Network Service Provider to take out an insurance policy or set of insurance policies at all, or on reasonable commercial terms.

The SA Power Networks, Ergon Energy and Energex 2020-25 Final 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 Network Service Provider has not been able to efficiently purchase insurance. This is in addition to circumstances where costs are incurred beyond a Network Service Providers insurance policy limit or cap. Within this Consultation Paper, we have referred to the insurance cap and coverage pass through events as the same issue.

For completeness, in the SA Power Networks, Ergon Energy and Energex 2020-25 Final Determinations pass through event definitions, the matters, amongst other things, that the AER will have regard to have been slightly amended as follows:

- The relevant insurance policy or set of insurance policies for the event
- The level of insurance that an efficient and prudent Distribution Network Service Provider would obtain, or would have sought to obtain, in respect of the event
- Any information provided by SA Power Networks to the AER about SA Power Networks' actions and processes.

The insurance coverage pass through event applicable in the 2020-25 regulatory control period for SA Power Networks, Ergon Energy and Energex is set out in Attachment A (for SA Power Networks).

In the SA Power Networks, Ergon Energy and Energex 2020-25 Final Determinations we foreshadowed a broader consultation process to provide the industry with greater clarity and guidance around the matters we would have regard to in assessing any insurance coverage pass through event applications that occur.

⁶ NER cl 6.6.1(j); 6A.7.3(j).

2. The key matters we will likely have regard to when assessing an insurance coverage pass through application

As set out in section 1, in the most recent electricity distribution reset determinations we refined the insurance cap pass through event definition. This recognised the changing environment, including the current insurance market conditions. However, given the changing insurance market conditions and recent major bushfire events, some Network Service Providers have also sought further information and clarity about how we would assess an insurance coverage pass through event application if such an event occurs. .

We have not previously had to assess an insurance coverage pass through event. However, the changing environment may lead to Network Service Providers experiencing future insurance coverage gaps and the potential for more catastrophic circumstances that are not covered by commercial insurance. Given this, we consider there is benefit in providing guidance on the key matters we will likely have regard to in assessing an insurance coverage pass through event application. This will allow Network Service Providers to be better informed about possible pass through assessment outcomes, including when acquiring insurance in the context of a changing and volatile insurance market. This consultation paper is our initial step in better understanding the relevant issues and developing a guidance note on these matters.

The primary questions raised to date by Network Service Providers around our likely assessment approach relate to how we will identify the level of insurance that an efficient and prudent Network Service Provider would obtain, or would have sought to obtain, in respect of the event.⁷ Further, how we will assess the efficiency of the Network Service Provider's actions and decisions in relation to the positive change event.⁸ To be clear, this is not primarily an assessment of the operating costs of insurance premiums – it is an assessment of a pass through event characterised by a low probability, high severity (catastrophic) set of circumstances, and of how the associated risks and costs should be managed between a Network Service Provider's insurance program and its customers. Understanding this will help to inform us whether a prudent and efficient level of insurance has been acquired in relation to an event.

A key issue and challenge for this assessment is that the decisions around how to manage the risks and costs of possibly catastrophic circumstances, and the prudent and efficient level of insurance cover, can vary between Network Service Providers and will involve consideration of the context in which each individual Network Service Providers operates. It is likely that this will include considering a number of factors such as risk tolerance levels, insurance policy structures, past liability claims, mitigation practices and operating environments. The prevailing insurance market conditions are also likely to be a factor. Further, potential future insurance coverage pass through events and applications are likely to be unique in terms of both the nature of the event and the Network Service Provider's insurance position.

However, we consider that there are relevant and common considerations that Network Service providers should take into account, and relevant and common processes that Network Service Providers should undertake, in seeking to acquire a level of insurance consistent with that of a prudent and efficient Network Service Provider.

Our view at this stage is that any assessment to be made by us on a pass through application will rely heavily on the key issues that the AEMC considered as part of its final

⁷ See Attachment A below.

