

29 October 2020

Mr S Roberts  
General Manager  
Transmission and Gas  
Australian Energy Regulator (**AER**)  
GPO Box 520  
Melbourne VIC 3001

Email: [AERInquiry@aer.gov.au](mailto:AERInquiry@aer.gov.au)

Dear Mr Roberts

### **Submission on AER Consultation Paper on assessing an insurance coverage pass through event application**

We refer to the Consultation Paper issued by the AER in August 2020 which:

- sets out the AER's preliminary views on key elements the AER considers should guide its assessment of an insurance cap/coverage pass through event application, which are to be set out in a guidance note (**Guidance Note**); and
- seeks comments and submissions from stakeholders about those elements.

We have responded, in the Attachment to this submission, to the specific questions raised in the Consultation Paper by the AER.

However, there is an issue which the Consultation Paper only touches on peripherally, but which SA Power Networks considers to be the most critical of all. That issue is addressed below.

#### ***Background***

In our revised proposal for the 2020-2025 regulatory control period (**2020-25 RCP**), we proposed important changes to the AER's historical wording of the nominated pass through event that had, until that time, consistently been referred to by the AER as an 'insurance cap' pass through event. With one critical exception which we address below, the AER accepted those changes and our rationale for them (albeit after making some slight alterations to the wording we had proposed). As a result, the AER now refers to this type of nominated pass through event as an 'insurance coverage' event.

The traditional 'insurance cap' event was just that; it was concerned with circumstances in which the level of cover provided by an insurance policy might be exceeded by one or multiple claims in a policy period, and so allowed for the network service provider (**NSP**) to make a pass through application in relation to the amount above the cap.

However, particularly in the case of bushfire liability insurance (characterised by its 'layering' of cover and multiple policies within each layer), and as a direct result of recent catastrophic events both in Australia and internationally (which have resulted in larger and more frequent levels of insurance claims), NSPs are already facing, and there is an ever increasing likelihood that in future insurance years NSPs will continue to face, a combination of the following material adverse circumstances:

- an inability to secure the same level of relevant insurance cover as it has been able to secure historically, particularly because of the ongoing withdrawal of capacity from the insurance market;
- gaps in available insurance cover, as a result of changing insurance market conditions;
- cover being available only on unreasonable commercial and economic terms (such as materially increased premiums and/or deductibles, and/or with materially wider exclusions from, or limits on, cover); and
- the loss or limitation of key policy terms such as reinstatement rights.

The occurrence of any, or a combination, of these circumstances could result in a material increase in the cost of provision of direct control services, ultimately leading to an increase in the price of electricity for consumers.

The risk of a NSP facing such adverse circumstances was recognised by the AER in its final decision for our 2020-25 RCP, resulting in the more expansive 'insurance coverage' nominated pass through event. However, one element that we proposed was not incorporated by the AER. We proposed that element in the long-term interests of consumers of electricity and, for the reasons outlined below, we submit that it should form a central plank in the AER's proposed Guidance Note.

#### ***Need for annual consultation with the AER***

The focus of the proposed Guidance Note is on how the AER will assess an application for an insurance coverage pass through event, ie it is focussed on an ex-post or 'after the event' analysis by the AER. However, in our view, and at least in relation to bushfire liability insurance, it is critical that there be ongoing dialogue and consultation between a NSP and the AER during each insurance year.

The obtaining of bushfire liability insurance cover has become a far more uncertain and fluid exercise in recent years, and there is no doubt this will continue to be the case in (at least) the short to medium term.

It was because of that uncertainty and fluidity that, in our revised proposal for the 2020-25 RCP, we proposed a process whereby:

- during each insurance year, we would provide the AER with relevant details concerning insurance market conditions and the bushfire liability insurance program that we could secure on reasonable commercial and economic terms for the relevant insurance year; and
- we would then consult with the AER about our proposed bushfire liability insurance program for the relevant insurance year, and explain and substantiate why that program is consistent with the level and terms of cover that an efficient and prudent NSP in SA Power Networks' then current circumstances would obtain in respect of bushfire liability.



