



# Insurance

**UE RRP BUS 9.05 - Insurance - Dec2020**

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**Revised regulatory proposal 2021–2026**

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# 1 Summary

The significant disruption to global insurance markets, driven primarily by recent bushfire events, is expected to continue into the next regulatory period. This will result in further withdrawal of insurance capacity for bushfire liability risks and material and sustained increases in the liability insurance premiums we will incur.

Under the base-step-trend approach to forecasting operating expenditure adopted by the Australian Energy Regulator (**AER**), step changes are required for costs not captured in the base year operating expenditure or the rate of change, where those costs reasonably reflect the prudent and efficient costs required to achieve the operating expenditure objectives and reflect a realistic expectation of the demand forecast and cost inputs required to achieve those objectives.

In addition, the uncertainty regime under the National Electricity Rules (**Rules**) allows the AER to accept nominated pass through events. This provides an avenue for the recovery of prudent and efficient costs that may be required during a regulatory period but which cannot be predicted with reasonable certainty at the time of the regulatory proposals or the AER's determination.

The regulatory framework set out in the Rules thus allows us to include in our forecast operating expenditure expected increases in the cost of insurance where we can predict those costs with reasonable certainty, but also allows us to propose nominated pass through events to enable us to request additional funding from the AER during the regulatory period in the event of material changes in costs, where increased costs are anticipated but the magnitude of the changes is difficult to predict with sufficient certainty.

## 1.1 Summary of our revised proposal

Our revised proposal includes:

- an operating expenditure step change to account, at least in part, for the substantial increases in insurance premiums expected over the 2021–2026 regulatory period, based on the actual insurance premiums incurred for the 2020/21 policy year
- an insurance premiums pass through event, as well as the insurance coverage pass through event accepted by the AER, to address the residual risk of materially higher insurance premiums and reduced capacity expected to arise in the next regulatory period.

In recognition of the difficulty associated with forecasting the magnitude of insurance premium increases, our proposed step change is conservative, based on the actual insurance premiums incurred for the 2020/21 policy year, rather than the higher increases forecast by our broker Marsh, a global leader in insurance broking and risk management. Given the step change captures only those increases in insurance premiums we have already incurred and there is considerable uncertainty as to the degree to which the further tightening of insurance markets will impact on distributors in the next regulatory period (both in terms of premiums and coverage), to ensure that we are provided with the opportunity to recover at least our efficient costs in providing direct control network services, we are proposing an insurance premiums pass through event, as well as the insurance coverage pass through event accepted by the AER.

This combination of a step change in operating expenditure, insurance premiums pass through event and insurance coverage pass through event, delivers the most appropriate regulatory outcome by:

- preserving the incentives to achieve efficiencies in the procurement of insurance products. Specifically, allowing a step change enables the incentive regime established by the Rules to operate as intended for a reasonable increase in efficient costs, given prevailing market conditions
- ensuring that the risk of increases in premiums that result in materially higher costs of providing direct control services in the next regulatory period are adequately addressed. Allowing an insurance premiums

pass through event ensures that there is an avenue to allow recovery of at least our prudent and efficient costs of insurance

- facilitating the prudent and efficient procurement of insurance products in circumstances where market conditions are rapidly changing:
  - the insurance premiums step change and insurance premiums pass through event allow us to maintain a level of insurance expected by government and the general public and to deliver lower volatility in tariffs to consumers
  - the insurance coverage pass through event allows us to pass through of costs associated with liability claims where insurance coverage was not available on commercially reasonable terms and thus allows us to procure a lower level of insurance coverage when appropriate to do so.

#### **1.1.1 Our insurance premiums are increasing at a rate unmatched by any other cost item**

We procure combined liability insurance via a program of insurance cover for Victoria Power Networks (**VPN**), United Energy and SA Power Networks (collectively, **VPN/UE/SAPN**). The premiums incurred by VPN/UE/SAPN increased by 75 per cent (in real terms) between the 2019/20 and 2020/21 policy years (fiscal years ending 30 September), while our overall policy limit was reduced (in nominal terms) by \$250 million (or 25 per cent) to \$750 million. Based on this increase in premiums, we are proposing a step change to reflect the increase in our liability insurance costs, namely \$12 million (\$2020-21) over the regulatory period. This is an increase in our annual premium allowance of 118 per cent (in real terms) over the premiums reflected in the 2019 base year (calendar year).

While the increase in premiums in the 2020/21 policy year was significant, the higher costs we incurred reasonably reflect the prudent and efficient costs required to meet the operating expenditure objectives. In particular our processes and procedures for procuring insurance ensure that we hold the right level of cover and achieve the best possible deal given the available options in the current market, including through the development of innovative approaches to procuring insurance products.

Accordingly, we consider our step change based on these increases reasonably reflects the prudent and efficient costs required to achieve the operating expenditure objectives and reflects a realistic expectation of the cost inputs required to achieve those objectives.

We disagree with the AER's analysis in the draft determination that our step change should be rejected on the basis that the increase in our insurance premiums is not material and is captured by the rate of change.

Regarding materiality, first, against the background of current market conditions and the 75 per cent increase (in real terms) in VPN/UE/SAPN 2020/21 policy year premiums, the AER can no longer maintain that the expected increases in insurance premiums over the forthcoming regulatory period are not material.

Secondly, and in any event, the AER's analytical framework for assessing the proposed step change is deeply flawed. This is because:

- there is no express materiality threshold under the Rules for the purposes of assessing whether operating expenditure should be included in the forecast
- there is no basis in the Rules for applying a materiality threshold to operating expenditure step changes in circumstances where we are an efficient distributor facing a range of other pressures on our operating expenditure in the next regulatory period, including:
  - a negative productivity adjustment, which reduces our total operating expenditure allowance
  - real non-labour price growth of zero, which means that the non-labour component of price growth is equal only to the consumer price index (**CPI**)

- the enduring impact of COVID-19, which (all other things being equal) increases our costs of providing network services
- the rejection by the AER of a number of other step changes we proposed, which costs will thus need to be absorbed
- there is no upward bias in our operating expenditure proposal as there are no matters that would warrant a negative step changes that are not reflected in our revised proposal.

Finally, the AER's approach to assessing the proposed step changes based on materiality would create perverse incentives where smaller networks are compensated for relatively larger cost increases, while larger networks like us are not compensated for minimising cost increases.

Regarding the rate of change, it is not reasonable for the AER to conclude that the \$12 million (\$2021) step change now sought is compensated for through non-labour price growth, which, in real terms, is set to zero, that is to say, equal to CPI only. There are no other non-labour cost inputs which have prices declining at anywhere near the same rate as insurance premium costs are rising and thus no consequential reduction in costs of this magnitude. The AER has not identified any such cost inputs and we consider that there are no cost inputs which have price reductions to offset the increase in insurance costs. Applying the rate of change will thus not adequately compensate us for increases in the costs of procuring insurance in the next regulatory period.

### 1.1.2 Revised proposal forecasts

The table below sets out our proposed operating expenditure step change for increased insurance premiums, which is based on actual premiums incurred in the 2020/21 policy year less the insurance premiums we paid in the 2019 base year.

Table 1 Liability insurance premiums step change, \$million 2021

	2021/22	2022/23	2023/24	2024/25	2025/26	Total
Insurance premiums step change	2.4	2.4	2.4	2.4	2.4	11.8

Note: the total is not the exact sum of the five years due to rounding.

Source: United Energy

# 2 Background

## 2.1 Rules requirements

The costs associated with insurance products are reflected in our operating expenditure. Accordingly, when considering our proposal to recover the costs associated with procuring insurance products in the next regulatory period, the Rules governing operating expenditure apply. In particular, clause 6.5.6(c) of the Rules provides that the AER must accept the forecast of required operating expenditure if it is satisfied that the forecast reasonably reflects each of the following (the operating expenditure criteria):

- the efficient costs of achieving the operating expenditure objectives
- the costs that a prudent operator would require to achieve the operating expenditure objectives
- a realistic expectation of the demand forecast and cost inputs required to achieve the operating expenditure objectives.

In deciding whether it is satisfied that the forecast reasonably reflects the operating expenditure criteria, the AER must have regard to the following operating expenditure factors (relevantly):

- the actual and expected operating expenditure of the distributor during any preceding regulatory periods (clause 6.5.6(e)(5))
- the extent to which the operating expenditure forecast includes expenditure to address the concerns of electricity consumers as identified by the distributor in the course of its engagement with electricity consumers (clause 6.5.6(e)(5A)).

