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Dear Sebastian

Insurance coverage pass-through event – Guidance Note

AusNet Services welcomes the opportunity to provide comments on the Guidance Note. We would also acknowledge that the Australian Energy Regulator has been making proactive improvements to this aspect of the regime in response to industry concerns on the ongoing health of the international bushfire liability insurance markets.

These concerns are ongoing as further catastrophic fire seasons in California in 2019 and 2020 and in Australia over the 2019-20 summer have resulted in further reductions in the availability of this insurance and very significant increases in premiums.

It is widely recognised that climate change is increasing the underlying risk increasing the probability that the pass-through will be exercised. Therefore, the development of a Guidance Note will increase the clarity and transparency for all stakeholders on how this pass-through will be assessed and what information should be provided by the network.

AusNet Services has provided detailed briefings on the insurance markets to the AER on several occasions previously. Since the last detailed briefing in October 2019 we now have the outcomes from the September 2020 insurance renewal. The observed continuation of adverse trends is discussed below as context for development of the Guidance Note.

Insurance market conditions post 2020 renewals

The 2020 insurance renewal saw further material reductions in the amount of insurance capacity available and very significant increases in premiums. Figure 1 below shows the cumulative number of insurance companies that have reduced or withdraw completely from the global market and the cumulative amount of cover withdrawn which has now reached over \$1.3 billion.

For AusNet Services specifically, this has meant that we failed to meet our target level of cover for the third year running with the shortfall reaching over 30%. By expanding the coverage of our captive insurer (a form of self-insurance) this has been reduced to a 25% net shortfall. Figure 2 below shows the shortfall we have experienced as global insurance markets have tightened in response to recent liability claims and ongoing climate change risks.

Figure 1: Cumulative Liability Insurance Capacity Withdrawn

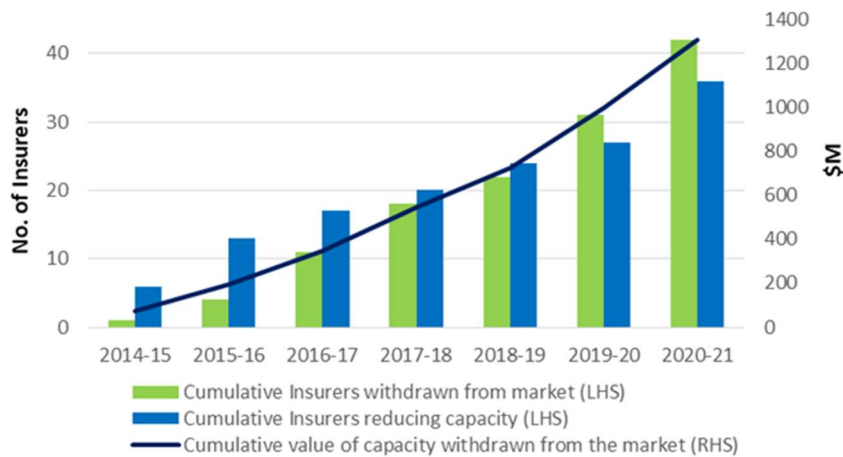
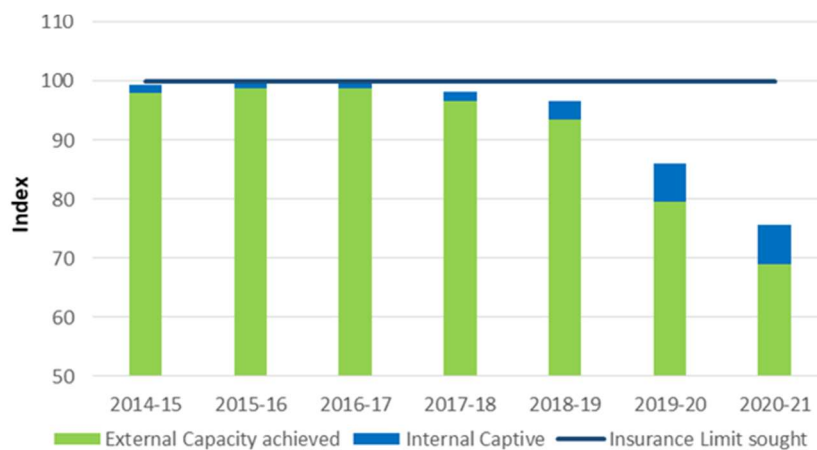


Figure 2: Cumulative Liability Insurance Capacity Withdrawn



While insurance capacity has been shrinking premiums have been rising. For the most recent year, for a 10% lower level of coverage at the existing \$10M deductible, the cost of liability insurance offered to the AusNet Services Group rose by \$7M or 60%.

The AusNet Services Board did not consider such a rise in the best interests of its customers and approved the business raising its deductible to \$25M. Even after this change, the premium rose by \$1.6M or 14%.

A **confidential** update on current insurance market conditions from insurance broker Lockton has been attached to this submission.

