Sydney
Level 22/45 Clarence St
Sydney NSW 2000
Australia
+61 2 9249 2900

Melbourne
Level 27/459 Collins St
Melbourne VIC 3000
Australia
+61 3 9658 2333

Wellington
Level 3/166 Featherston St
Wellington 6011
New Zealand
+64 4 974 5562

20 June 2022

Esther Tsafack
Assistant Director
Australian Energy Regulator
[redacted]

Dear Esther

TransGrid insurance arrangement review on behalf of the Australian Energy Regulator

Public Summary

Please find enclosed the public summary of our report reviewing TransGrid insurance arrangement and the forecasts put forward by their broker Aon.

Please do not hesitate to call should any aspect of the report require clarification.

Yours sincerely,

[redacted]

Daniel Smith
Fellow of the Institute of Actuaries of Australia
Taylor Fry

[redacted]

Adam Baker
Executive Director – Broking
Gallagher Re

Introduction

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

The AER is currently in the process of reviewing TransGrid's proposal for 2023-2028 revenues. As part of this review, the AER has engaged Taylor Fry and Gallagher Re to provide expert advice on the increase in insurance premium costs forecast to be incurred by TransGrid.

The scope of the review of TransGrid's insurance step change proposal is split into three core components:

- Review TransGrid's proposed insurance premium forecasts and provide our own estimates (if different)
- Review TransGrid's insurance program, including the structure, capacity and level of cover of the more major policies
- Review and provide commentary on TransGrid's insurance forecast report.

Our report is intended to be used by the AER in its assessment of the reasonableness of the insurance premium forecasts put forward by TransGrid. This document provides a public summary of the scope and conclusions of our review. We have also provided AER with a confidential document containing our full analysis which draws upon, the confidential information provided by TransGrid. We note that the conclusions presented may be inappropriate for other purposes.

Information that has been relied upon

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

- TransGrid's historical premium costs and recent history of their insurance structure.
- A report prepared by Aon on behalf of TransGrid which included:
  - Observations about the current market and future of the market and the impact of changes to various factors on the capacity of the market
  - The possible impact of changes to the market to the premium paid by TransGrid
  - TransGrid's expected future premium costs.
- Responses from TransGrid to specific queries about asset base, insurance coverage and forecast increases.

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

- The nature of TransGrid's risk and how this relates to the impacts caused by changes to the market
- Our own observations about the current market and future of the market and the impact of changes to various factors on the capacity of the market.

The results and subsequent conclusions we have made have been based on the information provided and our industry knowledge.

Conclusions

Based on the information provided to us, we have made a number of observations and conclusions, as required by the scope.

Our conclusions with regards to the current and expected market characteristics are:

- A significant amount of global capacity for bushfire liability risks has left the marketplace because of the perception of inadequate pricing, increasing volatility and insufficient returns.
- Insurers globally are increasingly updating their technical rating models to include the impact of the increase in natural catastrophe claims arising from climate change.
- Electricity transmission networks have become price takers in the market, as insurers dictate a minimum rate.
- There are limited alternatives to obtaining insurance in this industry segment in the manner currently utilised.

Our conclusions with regards to the insurance premium forecasts over the regulatory period are:

- We consider the forecast proposed by Aon is directionally consistent with our expectations of future premiums, given our understanding of the prevailing market conditions, and can be considered reasonable. Without a change in the market cycle, efforts to improve risk management will have a limited impact on reducing premiums.
- By using historical year on year increases to project forward, the forecast assumes that the historical impact of market hardening on the insurance costs will remain consistent into the future. Based on current general insurance market outlook, the assumption is considered reasonable.
- Given the prevailing market conditions, a further withdrawal of capacity from the market which reduces the supply of insurance is a reasonable scenario. In the event of a further deteriorating market, any reduction in the premium cost due to a modest reduction in the upper layer of cover purchased would be expected to be outweighed by the increases in premiums for the remaining lower layers of cover, resulting in an increase of the total premiums incurred.
- Our forecast has used Aon's forecast as a starting point and suggests a range around this forecast. We consider Aon's forecasts for general liability and ISR to be closer to the upper end of the range for the short term but moving towards a central estimate in later years of the forecast. We note that the percentages are applied to Aon's forecast increases and not the premiums.

Our conclusions with regards to the certainty of the insurance premium forecasts are:

- When forecasting future premiums, certainty is difficult to establish, especially in an increasingly hardening market where there is a perception of increased underlying exposure. It is equally difficult to show that the methodology used in Aon's forecasts are flawed or incorrect.
- It is extremely difficult to maintain a high level of certainty over forecasts for availability of capacity for bushfire liability insurance over the next five years.
- It is quite possible that the segment sees more capacity exit as insurers and reinsurers look towards allocating their capital to more sustainably profitable areas of the insurance market.