SA Power Networks believes that following this type of consultation process will:

- ensure that the AER has oversight of this critical issue;
- enable the NSP to satisfy its regulatory obligations whilst, at the same time, avoid imprudent, inefficient and unreasonable commercial insurance terms; and
- ultimately be in the long-term interests of consumers of electricity, both with respect to price and more broadly.

The bushfire liability insurance market, with its inherent layering of cover and multiple policies within each layer, and the annual process of placing that insurance cover, is extremely complex. The placing of such insurance also involves the disclosure of information that is both highly confidential and commercially sensitive to the NSP. While we remain committed to meaningful engagement with our stakeholders and customer representatives, the combination of these factors will limit dialogue with electricity consumers about appropriate levels of bushfire liability insurance cover and the terms of such cover. Accordingly, there is a need for the AER to actively engage with the NSP during the year regarding its annual bushfire liability insurance. The AER has access to the expert insurance knowledge that is required to promptly and efficiently understand the realities of the bushfire liability insurance market during each insurance year, and to fully inform itself (on behalf of consumers of electricity) in 'real time' of the ongoing, material structural, price and other changes that are taking place within that market and how they would impact on both consumers and the NSP.

To simply wait to deal with what are likely (over time) to be serious adverse changes in the availability, nature and extent of coverage of bushfire liability insurance until a pass through application is actually made, would not, in our view, amount to best practice regulation by the AER, nor would it provide any certainty to either consumers, the AER or the NSP that a prudent and efficient level of bushfire liability insurance cover has been put in place (on commercial and economic terms) for the relevant insurance year. We consider that the AER would want to know, both for its own purposes and on behalf of consumers of electricity, whether there would be, for example:

- a material gap in the insurance cover available to a NSP (ie a dollar band, or bands, of uninsured loss(es)); or
- (say) the doubling of a deductible; or
- the removal of a right of reinstatement; or
- the imposition of material, new exclusions from the cover.

There is no greater risk to network safety and reliability than bushfires which, as was (unfortunately) reinforced during last summer, can have catastrophic, life and death, property damage and business destruction consequences, for so many Australians. In our view there is simply no doubt that the AER should willingly engage in dialogue and consultation with a NSP during the placement of its bushfire liability insurance program for an insurance year, and make itself fully aware of the realities faced by the NSP and the consumers to whom that NSP distributes electricity. Such a level of involvement and oversight by the AER is most certainly warranted in relation to this critical issue (as compared to other aspects of a NSP's business) given the materially adverse (and potentially catastrophic) consequences for consumers of electricity and NSPs if the changes in the bushfire liability insurance market that are already taking place accelerate and expand. The AER needs to be well informed so there are 'no surprises' if and when adverse outcomes materialise.

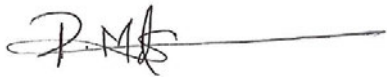


In its final decision in relation to our 2020-25 RCP, the AER asserted that it is inappropriate for the AER to form an ex-ante (or pre-emptive) view about bushfire liability insurance cover to be taken out by a NSP<sup>1</sup>. We agree. For clarity, SA Power Networks is not proposing that the consultation process be a 'sign off' by the AER on the adequacy of a NSP's insurances. Rather, it would be a process by which both the AER and the NSP can be satisfied that the NSP has appropriate processes in place to ensure that any material issues are identified and understood by the AER and NSP early, and are managed by the NSP in a way that is prudent and efficient in the circumstances, before an event that may trigger an insurance coverage pass through event occurs.

For the AER's benefit, we have attached in a confidential annexure, a brief outline of the material outcomes in relation to the placement of our bushfire liability insurance cover for the insurance year that commenced on 30 September 2020.

We would be pleased to engage further with the AER on any aspect raised in this submission or any other matter relevant to the proposed Guidance Note. Please contact [REDACTED] to further discuss this submission.

