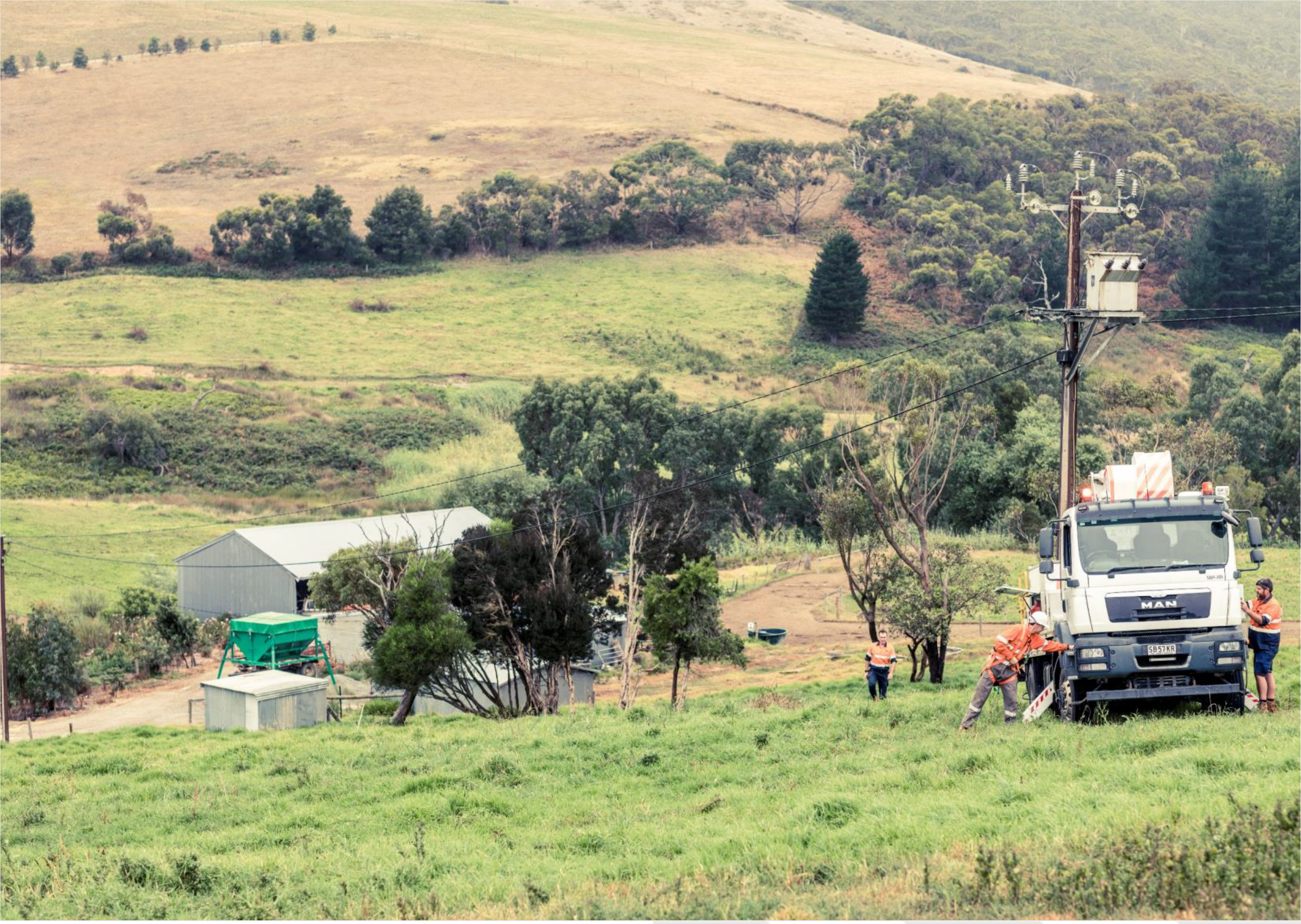

Business case: Insurance Premium Increase

2025-30 Regulatory Proposal

Supporting document 6.4

January 2024

SA Power Networks

Empowering South Australia

Contents

Glossary

Acronym / term	Definition
AER	Australian Energy Regulator
DNL	Distribution Network Lease
EFAG	Expenditure Forecast Assessment Guideline
Electricity Act	Electricity Act 1996 (SA)
ESCoSA	Essential Services Commission of South Australia
ISR	Industrial Special Risks
opex	Operating expenditure
Property	Industrial Special Risks
RCP	Regulatory Control Period

1 About this document

1.1 Purpose

This document sets out the justification for the stand-alone operating expenditure (**opex**) step change relating to increases in insurance premiums.