In addition, the Rules recognise that a prudent and efficient distributor can be exposed to risks beyond its control, which may have a material impact on its costs. The cost pass through regime enables a distributor to recover the costs of defined unpredictable, high-cost events not reflected in the distribution determination.

Clause 6.5.10(a) of the Rules provides that a distributor can include 'nominated pass through events' in their regulatory proposals. In determining whether to accept a distributor's proposed nominated pass through event, the AER must take into account the 'nominated pass through event considerations'. These are relevantly defined in chapter 10 of the Rules to be:

- whether the event proposed is an event covered by a category of pass through event specified in clause 6.6.1(a1)(1) to (4)
- whether the nature or type of event can be clearly identified at the time the determination is made for the service provider
- 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
- whether the relevant service provider could insure against the event, having regard to:
  - the availability (including the extent of availability in terms of liability limits) of insurance against the event on reasonable commercial terms; or
  - whether the event can be self-insured on the basis that:
    - it is possible to calculate the self-insurance premium; and
    - the potential cost to the relevant service provider would not have a significant impact on the service provider's ability to provide network services
- any other matter the AER considers relevant and which the AER has notified network service providers is a nominated pass through event consideration.

In assessing a distributor's operating expenditure forecast, the National Electricity Law (**Law**) provides that the AER is required to perform its function in a manner that will, or is likely to, contribute to the achievement of the national electricity objective (**NEO**).<sup>1</sup> The NEO is:<sup>2</sup>

*...to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to:*

- (a) price, quality, safety and reliability and security of supply of electricity*
- (b) the reliability, safety and security of the national electricity system.*

Finally, when exercising a discretion in making those parts of a distribution determination relating to direct control network services, the AER must take into account the revenue and pricing principles.<sup>3</sup> The revenue and pricing principles are set out in section 7A of the Law and relevantly include:

*(2) A regulated network service provider should be provided with a reasonable opportunity to recover at least the efficient costs the operator incurs in–*

- (a) providing direct control network services; and*
- (b) complying with a regulatory obligation or requirement or making a regulatory payment.*

*(3) A regulated network service provider should be provided with effective incentives in order to promote economic efficiency with respect to direct control network services the operator provides. The economic efficiency that should be promoted includes–*

- (a) efficient investment in a distribution system ... with which the operator provides direct control network services; and*
- (b) the efficient provision of electricity network services; and*
- (c) the efficient use of the distribution system ... with which the operator provides direct control network services.*

...

*(5) A price or charge for the provision of a direct control network service should allow for a return commensurate with the regulatory and commercial risks involved in providing the direct control network service to which that price or charge relates.*

...

## 2.2 Our original proposal

Our original proposal included an operating expenditure step change for increases in insurance premiums based on the insurance premiums incurred in the 2019/20 policy year. We capped our forecast insurance premiums over the 2021–2026 period to the same level as our premiums for the 2019/20 policy year. This was a conservative approach, adopted in the knowledge that we would have more information on prevailing market conditions when submitting our revised proposal.

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<sup>1</sup> Law, section 16(1)(a).

<sup>2</sup> Law, section 7.

<sup>3</sup> Law, section 16(2)(a).



In addition, we included an insurance coverage event as a proposed nominated pass through event.<sup>4</sup>

## 2.3 AER's draft determination

In its draft determination, the AER did not accept our proposed operating expenditure step change for the increase in insurance premiums.<sup>5</sup> The AER noted that the increases are not related to a new regulatory obligation or requirement or a substitution between capital and operating expenditure (being the most common circumstances for which the AER will allow a step change).<sup>6</sup> Under the AER's approach to considering step changes, this means the AER will accept the insurance premiums step change only under 'limited circumstances', after considering whether the costs are unavoidable and material such that they could not be recovered through the base operating expenditure trended forward by the forecast rate of change and whether we would continue to incur the costs of a proposed step change in future regulatory periods.<sup>7</sup>

The AER gave two key reasons for rejecting our step change:<sup>8</sup>

- the increase in insurance premiums was not material relative to our total operating expenditure (representing 0.3 per cent of total operating expenditure)
- it is not clear the increase in insurance premiums is not captured through the operating expenditure rate of change, specifically through non-labour price growth.

Accordingly, the AER concluded that we 'should be able to manage such proposed costs within both the trend forecast and reflecting the offsetting impact of decreases in cost categories over the 2021-26 regulatory period'.<sup>9</sup>

Given the AER determined real non-labour price growth of zero, the draft determination is, in effect, that it is not clear that the increase in insurance premiums is not captured through increases in CPI. The AER indicated that it expected that some non-labour components will increase by more than CPI and some less than CPI such that, to the extent insurance premiums increase by more than CPI, the AER expects this to be offset by other non-labour costs included in the operating expenditure allowance rising by less than CPI. The AER also noted that CPI includes household insurance premiums which cover bushfires and, while there are differences between household and utility insurance premium increases, there are similar drivers impacting both and their future growth.<sup>10</sup>

Given gaps in our insurance coverage may occur if we are unable to find suitable insurance providers to fill withdrawn capacity or cannot economically justify higher premiums, the AER accepted the insurance coverage pass through event proposed, making minor amendments to ensure the definition is consistent with recent determinations regarding SA Power Networks, Ergon Energy and Energex.<sup>11</sup> The AER also invited us to make submissions on a number of minor amendments to the AER's definition proposed by Jemena.

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<sup>4</sup> We also proposed (and the AER accepted) an insurer credit risk event. As this event is not directly related to the impact of volatility in the market for insurance, our response to the AER's decision in respect of this event is dealt with in the managing uncertainty appendix UE RRP APP04.

<sup>5</sup> AER, Draft Decision United Energy, Distribution Determination 2021-2026, Attachment 6: Operating expenditure, September 2020, pp 58-59

<sup>6</sup> AER, Draft Decision United Energy, Distribution Determination 2021-2026, Attachment 6: Operating expenditure, September 2020, pp 58-59

<sup>7</sup> AER, Draft Decision United Energy, Distribution Determination 2021-2026, Attachment 6: Operating expenditure, September 2020, p 19

<sup>8</sup> AER, Draft Decision United Energy, Distribution Determination 2021-2026, Attachment 6: Operating expenditure, September 2020, p 59

<sup>9</sup> AER, Draft Decision United Energy, Distribution Determination 2021-2026, Attachment 6: Operating expenditure, September 2020, p 59

<sup>10</sup> AER, Draft Decision United Energy, Distribution Determination 2021-2026, Attachment 6: Operating expenditure, September 2020, p 9

<sup>11</sup> AER, Draft Decision United Energy, Distribution Determination 2021-2026, Attachment 15: Pass through events, September 2020, pp 13-14

### 2.3.1 AER's draft determinations for Jemena and AusNet Services

In Jemena's draft determination, the AER accepted an operating expenditure step change for increasing insurance premiums.<sup>12</sup> Jemena's proposed step change was based on forecast insurance premiums prepared by its broker, AON. The AER concluded that Jemena's step change was a material increase in its operating expenditure (representing 5 per cent of total operating expenditure) and therefore not reflected in the operating expenditure rate of change.

However, the AER did not accept Jemena's proposed insurance premiums nominated pass through event to address the risk of further significant increases in insurance premiums arising from events outside of Jemena's control (namely, the prevailing limited capacity and highly volatile global liability insurance market).<sup>13</sup> The AER also rejected AusNet Services' proposed insurance premiums nominated pass through event.<sup>14</sup>

The AER stated in both draft determinations that it:<sup>15</sup>

- took account of the impact of the volatility in the insurance liability market on network providers by including an insurance coverage event
- considers the insurance coverage event addresses key aspects of the unusual and uncontrollable risks faced by the distributors in the prevailing insurance liability market.

The AER highlighted that using appropriate regulatory mechanisms is important to ensure:<sup>16</sup>

- there is no duplicate recovery for the same set of risks
- the mechanisms provide maximum incentives for service providers to address the identified risks and incur efficient costs.

