

# Guidance note on AER's assessment of insurance coverage event application

Evoenergy submission to AER consultation paper

30 October 2020

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# 1 Background

## 1.1 Introduction

Evoenergy welcomes the opportunity to make a submission to the Australian Energy Regulator's (AER's) August 2020 Consultation Paper '*Guidance note on key matters the AER is likely to have regard to when assessing an insurance coverage event application*'.

The objective of the proposed guidance note is to set out the AER's likely assessment approach to identifying the level of insurance cover that an efficient and prudent Distribution Network Service Provider (DNSP) would seek to obtain and the efficiency of the DNSP's actions and decisions. The guidance note will assist DNSPs in making cost pass through applications for insurance coverage events by providing greater certainty about the AER's assessment process. It will also assist DNSPs to understand expectations when undertaking the annual procurement process for insurance in a market that is offering higher costs for lower levels of insurance coverage.

This submission summarises the context in which the AER guidance note was proposed, the existing rules regarding the AER's assessment of cost pass throughs, key issues for Evoenergy and responses to the AER's questions.

## 1.2 Context

The AER's Consultation Paper notes that the 'insurance cap event' for cost pass throughs was revised to the 'insurance coverage event' in the 2020-2025 Final Determinations for SA Power Networks (SAPN), Ergon Energy and Energex released on 5 June 2020 (delayed from 30 April 2020). SAPN's revised proposal of 10 December 2019 and supplementary submissions in January and February 2020 highlighted SAPN's concerns about the difficulty in obtaining insurance coverage for the risk of bushfires and the implications for a potential future cost pass through application for an insurance coverage event. Many DNSPs had similar experiences to SAPN in facing significantly higher premiums and lower coverage for bushfire insurance, which are expected to tighten further in future years.

During its regulatory review process, SAPN proposed to manage the changing insurance market in a number of ways. SAPN proposed changes to the definition of the 'insurance cap' cost pass through event with a process to update the AER about the efficiency and prudence of its insurance decisions annually, an operational expenditure (opex) step change to allow for higher insurance bushfire premiums and a contingent project for the South Australian Government's Bushfire Risk Review.<sup>1</sup>

The AER's Final Determination for SAPN changed the definition of 'insurance cap event', rejected the proposed opex step change and rejected the annual AER assessment of the

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<sup>1</sup> SAPN (Feb 2020) SA Power Networks 2020-25 Distribution Determination – Bushfire Liability Insurance Premiums Step Change Submission and SAPN (Feb 2020) Submission on SA Power Networks Draft Decision 2020-25 – Final submission Bushfire Risk Review Contingent Project – February 2025.

prudence and efficiency of their insurance.<sup>2</sup> The AER stated that it was inappropriate to form any ex-ante or pre-emptive views about a potential cost pass through application. Instead the AER foreshadowed this Consultation Paper to provide guidance on their assessment criteria. This finding by the AER will also likely apply to the guidance note on key matters the AER is likely to have regard to when assessing an insurance event application.

The AER changed the definition of an 'insurance cap event' to recognise that network operators may have more than one insurance policy, to allow for 'changed circumstances' where the insurance market will not quote or has unreasonable terms and changed the name to insurance coverage event. It now applies to SAPN, Ergon Energy and Energex's 2020-2025 regulatory control periods and likely will be used in future regulatory determinations. The definitional changes ensure that this cost pass through event is up to date with the changes in the insurance market that occurred this year and expected in future years.

The AERs proposed guideline should help to address DNSPs' concerns about demonstrating to the AER that their level of insurance is prudent and efficient for any future cost pass through application, particularly if the coverage levels available in the market are low or no insurance is available at commercial rates.

## **2 Rules for AER assessment of pass throughs**

### **2.1 Existing guidance on the AER's assessment methodology for pass through applications**

The current cost pass through frameworks set out how the AER should assess applications and are summarised below for the National Electricity Rules (NER) and National Gas Rules (NGR).