1.2 Expenditure category

Standalone opex step change (ie no associated capital expenditure).

1.3 Related documents

This document should be read in conjunction with supporting document 6.7 – Marsh Insurance Report (**Marsh report**), which gives an in-depth analysis of the cost drivers and resulting insurance premium forecasts for the 2025-30 regulatory control period (**RCP**). Please note that the Marsh Report was completed before the 2023/24 premiums were available, as such, the 2025-30 forecast premiums included in that report are based on an estimate of the 2023/24 premiums. The forecast premiums included in this supporting document are based on the actual premiums for 2023/24.

Ref	Title	Author	Version / date
1	6.7 Marsh Insurance Report	Marsh	July 2023

2 Background

SA Power Networks procures insurance across multiple classes as a method to mitigate the financial risk which may arise due to claims linked to our operations. [redacted].

Our insurance brokers have warned us, and the insurance markets in general have indicated, that the upward pressure we have seen on insurance premiums, will continue for a number of years. In regard to bushfire insurance[1], we are likely to face significant challenges in securing the same level of insurance cover on reasonable commercial and economic terms during the 2025-30 RCP, particularly given the continuation of extreme events and the resulting tightening of insurance capacity.

The main implications for SA Power Networks given the current state of the insurance market and continuing associated pressures on price, capacity and coverage include:

- ongoing increases in premiums;
- potential for increases in deductibles, which will increase the expected value of uninsured risks; and
- insurers retracting policy coverage.

We engaged our insurance broker, Marsh, to prepare a forecast for any likely increases in premiums during the 2025-30 RCP. The Marsh Report addresses the current and likely insurance market conditions and explains how those market conditions will lead to continued increases in insurance premiums over the period. Given these forecasts, SA Power Networks are requesting a step change to reflect the expected increase in insurance premiums.

2.1 The purpose of insurance

As a Distribution Network Service Provider operating an electricity distribution network, it is critical that SA Power Networks have a comprehensive insurance program in place, including a combined general liability policy (which also incorporates cover for bushfire liability) and an industrial special risks (**property**) policy. The insurances help protect against a range of potential risks and financial impacts, ensuring resilience and continuity of our operations, which in turn benefits the communities we serve.

Insurance obligations are imposed on SA Power Networks as part of the Distribution Network Lease (**DNL**) Agreement with the Distribution Lessor Corporation. These obligations include specific limits and types of insurance to be in place. Adhering to these obligations is not only necessary to ensure regulatory compliance but is also part of responsible business practices and robust governance.

In particular, pursuant to the DNL, we are required to maintain the following minimum insurance policy coverage:

- [redacted]

[1] Bushfire insurance falls under the combined liability premium

In addition, SA Power Networks also has distribution licence conditions imposed on it by the Essential Services Commission of South Australia (**ESCoSA**). ESCoSA requires annual assurance that the bushfire liability insurance acquired by SA Power Networks is adequate and appropriate, given the nature of the operations carried out under the licence and the risks associated with those activities.