The AER did not consider that Jemena had provided evidence as to the additional risks and higher insurance costs that it would face in future, as it had sought (and the AER accepted) a step change that reflects its broker's advice as to increases in its bushfire liability insurance over the 2021–26 period.<sup>17</sup> Noting that AusNet Services had not proposed a step change, the AER indicated that AusNet Services had not provided sufficient details for it to understand the specific impacts that AusNet Services would face due to the unusual market conditions in the next regulatory period.<sup>18</sup>

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<sup>12</sup> AER, Draft Decision Jemena, Distribution Determination 2021-2026, Attachment 6: Operating expenditure, September 2020, pp 60-62

<sup>13</sup> AER, Draft Decision Jemena, Distribution Determination 2021-2026, Attachment 15: Pass through events, September 2020, pp 15-16

<sup>14</sup> AER, Draft Decision AusNet Services, Distribution Determination 2021-2026, Attachment 15: Pass through events, September 2020, pp 15-16

<sup>15</sup> AER, Draft Decision Jemena, Distribution Determination 2021-2026, Attachment 15: Pass through events, September 2020, p 15; AER, Draft Decision AusNet Services, Distribution Determination 2021-2026, Attachment 15: Pass through events, September 2020, pp 15-16

<sup>16</sup> AER, Draft Decision Jemena, Distribution Determination 2021-2026, Attachment 15: Pass through events, September 2020, p 15; AER, Draft Decision AusNet Services, Distribution Determination 2021-2026, Attachment 15: Pass through events, September 2020, pp 15-16

<sup>17</sup> AER, Draft Decision Jemena, Distribution Determination 2021-2026, Attachment 15: Pass through events, September 2020, p 15; AER, Draft Decision Jemena, Distribution Determination 2021-2026, Attachment 6: Operating expenditure, September 2020, p 61

<sup>18</sup> AER, Draft Decision AusNet Services, Distribution Determination 2021-2026, Attachment 15: Pass through events, September 2020, pp 15-16

# 3 Revised proposal

## 3.1 Summary of our revised proposal

Our revised proposal includes an operating expenditure step change to account, at least in part, for the material expected increase in insurance premiums over the 2021–2026 regulatory period. The step change is based on our 2020/21 policy year premiums as this is the level of premiums that can be forecast with sufficient certainty to warrant inclusion of the costs in forecast operating expenditure.

We do not agree with the draft determination that the expected increase in our insurance premiums is not material. We do not consider that the AER's analytical framework complies with the Law and Rules, and maintain that there was no basis to draw such a conclusion in respect of the step change. Further, our original proposal was based on premiums for the 2019/20 policy year and the premiums incurred by VPN/UE/SAPN for the 2020/21 policy year have increased by a further 75 per cent (in real terms) over and above 2019/20 premiums. With no decline in premiums forecast, but rather further substantial increases expected, there is no basis for the AER to uphold the position outlined in its draft determination in its final determination.

We also do not agree with the AER that the increase in our insurance premiums is captured by the non-labour component of the rate of change. Real non-labour price growth is set to zero, thus the non-labour rate of change is equal to CPI. Our insurance premiums are increasing at a rate that is significantly higher than CPI and there are no other non-labour cost inputs which have prices declining at anywhere near that same rate as insurance premium costs are rising. The AER has not identified any cost inputs which have price reductions of this magnitude and we consider that there are no such inputs. Applying the AER's rate of change will thus not adequately compensate us for increases in the costs of procuring insurance products in the next regulatory period.

While our broker Marsh has forecast further increases in insurance premiums over the 2021–2026 regulatory period, in recognition of the difficulty associated with forecasting the magnitude of increases in insurance premiums under prevailing market conditions, we have proposed a conservative step change that reflects only those increases that have already manifested in actual premiums incurred.

To ensure we are provided with the opportunity to recover at least our efficient costs, given further increases are likely, we are also including in our revised proposal an insurance premiums nominated pass through event. This event will ensure that, to the extent the tightening of the insurance markets continues to increase premiums in the next regulatory period, and we incur prudent and efficient material increases in the cost of providing direct control services, we will be provided with the opportunity to recover those costs.

As requested by the AER, we have considered Jemena's proposed amendments to the insurance coverage pass through event definition. We agree with each of those changes and propose only minor further amendments to that definition.

## 3.2 Changing global insurance market conditions

### 3.2.1 Role of insurance

We procure combined liability insurance (bushfire liability, general and products liability and professional indemnity) as a means of managing the financial risk of operating an electricity distribution network. Of these risks, bushfire liability is by far the most significant.

Insurance performs an important role in smoothing the costs of managing financial risk and ensuring we can continue to provide network services (specifically, by reducing the risk our business will face severe financial challenges, including bankruptcy, pursuant to liability claims following a catastrophic event). If we did not procure insurance, our customers would be exposed to higher overall costs and greater volatility in tariffs. In particular:

- if we did not hold liability insurance, we would need to self-insure (that is, hold funds in order to cover the costs of future liability claims and continue providing network services). Given the potential for significant liability that arises through the operation of an electricity distribution network (and thus the potential impact on our ability to provide network services), self-insuring such risks would require us to hold significant capital funds. This would lead to substantially higher costs of providing services compared to these risks being managed by the procurement of an appropriate level of insurance cover
- in circumstances where there is an insurance coverage nominated pass through event (formerly insurance cap event), a failure to procure insurance where it is available on commercially reasonable terms would result in greater volatility in tariffs if an event occurs. If third party claims are not covered by insurance, the costs associated with meeting those claims would be passed through by the distributor to consumers over a short period following a successful pass through application, increasing the volatility of prices paid by consumers.

The role of insurance, as a prudent and efficient means of managing financial risk, is expressly recognised in the Rules. Specifically, in considering whether to allow a nominated pass through event, the AER is required to have regard to whether the distributor could insure against the event having regard to the availability of insurance on reasonable commercial terms.<sup>19</sup>

In addition, the insurance experts engaged by the AER to review Jemena's insurance step change, Taylor Fry and Willis Re, acknowledge the importance of adequate liability insurance. While not all information regarding Jemena's insurance policies is publicly available, the public summary prepared by the experts engaged by the AER states, for example:<sup>20</sup>

*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 [sic], risk management, catastrophic event modelling error and the expectation of the general public at large[.]*

In any event, it is not a commercially realistic option not to hold adequate liability insurance. Our debt investors expect us to have adequate insurance cover. During our debt raising processes investors ask many questions about our insurance arrangements and therefore we actively provide this information in our debt presentations and documentation. If adequate cover was not perceived to be in place, then investors and rating agencies would need to re-evaluate the credit position and the cost of raising debt may increase as a consequence.

### 3.2.2 Impact of recent bushfires on insurance markets

The majority of our insurance costs (more than 90 per cent) relate to the risk of bushfire liability and bushfire liability is the most significant driver of insurance costs and availability in the next regulatory period.<sup>21</sup>

Our insurance broker, Marsh, has advised that the most recent 2019/20 bushfires in Queensland, New South Wales, Victoria, South Australia, Western Australia and the Australian Capital Territory have captured attention globally, with insurers monitoring the impact and the size and scale of the losses. In addition to utilities related liability losses, estimated insured property losses arising from the 2019/20 bushfire season now stand at \$2.32 billion.<sup>22</sup>

Insurance losses from bushfires are not limited to Australia, as major bushfires/wildfires have occurred throughout the world, including in North America (with frequency in California), France, Germany, Greece,

<sup>19</sup> Rules, clause 6.5.10 and Chapter 10 definition of 'nominated pass through event considerations'.

<sup>20</sup> UE RRP ATT 44: Taylor Fry and Willis Re, Jemena Bushfire Liability Insurance, Public Summary, 14 July 2020, p. ii.

<sup>21</sup> UE RRP ATT50: Marsh, Liability Insurance Premiums - 2020 - 2025, Victoria Power Networks and United Energy, November 2020, p. 9.

<sup>22</sup> UE RRP ATT50: Marsh, Liability Insurance Premiums - 2020 - 2025, Victoria Power Networks and United Energy, November 2020, p. 4.

Indonesia, Italy, Poland and Russia. The consequences are typically measured in terms of hundreds or thousands of buildings destroyed, number of lives lost, and millions of dollars in property damage. Recent events include:<sup>23</sup>

- March 2010: Western Russia — several hundred individual wildfires caused an estimated USD15 billion in damage
- May 2016: Alberta, Canada — the Fort McMurray Wildfire destroyed at least 2,400 homes and buildings. With estimated losses of around CAD4 billion, it is the costliest disaster in Canadian history
- November 2018: Butte County, California, US — the Camp Fire was the deadliest and most destructive in California history. It caused at least 86 fatalities and destroyed 18,804 structures. It was also the world's costliest natural disaster in 2018, with total damage of USD16.5 billion.