#### **2.1.2 AER's assessment under the NER**

There are two processes in the NER for the AER's assessment of cost pass throughs. Firstly, the regulatory review proposal process requires the AER to assess in advance if the DNSP should include the nominated pass through events proposed by the DNSP. Secondly, within the regulatory review period the AER must assess applications for cost pass throughs made by the DNSP.

For the AER to include a DNSP nominated pass through event into a building block decision in a regulatory determination the AER must take into account the nominated pass through event considerations, which include amongst other things:

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<sup>2</sup> Although the AER rejected SAPNs opex step change because this was an existing regulatory obligation and it was not a material change beyond the price growth forecast, the AER ultimately accepted the increased premium cost in the opex allowance of the Final Decision AER Attachment 6: Operating expenditure Final decision SA Power Networks 2020-25 p.27 and AER Overview Final Decision SA Power Networks distribution determination 2020-25 p.15, 33.

- whether a prudent service provider could reasonably prevent an event of that nature or type from occurring or substantially mitigate the cost impact of such an event; and
- whether the relevant service provider could insure against the event, having regard to:
  - (1) the availability (including the extent of availability in terms of liability limits) of insurance against the event on reasonable commercial terms; or
  - (2) whether the event can be self-insured on the basis that: (i) it is possible to calculate the self-insurance premium; and (ii) the potential cost to the relevant service provider would not have a significant impact on the service provider's ability to provide network services.<sup>3</sup>

These nominated pass through event considerations were included in the NER after an Australian Energy Market Commission (AEMC) rule change in 2012.<sup>4</sup> Grid Australia noted that the ability for Network Service Providers (NSPs) to propose additional pass through events at the same time as submitting their revenue proposal would enable:<sup>5</sup>

*“the AER to explicitly consider the trade-off between cost pass through events and forecast insurance costs (both direct insurance and self-insurance) at the same time.”*

The AER's assessment of the appropriateness of the DNSP's insurance coverage as one of the nominated pass through event considerations in the building block regulatory determination, only applies at the point in time of the regulatory determination. It is not an assessment that can be used to demonstrate prudent and efficient decision-making by the DNSP at the time when a pass-through event occurs.<sup>6</sup>

For all cost pass through applications, the AER must take into account the relevant factors, which include amongst other things:

- the efficiency of the DNSP's decisions and actions in relation to the risk of the event, including whether the DNSP has failed to take any action that could reduce the magnitude of the eligible pass through amount and whether the DNSP had taken or omitted to take any action where such action or omission has increased the magnitude of the amount.<sup>7</sup>

In addition, for an insurance coverage pass through event, the AER must assess:

- 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 the DNSP to the AER about the DNSP's action and processes.

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<sup>3</sup> National Electricity Rules, Glossary.

<sup>4</sup> AEMC, 2012 August, Rule Determination National Electricity Amendment (Cost pass through arrangements for Network Service Providers) Rule 2012, p. ii, accessed from <https://www.aemc.gov.au/rule-changes/cost-pass-through-arrangements-for-network-service>

<sup>5</sup> Grid Australia submission on the draft rule determination, June 2012, p. 3.

<sup>6</sup> SA Power Networks (Dec 2019) 2020-2025 Revised Regulatory Proposal – Attachment 13 Pass through events p.13 and AER (June 2020) Final Decision SA Power Networks Distribution Determination 2020-2025 – Attachment 14 Pass through events p.14.

<sup>7</sup> National Electricity Rules 6.6.1AB(j).

### 2.1.2 AER's assessment under the National Gas Rules

The NGR provides that DNSPs' gas cost pass through events are defined in DNSPs access arrangements (AAs). Evoenergy's current gas AA provides for an Insurance Cap Event. The AER's considerations in assessing an application for gas reflect the considerations that apply to electricity.

