Empower Results®

6 November 2020

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

Dear Sebastian

**Re: Submission on assessing an insurance coverage pass through event**

Aon Risk Services Australia (Aon) is delighted to provide a response to the Australian Energy Regulators invitation for submissions assessing an insurance coverage pass through event.

We support a review of the cost-pass through mechanism and any changes that provide greater certainty and clarity for Network Service Providers (NSPs) with regards to their options available to manage their risk insurance purchasing. Aon appreciates the current insurance market and recent natural events, require NSP to rethink traditional methods of managing risk and it is our objective to support them through this process with our expertise and knowledge of the insurance market.

The response contained herein is developed from the perspective of Aon's Data and Analytics (D&A) team. Whilst Aon provides many services to NSPs including insurance broking, the commentary and conclusions are primarily put together from our mature capability used to optimise insurance programmes using quantitative analytical methods in setting limits, deductibles and creating insurance vehicles for the benefit of our clients.

To reflect the above, our response will address questions 2 and 3.

We welcome these reforms as an important step forward in providing clarity to network service providers of the potential cost through mechanism.

For further information on our submission, please do not hesitate to contact us.

Yours sincerely

**Sulav Saha**
Managing Principal

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**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.*

| ***Key Element*** | ***Issues & Considerations*** | ***Assessment analysis and information*** |
|---|---|---|
| Efficient allocation of risk between Network Service Providers and end consumers | The allocation of risk is reliant on reliability and accuracy of risk exposure quantification using actuarial and mathematical predictive modelling techniques. The outputs produced are subject to historical and risk exposure data, expert judgements and statistical methods being applied according to actuarial industry standards such as;<br><br>(a) Professional Standard 305 (Financial Condition Reports and Review of Run-off Plans for General Insurance) – March 2013 – Actuaries Institute (PS 305);<br>(b) GPS 320 (Actuarial and Related Matters) – January 2013 – APRA (GPS 320);<br>(c) (c) GPS 116 (Capital Adequacy: Insurance Concentration Risk Charge) – January 2013 – APRA (GPS 116); and<br>(d) Professional Standard 302 (Valuations of General Insurance Claims) – March 2020 – Actuaries Institute (PS 302). | • Review supporting documentation for risk exposure calculations referenced in the application for cost pass through. This at a minimum would include the methodology, assumptions and data sets applied in the analysis; and<br>• Analyse independent review of risk exposure calculations including commentary on methodology and deviations from standard industry practise. |
| | The efficient allocation of risk between NSPs and end consumers is dependent on the extent they can absorb the financial impacts from an insurable risk materialising. In the insurance industry this is defined as the NSPs risk tolerance and for end customers this can be established by the end customer's scope to afford increases to their cost of service. This analysis will inform the affordability and capacity required from the insurance market. | • Analyse NSP risk tolerance study including the financials stress testing to loss scenarios;<br>• Review of the qualitative rational with supporting evidence in articulating an organisational risk tolerance;<br>• Review end customer risk tolerance study including stress testing loss scenarios and their relative impacts on socio economic end customer segments that will be impacted |

| *Key Element* | *Issues & Considerations* | *Assessment analysis and information* |
|---|---|---|
| | | by the cost pass through proposed; and<br>• Analyse supporting due diligence and controls demonstrating customer impacts from cost pass through are within the end customer's risk tolerance. |
| | The ability to obtain cost pass through may provide an economic incentive for NSPs to seek less insurance coverage than that is considered optimal and efficient for end customers. Since NSP coverage gaps e.g. by selecting lower insurance limit will provide a short-term benefit in lower premiums. Furthermore, the NSP would benefit from avoiding the downside of an insurance gap with the impact of a high severity and low frequency event to be borne by the end customer. For this reason, efficient allocation of risk for cost pass through would need to be assessed on reducing the Total Cost of Risk (TCOR) for both NSP and end customers. | • Review of methodology applied in designing NSP insurance programme and consideration for the TCOR for end customers as well as the NSP;<br>• Analyse supporting due diligence for the NSP selection of insurance limits creating gaps in coverage which at minimum would include the calculation of return periods and probability of exceedance for potential limits; and<br>• Assess significant deviations in insurance coverage through benchmarking and comparison of limits, return period and probability of exceedance implied in the insurance programmes of different NSPs. |
| Least cost option | The design and structuring of an insurance programme is intended to lower the TCOR, however other factors are also considered. This includes but is not limited to gaining long term stability in premiums, access to capacity in various insurance markets and seeking coverage through an aggregating structure. The strategy adopted and options available are dependent on the nature of the underlying risk, for example a NSPs with poor claims history and/or operating in areas considered more prone to catastrophic events could find it harder to lower TCOR and bridge insurance gaps. | • Review of due diligence applied for insurance programme design and/or feasibility studies into traditional and alternative insurance options and consideration for TCOR;<br>• Analyse by comparing and benchmarking TCOR of NSPs including those adopting traditional and alternative insurance programmes; and<br>• Assess rationale and justification supporting the insurance risk strategy and programme adopted especially where the lowest TCOR option had not been adopted or considered; |
| To what extent are events | The NSP in order to minimise the occurrence and severity of | • Review of NSP risk register and supporting documentation such |

| *Key Element* | *Issues & Considerations* | *Assessment analysis and information* |
|---|---|---|
| unexpected and outside of the Network Service Provider's control | unexpected events needs to proactively manage these risks through a combination of risk management practises, investment in risk management, which includes the regular identification and monitoring of risks and putting in place effective controls. The absence of these processes may place an undue exposure on end customers in the event of a low frequency and high severity event. | as Board or risk committee discussions relating to high severity risks and the ability (or inability) to further affect its impact or chance of occurrence, by demonstrating focus, management and continual review as guided by their internal risk management framework.<br>• Assessment of risk mitigation planning to ensure mitigations are in place and effective (or lack of, e.g. where risks are out of an NSP's control) as well as consideration for additional control improvements had been made.<br>• Assessment of risk mitigation planning to ensure mitigations are in place and effective (or lack of, e.g. where risks are out of an NSP's control) as well as considerations for additional control improvements had been made.<br>• Review of risk management framework and prioritisation methodology where the implementation of risk controls are selected based on balancing of resourcing constraints and financial benefit (i.e. a risk improvement outweighs its implementation and ongoing cost). |

**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)?*

The following information should also be considered in order to assess how low probability and high severity risks are managed, between NSP insurance programs and its customers that have not been referenced above (Question 2).

- Historical high severity, low probability losses and claims
- Root causes and contributing factors for the occurrence and severity of past losses;
- NSP risk management actions, planning and execution relating to past losses;
- Financially viable alternative insurance coverage options available to NSPs (which may be limited); and
- Past insurance renewal submissions and programme changes.