Yours sincerely

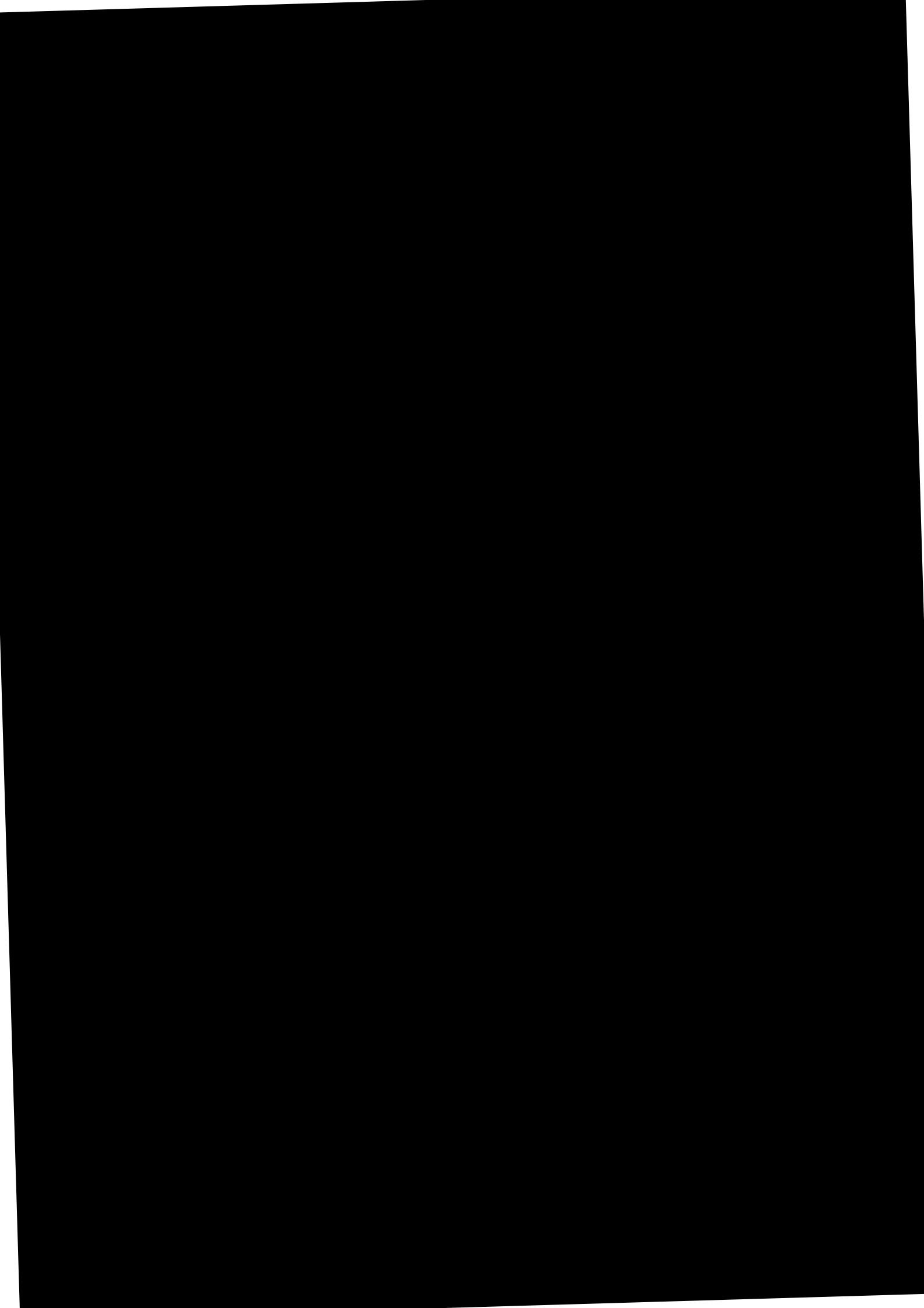


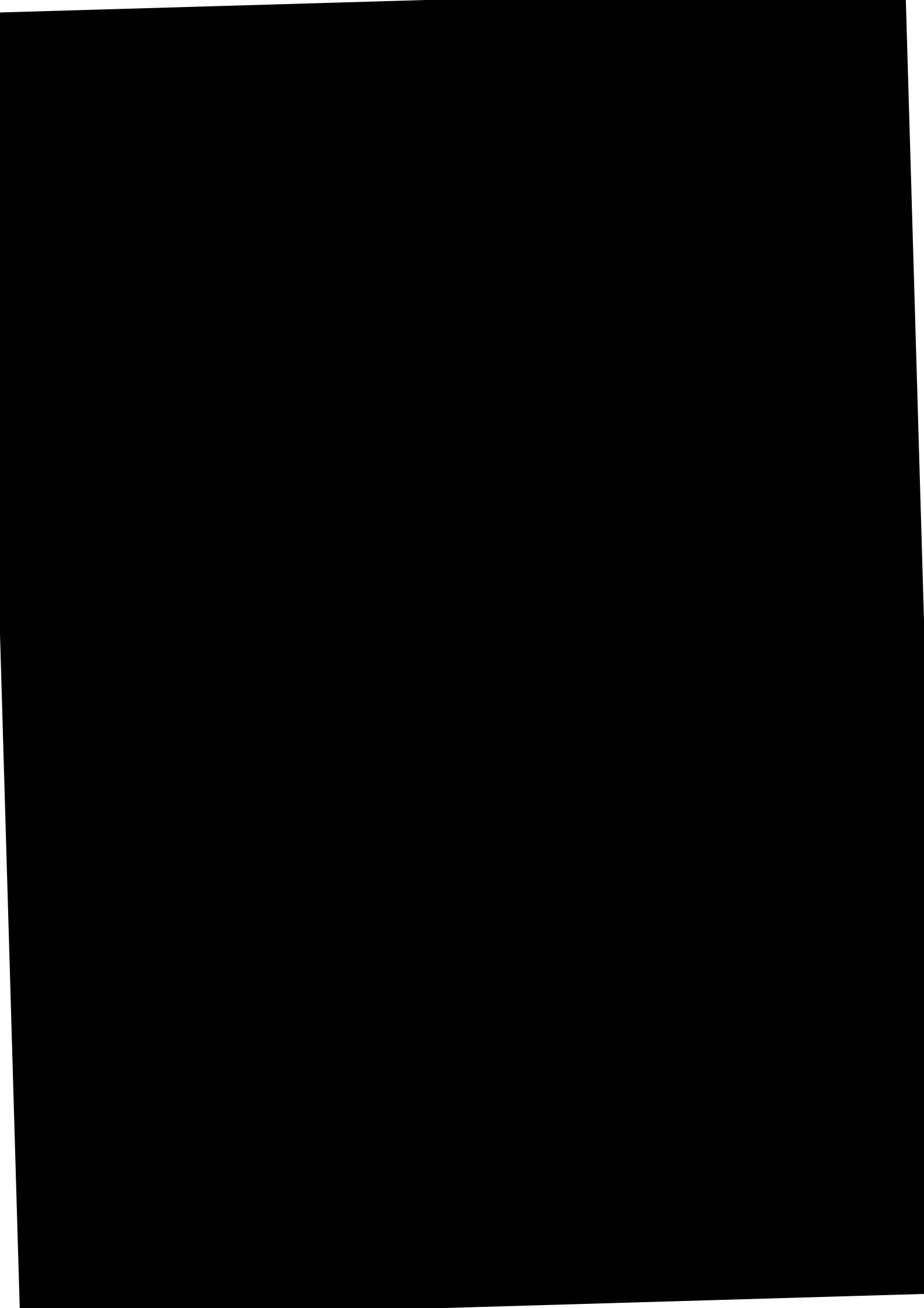
Patrick Makinson  
GENERAL MANAGER GOVERNANCE AND REGULATION  
GPO Box 77, ADELAIDE SA 5001

---

<sup>1</sup> AER, *Final Decision, SA Power Networks Distribution determination 2020 to 2025*, Attachment 14 Pass through events, page 14-14.