Marsh advises that, since the beginning of 2019, there has been a significant withdrawal of insurance capacity globally for bushfire liability risks, due to a combination of insurer consolidation, appetite changes and (re)insurers being more selective in how they deploy their capacity.<sup>24</sup> Specifically, Marsh estimates that well over \$500 million in capacity has exited the bushfire liability sector since 2019.<sup>25</sup>

As a result of these changes in the insurance market, there will be material and sustained increases in insurance premiums, as well as a decrease in the availability of insurance, in the next regulatory period.

The material and sustained increases are evident in:

- the sharp increases in premiums that we have incurred since the 2017/18 policy year
- the forecasts of insurance premiums to the 2025/26 policy year prepared by Marsh
- the conclusions of the AER's own insurance experts engaged to consider the forecasts prepared by Jemena of insurance premiums in the next regulatory period.

Each of these matters are discussed in turn.

### **3.2.3 Increases in actual insurance premiums incurred**

We procure combined liability insurance (bushfire liability, general and products liability and professional indemnity) via a program of insurance cover for VPN/UE/SAPN.

Our combined liability premiums have risen sharply since the 2017/18 policy year, in circumstances where there has been no increase (but rather a reduction) in the liability cap.<sup>26</sup> Figures 1 and 2 below show the changes in the liability limit and premiums of VPN/UE/SAPN since 2003/04 (noting that United Energy only joined the program in 2017/18).

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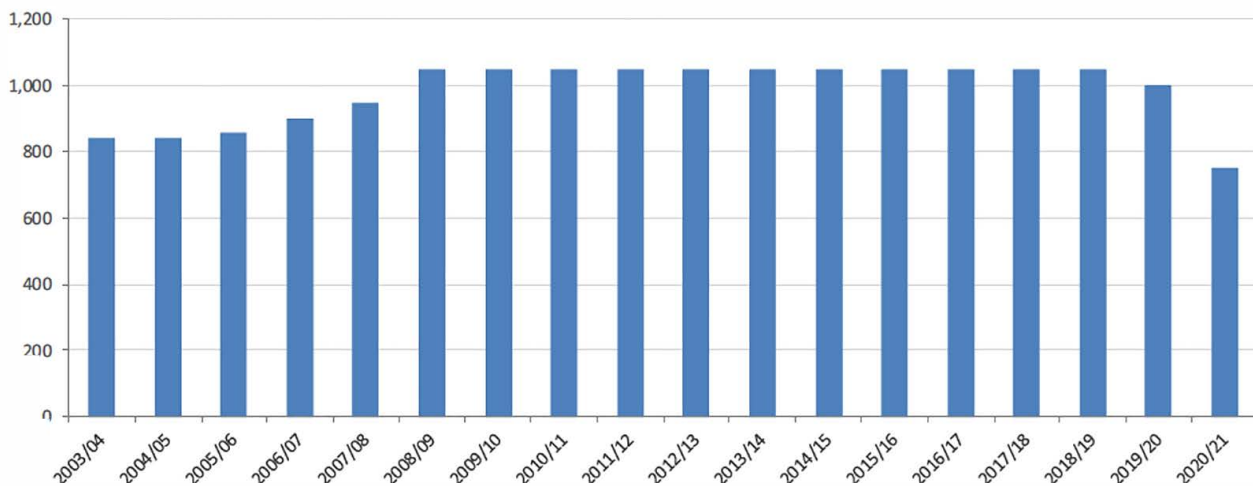
<sup>23</sup> UE RRP ATT50: Marsh, Liability Insurance Premiums - 2020 - 2025, Victoria Power Networks and United Energy, November 2020, p. 4

<sup>24</sup> UE RRP ATT50: Marsh, Liability Insurance Premiums - 2020 - 2025, Victoria Power Networks and United Energy, November 2020, p. 3

<sup>25</sup> UE RRP ATT50: Marsh, Liability Insurance Premiums - 2020 - 2025, Victoria Power Networks and United Energy, November 2020, p. 3

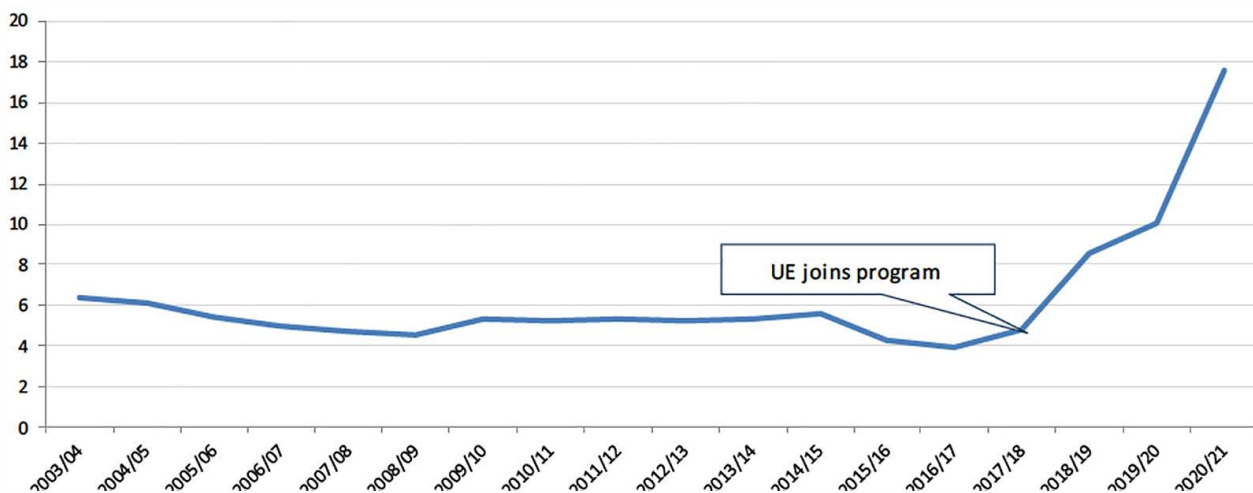
<sup>26</sup> Refer to UE RRP ATT46 for the 2018/19 insurance invoice, UE RRP ATT47 for the 2019/20 insurance invoice, and UE RRP ATT48 and UE RRP ATT49 for the 2020/21 insurance invoices.

Figure 1 VPN/UE/SAPN liability limit, 2003/04 to 2020/21, \$million nominal



Source: United Energy

Figure 2 VPN/UE/SAPN liability insurance premiums, 2003/04 to 2020/21, \$million 2021



Source: United Energy

The charts show that the premiums incurred by VPN/UE/SAPN have increased (in real terms) by a magnitude of 78 per cent in the 2018/19 policy year, 18 per cent in the 2019/20 policy year and 75 per cent in the 2020/21 policy year. While the level of cover was comparable between the 2017/18 and 2019/20 policy years, there was a reduction in the liability limit in the 2020/21 policy year (in nominal terms) of \$250 million (or 25 per cent) to \$750 million.

The actual insurance premiums captured in our 2019 base year reflect three quarters of the premiums for the 2018/19 policy year and one quarters of the premiums for the 2019/20 policy year. Based on the significant increase in premiums incurred in the 2020/21 policy year, we are proposing a step change to reflect the increase in our liability insurance costs of \$12 million (\$2020-21) over the regulatory period, which is an increase in our annual premium allowance of 118 per cent (in real terms) over the premiums reflected in the 2019 base year. It is therefore evident that there has been a significant increase in the level of premiums relative to the base year.

### 3.2.4 Increases in insurance premiums forecast for the next regulatory period

Marsh expects our insurance premiums to further increase during the next regulatory period.

