

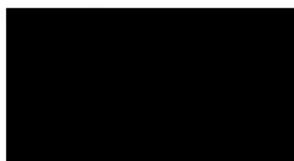


Australian Energy Regulator

Jemena Bushfire Liability Insurance

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Public Summary

Introduction

The Australian Energy Regulator (AER) regulates electricity networks and natural gas pipelines by setting the maximum amount of revenue they can earn. Decisions generally apply for five years, and network businesses adjust their prices annually during the five-year period.

The AER is currently in the process of reviewing Jemena's proposal for 2021-2026 revenues in Victoria. A part of this review, the AER has engaged Taylor Fry and Willis Re to provide expert advice on the increase in insurance premium costs expected to be incurred by Jemena to manage its bushfire liability risks.

The scope of the review into the Jemena bushfire step change proposal is split into three core components:

- » Review the insurance liability structure and capacity
- » Review Jemena's proposed insurance premium forecasts and provide our own estimates
- » Assess the sensitivity of insurance premiums.

Our report is intended to be used by the AER in its assessment of the reasonableness of the bushfire liability insurance cost projections put forward by Jemena. This document provides a public summary of the scope and conclusions of our review. We have also provided the AER with a confidential document containing our full analysis which draws on, and sets out, the confidential information provided by Jemena and our own sources. We note that the conclusions presented may be inappropriate for other purposes.

Information that has been relied upon

In preparing this report, we have considered a variety of information, the majority of which was provided by Jemena much of which is confidential in nature. This information has broadly included:

- » Legislation describing the duties imposed upon Jemena
- » Claim definitions within Jemena's liability insurance policy
- » Jemena's claim history (if any) on their insurance policy
- » Jemena's current insurance structure including their deductible, cover limits and layers of cover
- » Jemena's historical premium costs and recent history of their insurance structure
- » A bushfire mitigation plan and risk management policy
- » A report prepared by Jemena's insurance broker which included:
 - » Observations about the current market and future of the market and the impact of changes to various factors on the capacity of the market.
 - » The possible impact of changes to the market to the premiums paid by Jemena
 - » Jemena's and Jemena Electricity Network's (JEN) expected future insurance cost
- » A bushfire Liability Review prepared by Jemena's insurance broker
- » Other financial information relating to Jemena.

We have also considered current factors within the industry, external information and our industry knowledge, such as:

- » The nature of Jemena's risk and how this relates to the impacts caused by changes to the market
- » Our own observations about the current market and future of the market and the impact of changes to various factors on the capacity of the market
- » Relevant insurance placement data from the global insurance market including the average risk adjusted changes to reinsurance rates for all casualty (liability) insurance classes.

The results (including our own estimates of future insurance premiums) and subsequent conclusions we have made have been based on the information provided and our industry knowledge.

Conclusions

Jemena requested AON to provide an independent forecast of Jemena's liability insurance premiums for the upcoming regulatory period 2021-26. Our conclusions with regards to the insurance liability structure and capacity are:

- » The insurance structure currently in place is comprised of a number of layers. Given the comparative cheapness of insurance premiums in the upper layer of Jemena's policy and advice from their insurance broker – we consider Jemena's current level of cover to be reasonable
- » It would be difficult to recommend the purchase of a smaller Limit of Liability for the sole purpose of saving premium, especially considering principles of good government, risk management, catastrophic event modelling error and the expectation of the general public at large
- » Jemena has combined liability policies which provide broad coverage across general liability, products liability and professional indemnity. Cover is provided for both their gas and electricity distribution businesses. The overall costs of the policy are split, with a portion allocated to JEN. We have reviewed both the historical and forecast premium allocations and consider this to be a reasonable allocation of premium rates across the business.
- » Jemena has made claims that they have implemented extensive measures to mitigate risks – both legal and internally developed through risk management practices. However, given the prevailing insurance liability market conditions we consider that the nature of the insurance that Jemena requires is relatively immune to the risk faced by an individual organisation. The risk associated with an individual business is likely to have a greater impact on the ability to attract capital, and a minimal impact on the ability to find a lower premium rate. In essence, the insurance provided reflects the insurers' view of an efficient return on capital. An increased insurance risk cost (e.g. double the underlying insurance risk) will have a moderate impact on the return on capital required by insurers. For example, if the insurance risk doubles from 0.01% of sum insured to 0.02% of sum insured, the cost of insurance would not be expected to double
- » We consider that it is very likely that there will be a reduction in the capacity of the insurance market over the next five years. The reduction in capacity will impact the premiums imposed on Jemena and we anticipate significant premium increases over the next few years and maybe the next five.

Our conclusions with regards to Aon's insurance premium forecasts as well as our own forecasts are:

- » Based on current market conditions and their obligations, Jemena's public liability insurance cover/liability limit is commercially prudent
- » The higher insurance premiums proposed by Jemena over the Regulatory Period are directionally consistent with prevailing insurance liability market conditions and the current outlook for the next five years. The premiums forecast by Aon are neither exceptionally high, nor are they below our expectations, noting there is extreme difficulty in predicting future rate movements in a changing insurance market place.
- » Jemena has used the 2018 calendar year as the base year which was prior to the significant price increase in the 2019/20 policy year. There is an argument that, as insurers meet and/or exceed their technical pricing requirements, further rate increases either become unnecessary or unattainable as new capacity is attracted by large premiums in the market. However, it is difficult to see capacity flowing back to the market in 2020/21 after the Black Summer.
- » The current market focus on efficient use of capital means that Jemena has limited options to moderate the higher premium costs – particularly in relation to lower policy limits and deductible schedules.
- » We consider that the forecast insurance premium increase for 2021/22 to be reasonable, albeit subject to considerable uncertainty. Forecasts of premiums beyond 2021/22 are extremely uncertain. Nevertheless, we consider that it is more likely that premiums will continue to increase (in real terms) than remain at 2021/22 levels.

Our conclusions with regards to the sensitivity of insurance premiums are:

- » Savings from alternative arrangements are unlikely to be material without a material reduction in the insurance limit. Such a reduction in limit would place Jemena in financial risk should a major event occur
- » Given the considerable uncertainty surrounding liability premiums in the short- to medium-term, we question whether it would be feasible to include a modest allowance for a step change that can be reviewed following the 2020/21 premium renewal and adjusted if premiums actually achieved materially exceed allowed increase.