**ATTACHMENT – RESPONSES TO QUESTIONS OF THE AER**

**Question 1: Are there any other key elements that stakeholders believe should be included as part of our assessment process? Please detail what these are and why they should be taken into account. This could include any aspects which Network Service Providers consider are specific to their business circumstances and operating environment.**

<p><b>Other key elements?</b></p>	<p>Yes there are. As outlined in the body of this submission, we submit that the AER should be engaging with a NSP each year about material changes within the insurance market and the available insurance cover and policy terms for an insurance year. This is particularly the case in relation to bushfire liability insurance.</p> <p>The information provided by the NSP during those consultations should then form one of the key elements that is taken into account as part of the AER's assessment process if, and when, a pass through application is subsequently made by the NSP in respect of that insurance year.</p> <p>To be clear, we are not proposing that the consultation process would be a 'sign off' by the AER on the adequacy of a NSP's insurances. Rather, it would be a process by which both the AER and the NSP can be satisfied that the NSP has appropriate processes in place to ensure that any material issues are identified and understood by the NSP and the AER early, and are managed by the NSP in a way that is prudent and efficient in the circumstances, before an event that may trigger an insurance coverage pass through event occurs.</p>
-----------------------------------	---

**Question 2: Within each of the relevant key elements, what specific issues, considerations, analysis and information should be included as a part of our assessment process? Please set these out in detail and explain why they should be taken into account.**

<p><b>Overarching observation</b></p>	<p>Again, we repeat our submission that consultation between the NSP and the AER each insurance year is what is critical.</p>
<p><b>Independent expert's report or certification</b></p>	<p>One of the elements referred to by the AER is 'a report or certification from an independent insurance expert that details the Network Service Provider's insurance cover is appropriate'.</p> <p>A report or certification signing off on the adequacy of a NSP's insurance cover should not be a mandatory requirement for a number of reasons:</p> <ul style="list-style-type: none"> <li>given the complexity of the insurance market, and the potential enormity of the consequences of a catastrophic bushfire if one were to occur, we query the likelihood of a NSP being able to obtain a report or certification from an expert to the effect that such cover is 'appropriate';</li> </ul>

**Question 2: Within each of the relevant key elements, what specific issues, considerations, analysis and information should be included as a part of our assessment process? Please set these out in detail and explain why they should be taken into account.**

	<ul style="list-style-type: none"> <li>• we query whether such a report or certification would actually add any value to the consultation process; and</li> <li>• such a report or certification would come at an additional cost to the NSP which is not likely to be justified given the lack of value it would provide to the consultation process.</li> </ul>
<p><b>Consumer engagement about insurance cover</b></p>	<p>As noted in the body of this submission, the bushfire liability insurance market, with its inherent layering of cover and multiple policies within each layer, and the annual process of placing the insurance cover, is extremely complex, and the placing of such insurance also involves the disclosure by the NSP of highly confidential and commercially sensitive information. While we remain committed to meaningful engagement with our stakeholders and customer representatives, the combination of these factors will limit meaningful dialogue with electricity consumers about appropriate levels of bushfire liability insurance cover and the terms of such cover.</p> <p>We therefore submit that, whether or not a NSP has undertaken meaningful consumer engagement about these matters, is not an appropriate element to include as part of the assessment process for an insurance coverage pass through application. What will be meaningful and highly useful, is the extent to which the NSP has consulted with the AER during each insurance year and managed any material issues identified from its internal processes and that consultation.</p>
<p><b>Whether other risk mitigating insurance products have been explored</b></p>	<p>We agree with the inclusion of this element. [REDACTED]</p>
<p><b>Least cost option</b></p>	<p>Least cost is but one of the issues that should be considered and is, in our view, not necessarily the most material. There are a number of reasons why the least cost option may not be appropriate or result in the best outcome for both NSPs and consumers.</p> <p>The terms and conditions on which bushfire liability insurance cover is (or is not) available are critical, and it may be that it is prudent to pay a higher premium in return for an important condition not to be varied or excluded. For example, SA Power Networks would be prepared to pay a materially higher premium rather than lose the right of reinstatement that it has historically had under its bushfire liability insurance cover to ensure its insurance is able to respond when an insurable event occurs.</p>