## 2.2 AEMC Final Determination for cost pass through arrangements for network service providers

In the Consultation Paper the AER refers to the AEMC's 2012 Rule Determination National Electricity Amendment (Cost pass through arrangements for NSPs). The AER intends to rely heavily on the key issues that the AEMC considered as part of that final determination. Evoenergy notes that the AEMC used these criteria for assessing the rule change request rather than for assessing specific cost pass through applications. Other criteria the AEMC also considered were 'recovery of efficient costs' (rather than least cost option), 'regulatory certainty and transparency', 'alignment of incentives for transmission and distribution network service providers', and 'any other aspects relevant in the rules'.

The AEMC foreshadowed that at times insurance may be limited or not available and recognised the importance of the NSP recovery of efficient costs:

*"NSPs should be provided 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. Not to do so would, over the long term, be likely to affect the efficient investment in, and efficient operation of, those networks. This is because, NSPs that cannot recover their efficient costs are reluctant to invest in their networks."*<sup>8</sup>

## 3 Key issues for Evoenergy

A key objective of the AER's guidance note is to provide more information to DNSPs about how the AER will assess the level of insurance that an efficient and prudent DNSP would obtain or seek to obtain in the event that a cost pass through application is submitted for an insurance coverage event.

Evoenergy considers that an important factor for the AER to take into account is the DNSP's procurement strategy to obtain insurance and the insurance outcome that was achieved in the context of the market circumstances at the time. Information about the DNSP's procurement strategy and the insurance outcomes may be provided by a DNSP in a cost pass through application as evidence to demonstrate that the DNSP was acting prudently and efficiently by obtaining the insurance coverage it acquired. This may contain information about the specific characteristics and controls put in place by the DNSP that contribute to the prospective insurers' determinations of the DNSP's risks and the markets where the DNSP or DNSP's broker sought to acquire insurance.

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<sup>8</sup> Cost pass through arrangements for Network Service Providers Rule 2012, p. 18, accessed from <https://www.aemc.gov.au/rule-changes/cost-pass-through-arrangements-for-network-service>

Evoenergy confirms the findings noted by the AER in the Consultation Paper that Evoenergy has experienced higher insurance premiums for lower levels of coverage and more excluded circumstances, as well as withdrawal of insurers from some insurance categories. In particular, insurance protection against bushfire risk and Directors and Officers liability have been most effected by events within Australia and overseas.

The AER's guidance would be helpful in assisting DNSPs to address the issue of prudent and efficient decision making when faced with increasing premium costs and contracting insurance market. At what point is expenditure no longer value for money, given the insurance premiums and coverage that is available when the market is contracting? Historic benchmarking of premiums and coverage may not be as useful a guide to efficient and prudent outcomes as it was in the past. Re-assessment of what is considered to be prudent and efficient might be required for each cost pass through event.

In providing a guidance note, the AER must be mindful of any potential adverse impacts the AER may have on the insurance market which is highly sensitive to the conditions under which insured firms and potentially insured firms operate.

## 4 Appendix 1: Responses to AER questions

	Question	Evoenergy Response
1	<p><b>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.</b></p>	<p>We agree with the AER considerations of the level of insurance that an efficient and prudent NSP would obtain or have sought to obtain:</p> <ul style="list-style-type: none"> <li>• Efficient allocation of risks between NSP and end consumers;</li> <li>• Extent to which the events are unexpected and outside of the NSP’s control; and</li> <li>• The AER proposed criteria of ‘least cost option’ may not be as appropriate as the other criteria. This is because low cost insurers are more likely to refuse payout of insurance claims or have unrealistically restrictive terms and conditions. The least cost option does not always reflect prudent insurance coverage decisions of NSPs. Instead, ‘reasonable cost’ may be a more appropriate criterion.</li> </ul> <p>In practice the AER’s assessment would result in an overall position across the key elements in recognition that DNSPs need to make trade-offs between them.</p> <p>The unique characteristics of each DNSP applying for the cost pass through are important, including jurisdictional policies and the value of the insurance premium allowed in the operational expenditure applicable regulatory determination.</p>
2	<p><b>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.</b></p>	<p>The issues, analysis and information will vary with each cost pass through event application, nature of the applicants and over time as new information becomes available.</p> <p>Documentation that explains the DNSPs process to obtain insurance is important including internal risk analysis and assessment of quotes obtained. In the AER’s consideration of the efficient allocation of risks, the implications of an insurance coverage events on the DNSPs cashflow and bottom-line is relevant.</p>