While we have always taken steps to minimise insurance costs, the conditions in insurance markets and the perceptions regarding bushfire risk are creating strong upward pressure. We engaged Marsh to provide a forecast of the increases in combined liability insurance premiums we are likely to incur up to the 2025/26 policy year (i.e. the policy year ending 30 September 2026). Marsh indicates that:<sup>27</sup>

- increased bushfire activity in Victoria, Australia and globally has caused insurers to scrutinise and revise their pricing models, with a much greater focus on the 'pay-back' period
- insurers participating at primary layers of bushfire liability risks have been, and continue to be, significantly out of pocket as a result of bushfires over recent years, with insurance pay outs exceeding the premiums they have received by several fold, which is not sustainable. For example, insurers participating at the lower attachment points on the program have experienced actual and forecast pay outs in the vicinity of \$100 million across the sector against premiums received of circa \$25 million.
- insurers have made it clear that the recent catastrophic bushfires across Victoria and Australia, coupled with the fact that those insurers have not recovered losses from past bushfires, will result in significantly increased premiums in the next regulatory period
- in addition, there will be an element of our premiums 'catching up' to our peers in the next regulatory period given the lower premiums secured historically due to our strong bushfire mitigation practices will be brought into line with comparable businesses. Bushfires have continued to occur in spite of strong risk mitigation practices and mitigation practices no longer command lower premiums, rather they are now considered a minimum requirement to secure coverage.

Marsh sets out a range of forecast increases in premiums for the forthcoming regulatory period, which set out in the following table.<sup>28</sup>

Figure 3 Marsh's estimated costs of insurance for year ending 30 September (excluding GST and below deductible losses)

	2019/20 Actual	2020/21 Actual	2021/22 Estimate	2022/23 Estimate	2023/24 Estimate	2024/25 Estimate	2025/26 Estimate
Forecast Increase Range			20 - 45%	20 - 35%	10 - 20%	0 - 10%	0 - 10%
Low			AUD 5,058,294	AUD 6,069,953	AUD 6,676,948	AUD 6,676,948	AUD 6,676,948
High	AUD 2,374,690	AUD 4,215,245	AUD 6,112,105	AUD 8,251,342	AUD 9,901,611	AUD 10,891,772	AUD 11,980,949

Source: UE RRP ATT50: Marsh, Liability Insurance Premiums 2020-2026, Victoria Power Networks and United Energy, November 2020, p. 10.

While acknowledging the degree of certainty diminishes into the future, Marsh considered that the trend of increasing premiums will continue in the next regulatory period and recommended a minimum forecast of 32.5 per cent for the 2021/22 policy year, 27.5 per cent for the 2022/23 policy year, 15 per cent for the 2023/24 policy year and 5 per cent for the 2024/25 and 2025/26 policy years).<sup>29</sup>

### 3.2.5 Material increases expected by AER's own expert

The experts engaged by the AER to consider Jemena's forecast increases in insurance premiums in the next regulatory period (Taylor Fry and Willis Re) consider that:<sup>30</sup>

- it is very likely that there will be a reduction in the capacity of the insurance market over the next five years

<sup>27</sup> UE RRP ATT50: Marsh, Liability Insurance Premiums - 2020 - 2025, Victoria Power Networks and United Energy, November 2020, pp. 3-9

<sup>28</sup> UE RRP ATT50: Marsh, Liability Insurance Premiums - 2020 - 2025, Victoria Power Networks and United Energy, November 2020, p. 10

<sup>29</sup> UE RRP ATT50: Marsh, Liability Insurance Premiums - 2020 - 2025, Victoria Power Networks and United Energy, November 2020, p. 10.

<sup>30</sup> UE RRP ATT 44: Taylor Fry and Willis Re, Jemena Bushfire Liability Insurance, Public Summary, 14 July 2020, p. ii.



- it is more likely that premiums will continue to increase (in real terms) than remain at 2021/22 levels and anticipated significant premium increases over the next few years and maybe the next five.

Taylor Fry and Willis Re also conclude that:<sup>31</sup>

*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.*

While these conclusions were drawn in respect of Jemena's insurance arrangements, and we note extreme caution must be exercised when comparing policies of different distributors, these general and higher level conclusions relate to the insurance market in which all distributors are operating and are thus equally applicable to us.

### 3.3 Response to draft determination

The AER has proposed allowing an insurance coverage nominated pass through event to reflect the changes to insurance markets outlined in section 3.2 above. However, the insurance coverage event addresses only part of the impact that these changes in insurance markets will have on distributors in the next regulatory period. Specifically, it addresses the risk that the changes in insurance markets will mean that it is no longer possible, or prudent and efficient, for a distributor to take out the same level of insurance cover as it has taken out historically.

The draft determination does not, however, address the expected significant increase in insurance premiums. In particular, the draft determination does not address the impact that the changes in insurance markets have where it is prudent and efficient for us to incur materially higher costs in procuring insurance products.

As outlined in section 3.2 above, the expected impact on our insurance premiums in the next regulatory period is even more significant than contemplated at the time our original proposal was submitted.

However, we accept that forecasting insurance premiums is difficult. Accordingly, we are proposing:

- a step change to reflect the significantly higher expected insurance premiums in the next regulatory period, based on the actual premium amounts incurred in the 2020/21 policy year, being the higher costs that have already materialised, rather than the expected increases as forecast by Marsh
- an insurance premiums pass through event, to ensure that if further premium increases result in the costs of direct control services increasing materially, we are provided with an opportunity to recover at least our efficient costs
- an insurance coverage pass through event, to ensure that where it is prudent and efficient to decrease the level of insurance cover, we are provided with the opportunity to recover at least our efficient costs.

Each of these regulatory mechanisms is discussed in turn below.

### 3.4 Insurance premiums step change

Our proposed step change is based on actual premium amounts incurred in the 2020/21 policy year.

Contrary to the draft determination (and while we disagree with the AER's framework for assessing step changes, particularly for an efficient distributor like us), we note that our proposed step change for insurance

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<sup>31</sup> UE RRP ATT 44:Taylor Fry and Willis Re, Jemena Bushfire Liability Insurance, Public Summary, 14 July 2020, p. ii.



premiums is material and is not captured by the rate of change. We expand on these matters in sections 3.4.1 and 3.4.2 below.

Our proposed step change reasonably reflects the operating expenditure criteria. Specifically, it reasonably reflects the prudent and efficient costs required to achieve the operating expenditure objectives and reflects a realistic expectation of the cost inputs required to achieve those objectives. The AER is thus required to include the step change amounts proposed in the operating expenditure forecast for the next regulatory period. The reasons for this are outlined further in section 3.4.3 below.

### **3.4.1 Increases in insurance premiums are material**

We appreciate the draft determination considered a step change based on our premiums for the 2019/20 policy year, and premiums incurred by VPN/UE/SAPN increased by 75 per cent (in real terms) between the 2019/20 and 2020/21 policy years. Against the current market conditions and our 2020/21 policy year premiums, the AER can no longer maintain that the expected increases in insurance premiums over the forthcoming regulatory period are not material.

Our proposed step change for increased insurance premiums is \$12million for five years of cover, which is indisputably a material increase in our required operating expenditure.

For completeness, and in any event, we note that the AER's approach in the draft determination of rejecting proposed step changes on the basis that the proposed expenditure is not 'material' is deeply flawed.

First, there is no express materiality threshold under the Rules for the purposes of assessing whether operating expenditure should be included in the forecast. This can be contrasted, for example, with the cost pass through provisions, which require a pass through event to give rise to 'materially' higher or lower costs to the distributor in providing direct control services than it would have incurred but for the event, with 'materially' being defined as the change in costs being more than one per cent of the annual revenue requirement for a regulatory year.<sup>32</sup> The application of a materiality threshold in the pass through context is warranted given the adjustments made to operating expenditure are occurring *after* the distribution determination is made and a materiality threshold promotes the stability and predictability of the regime for the regulator and the service provider.<sup>33</sup> Similarly, the AER may revoke and substitute a determination during a regulatory period in the event of a 'material' error or deficiency of a specified kind.<sup>34</sup> Again, correction of errors occurs *after* the making of the distribution determination and a materiality threshold is important in this context in order to increase the certainty and transparency associated with the regulatory framework, and to maintain the incentives built into that framework.

Secondly, there is no basis in the Rules for applying a materiality threshold to operating expenditure step changes in circumstances where:

- we are an efficient distributor, and thus the base year operating expenditure can be assumed to reflect the prudent and efficient costs of meeting the operating expenditure criteria, having regard to the operating expenditure factors

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<sup>32</sup> Rules, clause 6.6.1; Chapter 10 definitions of 'positive change event', 'negative change event' and 'materially'.

<sup>33</sup> See, for example: Australian Energy Market Commission (AEMC), National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012, 29 November 2012, pp. 204-205.

<sup>34</sup> Rules, clause 6.13(a).