The bushfire liability insurance taken out by SA Power Networks [redacted]

Hardening of the market occurred in the following years with significant premium increases largely driven by low financial performance of insurers over several years, as well as national and global catastrophic events, such as the Californian wildfires and the Australian bushfire season in 2019/20. The volatile insurance market has led to multiple insurers either withdrawing or reducing capacity in the bushfire liability market, as well as higher prices. [redacted]

Given ESCoSA specifically requires insurance to be adequate and appropriate, consideration should be given to the Maximum Probable Loss analysis commissioned by SA Power Networks in 2019 which indicates that a catastrophic fire in the Adelaide Hills is estimated to [redacted]. If two catastrophic fires occurred during a bushfire season, in the Adelaide Hills and Port Lincoln areas, expected losses could total [redacted]

[redacted]

Furthermore, these insurances serve as a key mechanism for mitigating financial risks by transferring a portion of these risks to insurers. [redacted] Whilst insurances are in place to help reduce the financial impact of these events, our focus is to reduce the likelihood of events which may lead to an insurance claim and to manage the risk of our business operations, through advanced risk management procedures which are continually improved.

These insurance policies, mandated by licensing conditions, are a fundamental part of our risk management strategy and reflect prudent financial management practices, which are essential for the operation of a safe and reliable electricity network.

2.2 Summary of Insurance Cover

SA Power Networks' insurance program consists of the following insurance classes:

- Combined Liability - including Public and Products Liability (covering legal liability of the business to third parties in respect of personal injury or property damage), Bushfire Liability, Failure to Supply Liability and Professional Indemnity (covering legal liability to third parties for breach of professional duties). [redacted]
- Property - also referred to as Industrial Special Risks, covers loss and damage to real and personal property at various locations declared under the policy, including substations, but excluding distribution network poles and wires. [redacted]

- Other Insurance classes – including Directors and Officers, Workers Compensation Excess of Loss for SA, Workers Compensation (for various States/Territory), Employee Income Protection, Contract Works, Crime, Environmental Liability, Aviation, Motor Vehicle, Marine Cargo (Transit), Corporate Travel and Personal Accident (Board Members and Volunteers). [redacted]

As can be seen in Figure 1, in 2023/24 more than [redacted] of SA Power Networks' insurance premiums are attributable to the Combined Liability and Property premiums. Given the other insurance classes account for such a small proportion of our total insurance costs we are not seeking a step change for these classes. This is despite the fact that we have been informed by our broker that these classes will continue to increase at varying levels which generally speaking is expected to exceed inflation.

[redacted]

[2] These are total insurance costs and include expenditure not allocated to SCS.

3 Insurance Market Drivers

The following is a summary of the insurance market drivers as described in the Marsh report, please refer to the report for a full analysis. The insurance market is influenced by a number of key factors including:

- Size of premium pool;
- Claims paid and/or provisioned;
- Major loss events;
- Cost of reinsurance; and
- Investment returns and flow of additional funds into the sector from the insurance-linked-securities.

We are currently in the "hard market" section of the insurance market cycle, which is characterised by increasing premiums, selective underwriting and shrinking capacity. The current market cycle has been subject to 22 consecutive quarters of premium increases as measured by the Marsh Global Insurance Market Index.

The rising frequency and severity of natural disasters, such as hurricanes, wildfires, and floods, have led to significant financial losses for insurers. These catastrophic events have reduced insurers' reserves and prompted them to reassess their risk exposure, resulting in stricter terms and higher premiums to cover escalating costs. While a strong performance history on behalf of the insured may reduce some of the impact, ultimately price increases are being passed on, regardless of performance.

This is particularly relevant given the recent wildfires that occurred in Hawaii which are currently estimated to have caused between $4 and $6 billion in economic losses[3]. Maui county has already sued the Hawaiian Electric company claiming they were negligent in their response to the dangerous conditions and contributed to the fire start. Investigations still need to be conducted to determine the cause of the fires and whether Hawaiian Electric assets were involved, however if it is determined the distributor was negligent this will place further pressures on the global insurance market moving forward.

Given SA Power Networks are seeking a step change in regard to Combined Liability and Property Premiums, further detail of what is driving the premium increases relating to these two classes is outlined below.

3.1 Combined Liability

Our combined liability insurance class is made of the following subclasses:

- Bushfire Liability;
- Public and Products Liability;
- Failure to Supply Liability; and
- Professional Indemnity.

Although the combined liability insurance class covers more than bushfire liability, it is primarily the increases associated with bushfire premiums that are driving the expected increase in the combined liability insurance premium over the 2025-30 RCP.