More detailed responses to the AER's specific questions for stakeholders follows below. Please contact me with any questions on these responses or the broader insurance issues the industry is experiencing at [REDACTED]

Regards

A handwritten signature in black ink, appearing to read 'Tom Hallam', written in a cursive style.

Tom Hallam

General Manager Regulation
AusNet Services

Attachment 1: Response to AER Questions

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.

In our experience, the sort of information listed by the AER is likely to be available with a few material exceptions discussed below on independent certification and customer engagement. We would refer the AER to previous confidential AusNet Services submissions of material as an illustration of the typical information that our business could make available. It is worth emphasising again the strict confidentiality that pertains to the detailed evidence that underpins a business insurance coverage. This can restrict broader consultations outside confidential discussions with the AER.

Expectations on certification from an independent insurance expert that the level of cover is appropriate have to be realistic. The level of cover is fundamentally a Board decision and while an independent review will provide appropriate analysis and advice it will not warrant the level of cover is appropriate. In reaching decisions on the target and acceptable level of insurance coverage, the Board must take into account, actuarial estimates of liability, potential frequency of events, the financial capacity of the company and the nature of regulatory protections, among other things. In line with fiduciary duties, the Board must exercise judgement on how these factors will interact in highly infrequent and company threatening events, influenced by its confidence in insurers and regulatory arrangements. An advisor will not stand in the shoes of the business on such a material matter due to potential liability concerns.

Likewise, expectations on customer engagement also have to be realistic. Certainly, given Director responsibilities in this area, there cannot be a negotiation with customers on risk sharing and allocation. The sensitive and confidential nature of the information also prevents evidence to be shared with customer representatives. Recent experience during the current EDPR process indicates that customer representatives are reluctant to be involved in these discussions because they lack the required technical expertise and do not have access to the underlying information to participate meaningfully.

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.

Price reviews provide an allowance for insurance premiums. These premiums are calculated on a set level of coverage and deductible. If these things remain stable over the regulatory period, then questions of what the pass-through protection should apply does not arise. However, the current environment of significant insurance market changes requires that the pass-through protection established needs to be reset and agreed regularly. For example, AusNet Service's level of cover has been falling over the current period because of the lack of availability at any price. Therefore, if the pass-through protection is to be provided on a different basis to that underpinning the original decision, then the AER will need to be comfortable that the changes are efficient and AusNet Services needs to be comfortable it is covered by some form of protection. The information required by the AER should go to that answering that question.

With the exceptions outlined in the response to question 1, the information the AER is requesting appears to be reasonable.

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 a Network Service Provider has established a prudent and efficient level of insurance)?

The relevant price review decisions should establish clearly the five year premium allowance, deductible limit and coverage level assumed (noting that this will be confidential). This would establish the agreed baseline from which annual movements could be assessed for reasonableness.

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?

Some annual information on premiums and insurance market conditions will be useful for the assessment process and ensure a no surprises process in the event of a cost pass-through application. It also provides an opportunity for the AER to raise concerns with a network's approach or level of cover before an event occurs a key concern of network businesses.

However, it should be recognised that some information listed in the discussion paper is not sought annually. For example, expert advice on coverage levels is not required annually. Rather it is obtained only on an as needs basis in response to specific queries or issues.

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.

AusNet Services does not support the collection of insurance information for benchmarking purposes and would view results from a benchmarking exercise as largely meaningless. This is because each network in essence negotiates a bespoke level of cover and risk sharing that will be dependent on a multitude of factors including, the specific network risk profile, risk appetite and ownership (which can give access to different insurance markets and products). Insurers will also treat networks differently for a variety of factors including claims history and their own risk assessments and appetites.

As stated above, AusNet Services is willing to provide confidential information to the AER for an individual assessment subject to the agreement of its insurers and brokers.

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?

As PG&E's experience in California demonstrates, this liability is existential for a commercial business exposed to bushfire risk. In addition, material reputational and financial risk remains even after insurance cover and pass-through protection is provided. Insurance cover also requires

the business undertake all reasonable measures to mitigate the risk or it can risk the cover being voided (which would also void the pass-through protection).

Overlying this, our network is subject to strict legislative and regulatory requirements overseen proactively by a dedicated safety regulator in Energy Safe Victoria and Government and investment programs monitored closely by the Victorian Department of Environment, Land, Water and Planning. Breaches of these arrangements can and do result in significant financial penalties.

Broader questions on the balance of risk between networks, government and customers are rightly the purview of policy makers and processes. Once policy decisions are made, the regulatory regime should accept these decisions and adjust accordingly. The regime should not be used to second guess these decisions.

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?

In our experience, insurance is obtained for the entire business, not necessarily individual networks within the business. The premium cost is then allocated by the business. Recent volatility is associated with the risks in the electricity sector, therefore groups with electricity operations and particularly distribution operations are the most heavily impacted by premium rises.

For our own organisation the risk is considered to largely sit within electricity distribution network.