- the AER is proposing to assume productivity growth of 0.5 per cent, which has the effect of reducing real expenditure allowances in the next regulatory period (for example, the AER reduced total operating expenditure by \$9 million (\$2021) by way of a productivity adjustment)<sup>35</sup>
- the AER is proposing to apply real non-labour price growth of zero (i.e. non-labour price growth equal to CPI only) (discussed further in section 3.4.2 below)
- the enduring impact of COVID-19 will result in higher costs for our operations due to changed work practices beyond the next few years and will be difficult to unwind in future as expectations regarding social distancing have changed
- we are already being required by the draft determination to absorb a number of step changes, in addition to further step changes we chose not to include in our original proposal, to maintain affordability for our customers in what are challenging times.

The Rules require the AER to accept forecast operating expenditure where it reasonably reflects the prudent and efficient costs of achieving the operating expenditure objectives, and a realistic expectation of the demand forecast and cost inputs. Given the above pressures on operating expenditure that we will face in the next regulatory period, it is inconsistent with the requirements of the Rules and revenue and pricing principles to apply a 'materiality' threshold before making adjustments to the base year operating expenditure when determining total forecast operating expenditure in a distribution determination.

In addition, the AER makes a further fundamental error in rejecting a number of step changes on the basis they are, individually, not 'material'. This is not consistent with the requirements of the Rules or Law. As recognised by the AER, the assessment the AER is required to make is as to total operating expenditure and not the individual forecast expenditure components.<sup>36</sup> This means that it is the cumulative impact of expected changes on future total expenditure that is the relevant consideration. The AER recognises that the cumulative impact of changes is the relevant consideration when assessing materiality in the context of adjusting Powercor's capital expenditure sharing scheme reward payment, concluding that the impact of deferred expenditure on transformer replacement satisfies the materiality threshold because other expenditure considered has already met the threshold. The AER states:<sup>37</sup>

*As we are satisfied that the inclusion of the deferred poles repex into Powercor's approved total capex allowance is materially higher than had the poles repex not been deferred, it follows that the addition of \$8.9 million in deferred transformers repex into the approved total capex allowance satisfied the materiality threshold.*

Taken to an extreme, the AER's approach of considering the materiality of proposed step changes individually would mean a distributor's expenditure could be expected to double on the basis of step changes that are, on their own, not 'material' but which cumulatively have a significant impact such that a failure to include those step changes in the operating expenditure forecast would deprive the distributor of the opportunity to recover their prudent and efficient costs.

The AER appears to consider that a 'materiality' requirement is justified on the basis that it is necessary to avoid a potential upward bias in total operating expenditure given there is an incentive for distributors to identify

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<sup>35</sup> AER, Draft Decision United Energy, Distribution Determination 2021-2026, Attachment 6: Operating expenditure, September 2020, p 43

<sup>36</sup> AER, Draft Decision United Energy, Distribution Determination 2021-2026, Attachment 6: Operating expenditure, September 2020, p 13

<sup>37</sup> AER, Draft Decision Powercor, Distribution Determination 2021-2026, Attachment 9: Capital expenditure sharing scheme, September 2020, p. 12.

increasing new and costs but not the same incentive to identify decreasing costs.<sup>38</sup> The AER stated elsewhere in the draft determination that:<sup>39</sup>

*If we were to include step changes for immaterial costs in our alternative estimate, then arguably we should also include negative step changes for decreases in immaterial costs. In this regard, we note that over the next regulatory control period a possible negative step change could arise due to the relaxing of some obligations required by ESV in their electric line clearance regulations, which may lead to immaterial reductions in costs. United Energy has not proposed this as a negative step change. We consider step changes are not meant to be bottom up assessments of all cost categories, and that immaterial increases or decreases should be managed by businesses.*

We do not agree that there is upward bias in the total operating expenditure in our revised proposal. We have assessed our expenditure and changes in obligations for potential negative step changes in preparing our regulatory and revised proposal and have not identified any. This is not surprising as in our experience, the cost burden from obligations and regulations under which we operate only tends to increase, not decrease. With regard to the electric line clearance regulations, the author of the regulatory impact statement from which the AER draws support, Deloitte, accepted that there is 'some subjectivity' in relation to its impact assessment, expressly citing the potential impacts on distributors' clearance activities from the changes, which could impact the assessment of the difference between the prior and current line clearance regulations. Contrary to the AER's suggestion, the new regulations are not expected to decrease our costs of electric line clearance.

Finally, we note that the AER concluded that the value it accepted for Jemena's step change of \$28.2 million was material. This is comparable to the \$28 million step change now sought by Powercor. The AER's approach to assessing the proposed step changes based on materiality would create perverse incentives where smaller networks are compensated for relatively larger cost increases, while larger networks like us are not compensated for minimising cost increases.

### **3.4.2 Increases in insurance premiums are not captured by the rate of change**

We do not agree with the AER's conclusion that the increase in insurance premiums is captured by the operating expenditure rate of change through non-labour price growth.

As shown in figures 1 and 2 in section 3.2.3 above, our liability limit and the insurance premiums incurred by VPN/UE/SAPN were relatively stable up to the 2017/18 policy year. After that, there has been a structural break in the cost of insurance premiums. As discussed in section 3.2, the significant increase in insurance costs reflects turmoil in global insurance markets, and insurers leaving the market and reducing their risk exposure following several bushfire events both in Australia and internationally.

It is not reasonable for the AER to conclude that the significant increase in insurance premiums driven by illiquidity in global insurance markets is compensated for through the non-labour price escalator in the rate of change, which, in real terms, is set to zero (that is to say, is equal to CPI only).

Whereas the AER stated that it expects insurance premiums rising at a rate higher than CPI would be offset by other non-labour costs included in the operating expenditure allowance rising by less than CPI, there are no other non-labour cost inputs which have prices declining at anywhere near that same rate as insurance premium costs are rising. The AER has not identified any cost inputs which have price reductions of this magnitude and we consider that there are no such inputs. It necessarily follows that the trend component of the AER's base-step-trend approach will not adequately compensate us for increases in the costs of procuring insurance products in the next regulatory period.

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<sup>38</sup> AER, Draft Decision United Energy, Distribution Determination 2021-2026, Attachment 6: Operating expenditure, September 2020, p 20

<sup>39</sup> AER, Draft Decision United Energy, Distribution Determination 2021-2026, Attachment 6: Operating expenditure, September 2020, pp 60-61

Further, while acknowledging there are differences between household and utility insurance premium increases, the AER appears to rely on an assessment that CPI includes household insurance premiums which cover bushfires and there are similar drivers impacting both household and utility insurance premiums and their future growth. To the contrary, the drivers of household insurance premium increases and our liability insurance premium increases are not comparable. There is a fundamental difference in that household insurance is limited to the costs associated with the loss of, or damage to, a home (including in the event of a bushfire), which costs are readily defined. By contrast, we procure liability cover, which covers the costs associated with damage caused by our network to third parties. As a result, there is significantly greater potential liability, and uncertainty in respect of the potential liability, which means there is a substantial divergence in the drivers of increases to household insurance premiums and our premiums.

Marsh highlights that there are significant differences in the way domestic and utility insurance premium increases are priced, which demonstrates that the drivers are not the same. Specifically, Marsh explains that the market assessment of bushfire risk is not an actuarial exercise, as might be expected in relation to household insurance. Marsh states:<sup>40</sup>

*Household (or domestic) insurance products are priced by insurers on an actuarial basis. This is not the case with bushfire risk for network businesses.*

*The reason an actuarial approach can be taken by household insurers is because there is a very high volume of incidents and claims, and a significant amount of data available to the insurance market, to adopt such an approach to pricing. This is not the case with bushfires.*

Rather, for utility insurance premiums, insurers are scrutinising and revising their pricing models, with a greater focus on 'pay-back' period.<sup>41</sup>

The AER's assessment that similar drivers impact on household and utility insurance premiums such that the impact of household insurance on CPI supports the AER's conclusion that the impact on our insurance premiums is captured by increases CPI, is thus misplaced.

Given the expected increases in insurance premiums are not captured by the rate of change, the AER is required to allow our proposed step change for insurance premiums in order to ensure the operating expenditure forecast reflects a realistic expectation of our cost inputs, and allows us to recover our prudent and efficient costs in achieving the operating expenditure objectives.