The bushfire liability sector experienced significant reduction in capacity in 2019 and 2020 which in the main has not returned to the market. Insurers are continuing to revise their pricing models which is resulting in upward pressure on premiums and downward pressure on overall policy limits.

[3] *Moody's RMS Estimates USD 4 to 6 Billion in Economic Losses from Hawaii Wildfires | Moody's RMS*, 22/08/2023

[redacted]

- [redacted]
- [redacted]
- [redacted]
- [redacted]

[redacted]

[redacted]

As part of the 2023/24 renewal process insurers have had an increased focus on:

- vegetation levels attributed to recent weather patterns which have been more conducive to growth; and
- the expected onset of El Nino weather conditions during the coming bushfire season and beyond which would likely result in unfavourable climatic conditions associated with an increase in the number of expected high fire danger days.

These factors have led to further apprehension among insurers regarding bushfire exposure.

In summary, the bushfire liability insurance market remains in an environment whereby another severe bushfire event is anticipated to result in further reductions in current available capacity, with the remaining capacity available in the market coming at a substantially increased cost and greater cover restrictions.

3.2 Property ISR

Hard market conditions associated with property insurance are expected to persist for the foreseeable future due to recent natural catastrophe events, in particular hurricane Ian resulted in reinsurance premium increases from 20-50 percent, which insurers will be looking to pass onto insureds.

Major flooding events in Australia in 2022 which resulted in exceptional flood losses estimated at $10 billion, along with additional natural catastrophe events in New Zealand have also made the Pacific region less attractive to insurers, leading to increased premiums and reduced coverage.

A further driver for the increases seen in property premiums are the issues surrounding increased labour costs and global supply chain management both of which are driving up the quantum of claims.

Natural catastrophe aside, given the current state of inflation insurers are expecting to see demonstrable updates to insured's property values and, where they feel these are out of step with current trends, will instead build increases into their pricing models accordingly. To address this concern, [redacted]

[redacted]

In summary, Property market conditions are anticipated to be challenging and are expected to persist into the foreseeable future.

4 Insurance Premium Forecasts

Included in Table 1 are the insurance premium forecasts supplied by our insurance broker Marsh, for Combined Liability and Property premiums over the 2025-30 period.

Table 1: Insurance premium forecasts for the 2025-30 period ($ million, December 2023)[4]

	2025/26	2026/27	2027/28	2028/29	2029/30
Combined Liability Premium					
Forecast real increase	15%	10%	7%	5%	5%
Premium estimate	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]
Property premium					
Forecast real increase	5%	5%	2%	0%	0%
Premium estimate	[redacted]	[redacted]	[redacted]	[redacted]	[redacted]

The forecasts are based on a midpoint of premium projections as determined by Marsh and include the following assumptions:

- Continuing hard market conditions in the short to medium term which are expected to gradually ease through the regulatory period provided there are no significant events that would apply further pressure to the insurance market.
- No change in future premium allocation approach applicable to the [redacted]
- The absence of any catastrophic bushfire event(s) which have a meaningful impact on [redacted]
- The absence of any catastrophic event causing a major Property claim which has a significant impact on Property insurance claims performance and subsequent renewal pricing and coverage terms.
- No changes to SA Power Networks' risk profile or exposure to be insured.
- No significant losses developing within the SA Power Networks' liability program, [redacted]
- No future increases in asset bases which form the basis of the property premium forecasts, noting that any increase in the value of the asset base will result in higher premiums than those reflected in the above forecast.

4 Statutory charges and broker fees are not included.

5 Step change forecast

Given the matters outlined above and the findings of the Marsh Report, we are seeking a step change in relation to our forecast opex for the 2025-30 RCP to take into account the material increase in our insurance premiums.