⁸ NER cl 6.6.1(j)(3); 6A.7.3(j)(3).

determination 'cost pass through arrangements for network service providers' published on 2 August 2012. At a high level, these include:

1. **Efficient allocation of risks between Network Service Providers and end consumers:** Our view is that Network Service Providers are best placed to manage these risks, having to constantly address them through commercial and self-insurance, mitigation efforts and in extreme circumstances, the need to share some of these risks with customers. We would expect our assessment to consider to what degree the Network Service Provider has achieved this and arrived at an efficient trade-off between the Network Service Provider mitigating its risk through commercial and/or self-insurance, and end consumers bearing the risk over and above the insurance premiums paid by, or offered to, Network Service Providers. This may require the Network Service Provider to provide material that includes:
 - a. A Maximum Foreseeable or Probable Loss assessment in the operator's region or specific areas within that region
 - b. Relevant and expert information of the insurance liability market (trends and movements in premiums and coverage) and its efforts to seek appropriate cover
 - c. The rationale behind how an Network Service Provider chooses to insure against an event and the level of cover obtained
 - d. An independent report or certification from an insurance expert that details the Network Service Provider's insurance cover is appropriate
 - e. Whether the Network Service Provider has undertaken meaningful consumer engagement about its insurance cover
 - f. Whether the Network Service Provider has explored the availability of other risk mitigating insurance products
2. **Least cost option:** Our view is that Network Service Providers should seek to determine the optimal, least cost, way to manage their risks through commercial, and/or self, insurance. We would expect our assessment to consider the analysis that the Network Service Providers 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. This may include assessments of acceptable and unacceptable risks that the Network Service Provider faces, the premium costs and deductibles and the impact of changing market conditions.
3. **To what extent are the events unexpected and outside of the Network Service Provider's control:** Our view is that Network Service Providers should seek to manage those risks which are within their control and use commercial or self-insurance for low probability, high severity events beyond their control. We would expect our assessment to consider details of the Network Service Provider'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 Network Service Providers commercial and self-insurance coverage choices. This may include supporting evidence that the Network Service Provider 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.

Question 1: *Are there any other key elements that stakeholders believe should be included as part of our assessment process? Please detail what these are and why should they be taken into account. This could include any aspects which Network Service Providers consider are specific to their business circumstances and operating environment.*

Question 2: *Within each of the relevant key elements, what specific issues, considerations, analysis and information should be included as a part of our assessment process? Please set these out in detail and explain why they should be taken into account.*

As a part of responding to these questions, we encourage stakeholders, and particularly Network Service Providers, to consider providing supporting information that will help inform this consultation process and the development of draft and final guidance notes. This could include the key information and processes which are required to establish how the associated risks and costs should be managed between an Network Service Provider's insurance program and its customers (to inform its decision around a prudent and efficient level of insurance), or other substantiation or evidence which a Network Service Provider relies upon as part of making its decision. We consider this would help to ensure the guidance note takes account of the key considerations and processes that we should be factoring into any future assessments. We are also interested in understanding whether there is benefit in establishing an annual information process (which depending on its purpose could be opt-in) that provides Network Service Providers the opportunity to inform and update us if there are any material changes relating to its insurance position or to enable benchmarking across Network Service Providers.

Question 3: *Is there any other specific information or processes that stakeholders see as crucial, and consistent with the National Electricity Rules, that we should take into account in assessing how low probability, high severity risks and costs should be managed between an Network Service Provider's insurance program and its customers (to inform whether an Network Service Provider has established a prudent and efficient level of insurance)?*

Question 4: *Do stakeholders see benefits in us having an annual information provision process for Network Service Providers to inform us of material changes relating to its insurance position? Please detail what value / advantages and costs / disadvantages you consider such an information process would provide for the AER, Network Service Providers and other stakeholders. Please also detail what information you consider could be provided and outline your views about the form and timing of any process. We would also be interested to understand whether Network Service Providers are likely to use an annual opt in process?*