**Question 2: Within each of the relevant key elements, what specific issues, considerations, analysis and information should be included as a part of our assessment process? Please set these out in detail and explain why they should be taken into account.**

In addition, the financial standing, credit rating and reputation of the particular insurer that is to provide the relevant cover is likely to be far more critical to both the NSP and the consumers of electricity than the mere cost of the insurance cover. What ultimately matters is that the insurance actually responds when an insurable event occurs, and there will be far more comfort that this will be the case if financially sound and reputable insurers are included on the insurance program.

**Question 3: Is there any other specific information or processes that stakeholders see as crucial, and consistent with the National Electricity Rules, that we should take into account in assessing how low probability, high severity risks and costs should be managed between a Network Service Provider's insurance program and its customers (to inform whether a Network Service Provider has established a prudent and efficient level of insurance)?**

**Other information and processes?**

Again, we repeat our submission that consultation with the AER during each insurance year, and the extent and quality of the information provided by the NSP during that consultation, is the most critical.

In that regard, the NSP must be able to support and justify, through supporting materials, reports and analyses, the processes it has followed in order to arrive at its proposed insurance program for the relevant insurance year and its conclusions that the level, and terms, of cover, and any 'gaps' or exclusions in cover (the effect of which will ultimately be borne by electricity consumers), are prudent and efficient in the circumstances.

**Question 4: Do stakeholders see benefits in us having an annual information provision process for Network Service Providers to inform us of material changes relating to its insurance position? Please detail what value / advantages and costs / disadvantages you consider such an information process would provide for the AER, Network Service Providers and other stakeholders. Please also detail what information you consider could be provided and outline your views about the form and timing of any process. We would also be interested to understand whether Network Service Providers are likely to use an annual opt in process?**

**Annual information provision process?**

As we have stressed in this submission, information provision by the NSP is more than beneficial, it is, in our view, necessary. However, it is not mere information provision that is needed, but rather the two-way consultation and engagement between the AER and the NSP that is most critical.

If there should (for example) be any prospect of a NSP having a material layer of uninsured liability, due to either actual unavailability of cover in that layer or the premium being well above and beyond a level that a prudent NSP would pay, then the AER needs to be aware of that possibility well ahead of the potential bushfire season, not merely after the event.

	Given the critical nature of the two-way consultation and engagement between the AER and the NSP on this issue, the provision of information should be undertaken as a standalone exercise and not as part of the AER's existing annual RIN processes.
<b>Costs / disadvantages?</b>	<p>There is a very significant amount of time and resources consumed during each insurance year in preparing the necessary information required by insurers, and in then negotiating premiums and terms of cover with them. The additional cost of them sharing that information, and consulting, with the AER (as we have proposed), would be immaterial. Regardless, the benefit for the AER, the NSP and all consumers of electricity, in doing this would be highly valuable.</p> <p>We see no disadvantages in what we have proposed, but note that much of the information provided by a NSP would have to be kept confidential by the AER due to its commercially sensitive nature.</p>
<b>Types of information?</b>	<p>The types of information that SA Power Networks would be prepared to provide to, and consult with the AER about, on a strictly confidential basis would include:</p> <ul style="list-style-type: none"> <li>• maximum probable loss analysis;</li> <li>• program structure/price per layer; and</li> <li>• market updates from insurance brokers.</li> </ul>
<b>Timing?</b>	<p>The timing of each NSP's insurance year and when the NSP commences the long and detailed work that is required in placing insurances each year, is likely to differ. Therefore the timing for when NSPs should consult with the AER is also likely to differ.</p> <p>SA Power Networks' insurance year for its combined liability program (which includes public and product liability, and professional indemnity) currently runs from 30 September in one year to 30 September in the following year. We commence preparations for discussions and negotiations with insurers around June / July each year.</p> <p>We would propose that dialogue and information sharing with the AER by SA Power Networks would commence around August each year. In the event of positive market conditions, we expect that this would be a very brief process.</p>
<b>Opt in?</b>	As mentioned above, we are of the view that proper oversight and consultation on this material issue, as compared to other aspects of a NSP's business, is critical for all NSPs as they are largely subject to the same risks and the same insurance markets and providers when it comes to bushfire liability insurance. Therefore SA Power Networks is of the view that this should at least be an opt out (and not an opt in) process.