### **3.4.3 Our insurance coverage and premiums for the 2020/21 policy year are prudent and efficient**

For the ten years to the 2018/19 policy year, VPN/UE/SAPN had an overall policy limit of \$1.05 billion, with United Energy joining the program in the 2017/18 policy year. In 2019/20, the limit was decreased slightly due to market pressures to \$1 billion. For the 2020/21 policy year, however, the overall policy limit was reduced by \$250 million (or 25 percent) (in nominal terms) to \$750 million, a reflection of the diminishing availability of insurance capacity in the market, as a result of global losses from bushfires.

The current VPN/UE/SAPN insurance cover is a complex placement with [Confidential: XXXXXXXXXX] insurers providing various amounts of capacity at varying premiums across the different layers of the program. The placement varies from year to year, depending on pricing and insurer's appetite for risk. Confidential Figure 4 below depicts the insurance stack for 2020/21.<sup>42</sup>

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<sup>40</sup> UE RRP ATT50: Marsh, Liability Insurance Premiums - 2020 - 2025, Victoria Power Networks and United Energy, November 2020, p. 8

<sup>41</sup> UE RRP ATT50: Marsh, Liability Insurance Premiums - 2020 - 2025, Victoria Power Networks and United Energy, November 2020, p. 3.

<sup>42</sup> UE RRP ATT50: Marsh, Liability Insurance Premiums - 2020 - 2025, Victoria Power Networks and United Energy, November 2020, p. 7.

Figure 4 Insurance coverage stack, VPN/UE/SAPN, 2020/21 policy year

[Confidential:]



While our premiums for the 2020/21 policy year represent a significant increase on historical premiums, we have acted prudently and efficiently in procuring this insurance and the AER can be satisfied that the increases in our insurance premiums are an appropriate basis on which to determine the step change for the next regulatory period. In particular, our processes and procedures for procuring insurance ensure we adopt innovative approaches and procured insurance products for 2021/21 which represent the best deal possible given the available options in the current market.

In this section, we discuss our processes and procedures, including the options considered and our initiatives to keep our overall insurance costs at a prudent and efficient level. We then describe the extensive risk mitigation practices undertaken to minimise the bushfire danger arising from our network and the impact this has on our liability insurance.

#### **Our processes and procedures for procuring insurance gave us the best possible deal**

Our insurance strategy and the steps taken when procuring insurance ensure that the resulting costs are prudent and efficient. Our approach encompasses rigorous internal review processes and working closely with Marsh, a global leader in insurance broking and risk management, to obtain the best possible outcome for our customers.

Our internal review processes include the following:

- our Board delegates the ongoing review of insurance renewals to the Audit and Risk Committee. This Committee receives updates as to developments in the insurance market and indicative pricing for the forthcoming policy year
- if required, an Insurance Sub Committee is established to enable timely decisions on key issues between Board meetings. [Confidential: [REDACTED]  
[REDACTED]  
[REDACTED]]
- the Board has oversight of the insurance renewal process each year in advance of the program being accepted
- the Board has delegated approval of liability insurance premiums in a Standing Delegation of Authority. Depending on the total premiums for a given year, the delegation enables our Chief Executive Officer (CEO) or, for higher amounts, CEO and Chairperson to approve the program. For example, for the 2020/21 policy year renewal, our premium exceeded \$7 million (the delegated standing authority limit) and thus the expenditure was required to be approved by both the CEO and Chairperson in line with Board approved delegations of authority.

We engage extensively with Marsh to find ways to minimise the costs of our insurance cover. In seeking to procure the best deal for the 2020/21 policy year, an extensive marketing campaign across almost 80 insurers was undertaken as part of renewal whereby:

- 36 markets were approached across the Asia Pacific region inclusive of Australia, Singapore, Hong Kong and China
- 40 London markets were approached
- all other viable international markets were considered.

#### **Insurance renewal options considered**

During the insurance renewal process we consider different options in relation to key parameters of our insurance cover, these include:

- the highest level of insurance cover ('insurance cap' or 'liability limit')
- the value of the deductible
- whether to have any gaps in insurance coverage below the insurance cap
- the terms of cover (what circumstances are actually covered).

The factors influencing our decision on each of these parameters include:

- the availability, risk and price of the insurance or other insurance products
- the risk and likely consequence (liability) of an event occurring.

During the 2020/21 insurance renewal process we:

- reduced our insurance cap from \$1 billion to \$750 million. This decision was made because the price of insurance cover above \$750 million was excessive, averaging \$160,000 per \$1 million in cover which was considered uneconomic for our customers. Further, the availability of insurance cover above \$750 million was very limited and we would have needed to obtain this high cost cover from higher risk markets

- [Confidential: [REDACTED]  
[REDACTED]  
[REDACTED]  
[REDACTED]
- investigated an alternative approach to procuring capacity at higher-up attachment points in our program via parametric capacity. However, due to hard market conditions, availability of parametric capacity in the 2020/21 policy year was only available at pricing in excess of traditional insurance products.
- secured insurance cover for 100 per cent of liability cover up to the insurance cap. In recent years it has become more challenging to obtain insurance cover at all levels within the insurance stack due to a lack of insurance capacity available in the market. Our commitment to bushfire mitigation and our long-standing relationship with our insurers has enabled us to continue to secure the limited capacity available in the market (which can be seen in confidential Figure 4 above).

#### Our initiatives to minimise total insurance costs

Given the hardening in market conditions, we actively explored alternatives to traditional renewal plans to ensure that our total insurance costs (premiums and below deductible losses) are minimised. [Confidential:

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### Risk mitigation

Given the significant bushfire risk in Victoria, there have been a number of government and regulatory initiatives to reduce the risk of fire starts. These include:

- the introduction in 2012, in response to the Black Saturday fires, of the f-factor incentive scheme under the *National Electricity (Victoria) Act 2005* (Vic) to reduce the number of fire starts
- directions from Energy Safe Victoria (ESV) under the *Electricity Safety Act 1998* (Vic) (ESA) to give effect to recommendation 30 of the 2009 Victorian Bushfires Royal Commission, specifically a direction in 2011 to amend our Electricity Safety Management Scheme (ESMS) to include the development (or reinforcement) of plans and procedures in relation to the fitting of spacers / spreaders, vibration dampers and armour rods.
- There are a range of other legislative requirements on electricity distribution businesses to manage bushfire risk including under the ESA, the Electricity Safety (Bushfire Mitigation) Regulations 2013 and Electricity Safety (Electric Line Clearance) Regulations 2015.

Consistent with our legal obligations, as well as expectations of insurers, government and the general public, we have undertaken extensive risk mitigation works and improvements to network management to reduce bushfire risk and, at least historically, keep insurance premiums at low levels. Significant risk mitigation measures we have undertaken include the following:

- three rapid earth fault current limiters (REFCL) in operation throughout the 2019/20 summer season, with a further four REFCLs to be deployed prior to the 2020/21 summer season, increasing REFCL protection to 13,000 kilometres of the network
- implementation of improvements to our pole management program (discussed in detail in our Poles chapter)
- in 2019, we undertook a comprehensive audit of spans for adequate vegetation management
- we have insourced light detection and ranging (LiDAR) processing to our LiDAR Lab, improving the quality of our inspections and facilitating continuous improvement activities
- we have implemented a new Vegetation Management System which provides better visibility over vegetation status
- in 2019, we implemented a hazard tree program, increasing the target number of inspections of fall-tree spans undertaken
- we continue to focus on trialling new technologies to mitigate bushfire risk. This has included:
  - a bushfire risk tool that can assess bushfire risk at pole or aggregated risk in a certain area
  - early fault detection technology to pre-emptively detect a fault on our overhead high voltage network.



Our strong risk mitigation practices and strategies have, to date, allowed us to secure liability premiums that are very competitive and, as Marsh indicates, better than our peers.<sup>43</sup> However, in the next regulatory period, market conditions mean that we are not likely to benefit from reduced premiums relative to other network service providers due to risk mitigation strategies. Our strong risk mitigation practices do, however, give us access to capacity that would not otherwise be made available.

The limited impact that risk mitigation now has on the procurement of insurance was recognised by the insurance experts engaged by the AER, Taylor Fry and Willis Re, who state that the prevailing insurance liability market conditions are such that the nature of the insurance that distributors require is now relatively immune to the risk faced by an individual organisation.<sup>44</sup> That is, risk mitigation practices are not a basis for ensuring premiums and coverage comparable to historic levels.