Question 5: *Do stakeholders see benefits in us collecting insurance information for benchmarking purposes in the annual information provision process? Please detail what value / advantages and costs / disadvantages you consider this would provide for the AER, Network Service Providers and other stakeholders. This information could be captured as part of the annual Regulatory Information Notice or a separate annual opt in process.*

Further to the above considerations, we are also interested in understanding how Network Service Providers manage their exposures in circumstances where costs are incurred beyond policy limits or where there are gaps in their insurance cover, and they face potential third party claims arising from bushfires. This reflects the fact that that, in assessing a cost pass through event application, we must also examine the incremental change in costs and the efficiency of the Network Service Providers actions to reduce the costs.

Question 6: *What processes are in place (or planned) by Network Service Providers to manage circumstances where costs are incurred beyond policy limits or there are gap(s) in their insurance cover, and they face potential third party claims arising from bushfires? How do Network Service Providers manage or plan to manage their exposures in cost effective ways under these circumstances? Given that an insurance coverage pass through event is in place, how do stakeholders think that the incentives of Network Service Providers to be efficient and cost effective are affected in their efforts to minimise their exposure above the insurance cover limit or gaps in their insurance policies? How can we incentivise a Network Service Provider to be prudent and efficient under these circumstances?*

Question 7: *We understand that the recent volatility in the liability insurance market have been having a major impact on electricity distribution and transmission businesses; do gas businesses face similar impacts?*

Attachment A – Insurance coverage pass through event definition

Pass through event	Definition
Insurance coverage	<p>An insurance coverage event occurs if:</p> <ol style="list-style-type: none"> 1. SA Power Networks: <ol style="list-style-type: none"> a) makes a claim or claims and receives the benefit of a payment or payments under a relevant insurance policy or set of insurance policies; or b) would have been able to make a claim or claims under a relevant insurance policy or set of insurance policies but for changed circumstances; and 2. SA Power Networks incurs costs: <ol style="list-style-type: none"> a) beyond a relevant policy limit for that policy or set of insurance policies; or b) that are unrecoverable under that policy or set of insurance policies due to changed circumstances; and 3. The costs referred to in paragraph 2 above materially increase the costs to SA Power Networks in providing direct control services. <p>For the purposes of this insurance coverage event:</p> <ul style="list-style-type: none"> • 'changed circumstances' means movements in the relevant insurance liability market that are beyond the control of SA Power Networks, where those movements mean that it is no longer possible for SA Power Networks to take out an insurance policy or set of insurance policies at all or on reasonable commercial terms that include some or all of the costs referred to in paragraph 2 above within the scope of that insurance policy or set of insurance policies. • 'costs' means the costs that would have been recovered under the insurance policy or set of insurance policies had: <ol style="list-style-type: none"> i. the limit not been exhausted; or ii. those costs not been unrecoverable due to changed circumstances. • A relevant insurance policy or set of insurance policies is an insurance policy or set of insurance policies held during the regulatory control period or a previous regulatory control period in which SA Power Networks was regulated; and • SA Power Networks will be deemed to have made a claim on a relevant insurance policy or set of insurance policies if the claim is made by a related party of SA Power Networks in relation to any aspect of SA Power Networks' network or business; and • SA Power Networks will be deemed to have been able to make a claim on a relevant insurance policy or set of insurance policies if, but for Changed Circumstances, the claim could have been made by a related party of SA Power Networks in relation to any aspect of SA Power Networks' network or business. <p>Note for the avoidance of doubt, in assessing an insurance coverage event through application under rule 6.6.1(i), the AER will have regard to:</p> <ul style="list-style-type: none"> • The relevant insurance policy or set of insurance policies for the event • The level of insurance that an efficient and prudent DNSP would obtain, or would have sought to obtain, in respect of the event; and • Any information provided by SA Power Networks to the AER about SA Power Networks' actions and processes.