The Australian Energy Regulator's (**AER**) Expenditure Forecast Assessment Guideline for Electricity Distribution – August 2022 (**EFAG**) and associated Explanatory Statement (**Explanatory Statement**) set out the methodology utilised by the AER in assessing forecast operating expenditure, which includes the 'base-trend-step approach. The EFAG states that:

- Step changes may be added (or subtracted) for any other costs not captured in base opex or the rate of change that are required for forecast opex to meet the opex criteria[5].
- We will only approve step changes in costs if they demonstrably do not reflect the historic 'average' change in costs associated with regulatory obligations[6].

The explanatory statement further clarifies that the AER will adjust actual opex from the base year to account for:

- 'changes in circumstances that will drive changes in opex in the forecast regulatory control period', which include, amongst other things, '…costs due to changes in regulatory obligations and the external operating environment beyond the Network Service Provider's control (step changes)'[7].

Turning to these matters:

Opex criteria and regulatory obligations

The opex objectives are set out in clause 6.5.6(a) of the National Electricity Rules, and include compliance with regulatory obligations or requirements associated with the provision of standard control services. SA Power Networks has a regulatory obligation, under condition 19 of our Distribution Licence issued under the Electricity Act 1996 (SA) (**Electricity Act**), to maintain adequate and appropriate bushfire liability insurance.

In addition, we have an obligation under clause 9.1 of the lease of our electricity distribution network from the Distribution Lessor Corporation to maintain:

- [redacted]

Major external uncontrollable factor

As in past years, SA Power Networks will, of course, seek to negotiate the lowest possible premiums for our insurance for each insurance year that occurs during the 2025-30 RCP. However, the magnitude of insurance premiums is ultimately a matter that is beyond our control with premiums being set by the insurance market and controlled in part by competition between insurance providers. As discussed in the Marsh Report the insurance market is currently in a hard market phase of the insurance market cycle, which is characterised by increasing premiums, selective underwriting and shrinking capacity.

5 AER, *Better Regulation, Expenditure Forecast Assessment Guideline for Electricity Distribution*, August 2022, page 26.

6 Ibid

7 Explanatory Statement, page 12

In addition, persistent occurrences of significant natural catastrophes around the world are having a detrimental effect on the availability of coverage, which is further driving up premiums for associated insurance classes.

Not captured in rate of change

It is evident from the Marsh Report that insurance premiums will continue to increase throughout the 2025-30 RCP and that increase will be substantial. The AER methodology to trend forward operating expenditure based on output growth, labor price growth and productivity will not provide adequate compensation for these forecast increases, this is demonstrated in Figure 2[8].

[redacted]

Assuming our base year costs are deemed efficient and given the expected material increase in insurance premiums over and above the quantum that was reflected in our base year, SA Power Networks proposes this step change. The magnitude of that step change is addressed below.

8 Rate of change used in figure 3 is based on forecast rate of change for the 2025-30 period as per the opex forecast.

9 The premiums included in this chart are the total premiums, not just those allocated to SCS.

5.1 Step change magnitude

This step change is limited to the amount of likely increase in the total costs of SA Power Networks' Combined Liability and Property insurance premiums over the 2025-30 period. The step change is only in relation to the portion of insurance premiums that are allocated to standard control services.

Our build-up of costs for this step change also considers the effect of the rate of change, which is applied to the opex base year to account for changes in output growth, price growth and productivity. When calculating the expected increase in insurance premiums over base year costs, we have applied the rate of change (see **Attachment 6: Operating Expenditure**) to base year insurance costs to remove any possibility of double counting. The property premium forecast provided by Marsh also assume no future increases in asset bases which form premium forecasts, noting that any increase in the value of the asset base will result in higher premiums than those reflected in the forecasts.

Based on the forecasts provided by Marsh, our Combined Liability and Property premiums over the 2025-30 RCP will exceed the equivalent premiums over the 2020-25 RCP (as determined using the premiums for the 2023/24 base year) by an amount equal to $17.1 million ($ June 2022).

Table 2 sets out the step change in forecast opex for each regulatory year of the 2025-30 RCP.

Table 2: Insurance premium step change forecast for the 2025-30 period ($ million, June 2022)

	2025/26	2026/27	2027/28	2028/29	2029/30	Total
Insurance premium step change	1.97	2.93	3.66	4.10	4.48	17.13