**Question 5: Do stakeholders see benefits in us collecting insurance information for benchmarking purposes in the annual information provision process? Please detail what value / advantages and costs / disadvantages you consider this would provide for the AER, Network Service Providers and other stakeholders. This information could be captured as part of the annual Regulatory Information Notice or a separate annual opt in process.**

<b>Collecting information for benchmarking purposes?</b>	SA Power Networks sees limited value in the AER conducting benchmarking, at least in relation to bushfire liability insurance.
<b>Lack of value</b>	<p>It is very difficult to conduct any meaningful benchmarking in circumstances where a 'like for like' comparison cannot be undertaken. There are many factors and variables which significantly influence the premiums payable for, and the terms of, bushfire liability insurance cover. In particular, there are material differences between jurisdictions which impact the insurance cover taken out by the NSP, including the following:</p> <ul style="list-style-type: none"> <li>• <u>Environment in which the NSP operates and level of bushfire risk</u> – Bushfire risk levels are assessed based on a wide combination of factors including climatic and drought pattern, history of bushfires and fire starts, areas of highly flammable forest and grassland, accessibility of terrains, vegetation density, and agricultural practices where fire is routinely used.</li> </ul> <p>The maximum probable loss from bushfires can also vary significantly between jurisdictions, based on factors such as population density in bushfire prone areas, housing prices and construction type. For example, there are far fewer wooden or fibreboard houses in South Australia, than there are in (say) Victoria or Queensland.</p> <ul style="list-style-type: none"> <li>• <u>Bushfire risk mitigation measures</u> – Accepted bushfire mitigation practices are considered in the context of the environment the NSP operates in as above. Practices adopted in one jurisdiction may not necessarily constitute good electricity industry practice in another jurisdiction. For example, the AER did not consider that the recommendations of Victorian Bushfire Royal Commission (VBRC) and the resulting Powerline Bushfire Safety Taskforce (PBST) automatically qualify as 'good electricity industry practice' in the South Australian context.</li> <li>• <u>Jurisdictional and regulatory requirements</u> – For example, SA Power Networks has the authority to disconnect power in high bushfire risk situations whereas the Victorian distributors do not have that measure available to them.</li> <li>• <u>Network construction (including their design and operation)</u> – For example, construction standards in South Australia are different to those in some other jurisdictions, such as the widespread use of concrete and steel poles (Stobie poles) and steel cross arms which are not combustible and prone to termite attack, whereas wooden poles are used elsewhere which are susceptible to burning.</li> </ul>