	Question	Evoenergy Response
		<p>The information requirements should be commensurate with the value of the eligible pass through amount and the relatively short timeframes for DNSPs to collate materials for an application after the event arises.</p>
3	<p><b>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)?</b></p>	<p>As insurance markets have tightened and the availability of coverage has declined, DNSPs may not be able to obtain adequate insurance coverage at all. Evoenergy supports the AER’s consideration of the availability and cost of insurance coverage. Classification of an event as low probability and high severity risk may change over time and for each DNSP.</p> <p>The AER’s guidance note may be used by insurers for information required to support a DNSP claim or insurance application.</p>
4	<p><b>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?</b></p>	<p>An annual process for DNSP provision of insurance information to the AER is unnecessary. The provision of insurance details to the AER is only required when there is a regulatory process on foot related to an insurance coverage event, which would be either a DNSP application to pass through costs or AER review of a nominated pass through event proposed by a DNSP during a regulatory determination.</p> <p>Furthermore, the usefulness of annual provision of information to the AER is questionable when the AER has indicated that it would be inappropriate to form any ex-ante or pre-emptive views about a potential cost pass through application.</p>
5	<p><b>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</b></p>	<p>Benchmarking of insurance coverage information is problematic as premiums and coverage details are specific to the DNSP risk profile and reflects circumstances such as the DNSPs location for bushfire insurance. Factors like positioning of assets, network size, maintenance regimes, drought conditions etc all impact bushfire risks so comparisons are difficult to draw from. The portfolio of risks insured</p>

	Question	Evoenergy Response
	<p><b>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.</b></p>	<p>will vary with each firm and some jurisdictions may place different requirements and expectations on insurance.</p> <p>Confidentiality of insurance premiums and insurance coverage details will limit the publication of the information. If this data were to be published such data would likely have negative impacts for some DNSPs in relation to competitive procurement of insurance coverage.</p>
6	<p><b>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?</b></p>	<p>Evoenergy seeks to minimise exposure to the risk of an insurance coverage pass through event by undertaking activities to reduce the risk of loss or damage to resources, potential harm to property, life and reputation as well as purchasing insurance policies.</p> <p>Existing operational incentive mechanisms in the rules apply to electricity and gas operations. No additional incentives are required to be established by the AER.</p> <p>Regarding bushfire risk, where available coverage from insurance firms reduced in 2020, Evoenergy’s current insurance coverage is less than the value Evoenergy would prefer, although the premiums paid were higher than last year.</p> <p>Mitigation strategies are:</p> <ol style="list-style-type: none"> <li>1) Approach the insurance market for additional public liability capacity throughout 2020/21.</li> <li>2) Utilise the maximum foreseeable loss bushfire scenarios to help determine areas of higher financial risk should assets causing a bushfire event take place. Conduct operational risk assessments of these areas to see if there are any additional measures that can further reduce this risk to as low as reasonably practicable.</li> <li>3) Deployment of Remote Area Power Supply (RAPS, otherwise known as stand-alone power systems or SAPS) in areas of higher risk during bushfire season.</li> </ol>

	Question	Evoenergy Response
		Re-assess policy limits across each type. Consider long term insurance coverage arrangements (1-3 years) to help spread risk over multiple years, although none of these arrangements are available in the current market.
7	<b>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?</b>	Yes, declining coverage and increased premiums in the insurance market are impacting Evoenergy's gas network as well as the electricity network. All the same principles apply to gas insurance, as Evoenergy could only obtain lower coverage with more exclusions for higher cost premiums this year.