### 3.5 Insurance premiums pass through event

Given we have proposed an insurance premiums step change based on actual premiums incurred for the 2020/21 policy year, rather than the higher forecast premiums for the balance of the 2021–2026 regulatory period, we are also proposing an insurance premiums pass through event.

Against the background of a step change in operating expenditure proposed by reference to the significantly higher premiums we have already incurred, an insurance premiums pass through event will only become relevant in the event that we experience prudent and efficient increases in premiums that result in a materially higher cost in providing direct control services. That is, an insurance premiums pass through event is a ‘backstop’ in the event of significant further deterioration in market conditions.

While the AER declined to accept Jemena's proposed insurance premiums nominated pass through event, Jemena's step change was based on forecast insurance premiums rather than premiums actually incurred.<sup>45</sup> That is, whereas the expected further increases in insurance premiums were already reflected in Jemena's draft determination (through a higher step change than would otherwise have been proposed), we have not reflected the further increases in insurance premiums above the 2020/21 policy year levels expected in the next regulatory period in our step change on the basis these cannot be predicted with adequate certainty at this time.

In addition, whereas the AER indicated it did not accept Jemena's insurance premiums pass through event on the basis this risk was already addressed by the insurance coverage pass through event, as noted in section 3.3 above, the AER's insurance coverage pass through event addresses the risk that the changes in insurance markets mean that it is no longer prudent and efficient for a distributor to take out the same level of insurance cover as it has taken out historically. The insurance coverage event does not address the expected significant increase in insurance premiums above the level reflected in the 2019 base year. To address the impact that the changes in insurance markets have where it is prudent and efficient for us to incur materially higher costs in procuring insurance products, we have proposed a step change (for those increases known with adequate certainty) and an insurance premiums pass through event (for those increases that are too difficult to predict at this point in time).

For the wording of the proposed insurance premiums pass through even refer to the uncertainty appendix, UE RRP APP04.

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<sup>43</sup> UE RRP ATT50: Marsh, Liability Insurance Premiums - 2020 - 2025, Victoria Power Networks and United Energy, November 2020, p. 9.

<sup>44</sup> UE RRP ATT 44: Taylor Fry and Willis Re, Jemena Bushfire Liability Insurance, Public Summary, 14 July 2020, p. ii.

<sup>45</sup> AER, Draft Decision Jemena, Distribution Determination 2021-2026, Attachment 15: Pass through events, September 2020, pp 15-16.

### 3.6 Insurance coverage pass through event

As well as increasing the premiums for a given level of coverage, the further tightening of the insurance market may have the following potential impacts over the next regulatory period:

- reduced cover (for example, there may be 'gaps' in layers of coverage as capacity is either not available, or no longer available on commercially reasonable terms)
- policy limit reinstatements may no longer be available at future renewals (for example, terms that provide for an automatic reinstatement of the policy limit should there be two catastrophic fire losses within a single policy year may no longer be offered)
- failure to supply coverage will likely be restricted to losses arising from personal injury and property damage triggers above a certain attachment point (for example, \$100 million).

We welcome the AER's acceptance of an insurance coverage event. The AER has invited comments on Jemena's proposed amendments to the definition of the insurance coverage pass through event set out in the draft decision. We agree that each of the amendments proposed by Jemena improves the clarity of the definition and adopt these changes in our revised regulatory proposal.

We also propose two additional amendments. These are as follows:

- an amendment to the definition of 'changed circumstances' to clarify the point in time by reference to which the question of whether there are 'changed circumstances' is assessed. That is, we suggest amending the definition to indicate that it is the movements in the insurance market since the acquisition of the insurance policy or set of insurance policies that applied for the majority of the base year that are to be assessed
- an amendment to include the AER's guidance note as a matter to which the AER must have regard in assessing an insurance coverage event pass through application. Given distributors will be making decisions based on that guidance, the AER ought to be required to take the guidance into account in making its decision regarding pass through applications.

The amendments to Jemena's drafting provided with the draft decision are set out in uncertainty appendix, UE RRP APP04.

### 3.7 Appropriate regulatory outcomes

Our proposed combination of a step change, together with an insurance premiums pass through event and an insurance coverage event, creates appropriate regulatory outcomes in respect of insurance by:

- preserving the incentives to achieve efficiencies in the procurement of insurance products. Specifically, allowing a step change enables the incentive regime established by the Rules to operate as intended for a reasonable increase in costs, where this is possible given prevailing market conditions
- ensuring that the risk of increases in premiums that result in materially higher costs of providing direct control services in the next regulatory period are adequately addressed. Allowing an insurance premiums pass through event ensures that there is an avenue to allow recovery of at least our prudent and efficient costs of insurance
- facilitating the prudent and efficient procurement of insurance products in circumstances where market conditions are rapidly changing:
  - the insurance premiums step change and insurance premiums pass through event allow us to maintain a level of insurance expected by government and the general public and to deliver lower volatility in tariffs to consumers

- the insurance coverage pass through event allows us to pass through of costs associated with liability claims where insurance coverage was not available on commercially reasonable terms and thus allows us to procure a lower level of insurance coverage when appropriate to do so.

Consistent with the AER's regulatory intent, under our proposed approach, there is no duplicate recovery for the same set of risks. This is because, as can be seen in the movements in our policies and premiums for the 2018/19 to 2020/21 policy years, increases in insurance premiums can (and will likely) occur at the same time as the level of insurance cover decreases. That is, the risk of increasing premiums exists alongside, and somewhat independently of, the risk of gaps in coverage or increases in deductibles. There will not necessarily be a correlation between premiums and coverage and we will not necessarily be able to reduce our premiums in the next regulatory period by reducing our level of insurance coverage. Rather, we may face higher premiums while simultaneously procuring lower levels of coverage.

Further the regulatory mechanisms proposed provide maximum incentives for us to address the identified risks and incur efficient costs. We accept that the natural incentive properties of cost pass throughs are weak relative to the inclusion of costs in an operating expenditure allowance. There is no direct financial benefit to the service provider from out performing in relation to those events that are covered by cost pass throughs, unlike the incentive arrangements for operating expenditure captured in the building blocks.<sup>46</sup> The incentives of cost pass throughs are bolstered under the Rules by the requirement that the AER take into account the efficiency of the service provider's decisions and actions in relation to the risk in assessing a cost pass through application,<sup>47</sup> as well as the inherent risk to the service provider that the AER will not allow the costs incurred (i.e. the credible threat of retrospective review of those costs for prudence and efficiency), but they nonetheless remain weak relative to the incentives in relation to expenditure reflected in the operating expenditure forecast. Accordingly, we have proposed a step change for the amounts we can forecast with reasonable certainty, which creates incentives to outperform that allowance where possible given prevailing market conditions.

However, given the uncertainty associated with forecasting insurance premiums, seeking to 'lock in' cost recovery for the entirety of the forecast increases in insurance premiums through a step change gives rise to a risk we will significantly over or under recover our costs. In these circumstances, allowing an insurance premiums pass through event is the most efficient method to manage the risks of higher insurance premiums being incurred.

Finally, the insurance coverage event enables the recovery of costs associated with liability where insurance coverage has decreased as a result of changes in the market. Given there is no basis on which to predict when and where a part of the insurance stack cover will cease to be available (either at all or on reasonable commercial terms) in the next regulatory period, there is also no basis on which to forecast with any certainty at this point in time the additional operating expenditure we require in light of this. Similarly to the insurance premiums pass through event therefore, an insurance coverage pass through event is the most efficient method for managing the risks of insurance coverage decreasing in the next regulatory period.

### 3.8 Revised proposal forecasts

Our revised proposal liability insurance step change forecasts for the 2021–2026 regulatory period are set out in the following table.

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<sup>46</sup> This has been recognised by the AEMC, for example: AEMC, National Electricity Amendment (Cost pass through arrangements for Network Service Providers) Rule 2012, 2 August 2012, p. 3.

<sup>47</sup> Rules, clause 6.6.1(j)(3).

Table 2 Liability insurance premiums step change, \$million 2021

	2021/22	2022/23	2023/24	2024/25	2025/26	Total
Insurance premiums step change	2.4	2.4	2.4	2.4	2.4	11.8

Note: the total is not the exact sum of the five years due to rounding.

Source: United Energy

For details of the step change refer to UE RRP MOD 9.01.

Our proposed definitions for each of the insurance premiums and insurance coverage nominated cost pass through events are set out in our managing uncertainty appendix, UED RRP APP04.