	<ul style="list-style-type: none"> <li>• <u>Level and terms of insurance cover</u> – The insurance cover sought, and able to be obtained, can differ materially between NSPs depending on a range of factors such as the risk appetite and risk profile of an NSP (as set out above), and its insurance requirements (including differing insurance limits, levels of deductible, cover exclusions, and policy terms and conditions such as reinstatement rights). What the insurance market is able to offer can also be impacted by the ownership structure of the NSP. For example, SA Power Networks is not able to access the Chinese insurance markets, as it does not have Chinese ownership unlike some other NSPs. Further, this must be considered in the context of the confidentiality issues highlighted below.</li> </ul> <p>It might be possible for the AER to benchmark some things, e.g. total costs of insurance, levels of deductible, the average premiums paid per customer, and limits on NSPs' bushfire liability insurance cover. However, such benchmarking would only be able to be carried out at a very high level and certainly not in the way benchmarking is usually employed by the AER.</p> <p>Further, the confidentiality issues highlighted below will significantly reduce the value of any benchmarking of this information.</p>
<p><b>Confidentiality issues</b></p>	<p>The information relating to a NSP's insurance cover, including bushfire liability insurance cover, is both highly confidential and highly commercially sensitive. It would therefore be inappropriate for that information to be disclosed (other than to the AER alone), even if disclosure is made by the AER as part of a general benchmarking exercise without naming individual NSPs. This means that any benchmarking information would only be able to be used by the AER internally to identify potential issues that may need to be raised and/or investigated with a particular NSP as part of its consultation process and would in this sense be highly valuable.</p>



**Question 6: What processes are in place (or planned) by Network Service Providers to manage circumstances where costs are incurred beyond policy limits or there are gap(s) in their insurance cover, and they face potential third party claims arising from bushfires? How do Network Service Providers manage or plan to manage their exposures in cost effective ways under these circumstances? Given that an insurance coverage pass through event is in place, how do stakeholders think that the incentives of Network Service Providers to be efficient and cost effective are affected in their efforts to minimise their exposure above the insurance cover limit or gaps in their insurance policies? How can we incentivise a Network Service Provider to be prudent and efficient under these circumstances?**

<p><b>Processes</b></p>	<p>Again, the key issue is that the AER should be engaging with a NSP during each year about material changes within the bushfire liability insurance market and the available bushfire liability insurance policies for an insurance year so the AER is fully aware ahead of a bushfire season if there are gaps in insurance liability layers, the loss of reinstatement rights, new exclusions from cover, etc.</p> <p>The AER needs to have a level of comfort, before a bushfire season starts, that consumers of electricity are either not materially exposed or, if there is a level of potential exposure through lack of availability of cover or lack of cover on acceptable commercial and economic terms, that that is appropriate in the circumstances.</p>
<p><b>Management of exposure</b></p>	<p>SA Power Networks is not simply accepting the possibility of there being gaps in bushfire liability insurance cover. We are investigating and exhausting all other options. [REDACTED]</p>
<p><b>Incentivisation of NSPs</b></p>	<p>NSPs are already strongly incentivised to be efficient and cost effective in their efforts to minimise their exposure above the insurance cover limit or gaps in their insurance policies through a number of means.</p> <p>First, the pass through event mechanism itself requires a NSP to demonstrate that (amongst other things) the costs have occurred solely as a consequence of the insurance coverage pass through event and are prudent and efficient, and the NSP has not failed to take any action that could reasonably be taken to reduce the magnitude of the pass through amount. If a NSP fails to demonstrate this to the satisfaction of the AER, it will be required to bear the costs it incurs in relation to the event, which is a significant driver and incentive to ensure these costs are prudent, efficient and cost effective.</p> <p>Secondly, an NSP's insurer will drive the NSP to minimise the costs associated with an insurance coverage pass through event, as it will otherwise bear all of the costs up to the insurance limit. These insurers also typically engage external lawyers in relation to any claim by a NSP, which provides an additional level of oversight and incentive to mitigate costs.</p> <p>Thirdly, multi-million dollar deductibles are required to be paid by a NSP before an insurance provider will pay any expenses, which incentivises a NSP to mitigate costs associated with an event.</p>

**Question 7: We understand that the recent volatility in the liability insurance market have been having a major impact on electricity distribution and transmission businesses; do gas businesses face similar impacts?**

**Comment**

SA Power Networks does not have a view in relation to the gas industry.