Australian Energy Regulator

SAPN Bushfire Liability Insurance

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Public Summary

Introduction

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

The AER is currently in the process of reviewing the South Australian Power Network's (SAPN's) proposal for 2020-2025 revenues. A part of this review, following a proposal by SAPN, the AER has engaged Taylor Fry and Aon to provide expert advice on the increase in insurance premium costs expected to be incurred by SAPN to manage its bushfire liability risks.

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

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

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

Information that has been relied upon

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

- Legislation describing the duties imposed upon SAPN as well as any legislative immunities
- Claim definitions within SAPN's liability insurance policy
- Details about bushfire related claims where SAPN has made payments or claimed on their insurance policy
- SAPN's current insurance structure including their deductible, cover limits, layers of cover and interactions with third parties
- SAPN's historical premium costs and history of their insurance structure
- Comments made regarding the reasons behind their current insurance structure and the Board of SAPN's risk appetite
- A report prepared by SAPN's insurance broker which included:
  - Observations about the current market and future of the market and the impact of changes to various factors on the capacity of the market.
  - The possible impact of changes to the market to the premiums paid by SAPN
  - A range of SAPN's expected future insurance cost between a high and low scenario
- Other financial information relating to SAPN.

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

- The nature of SAPN's risk and how this relates to the impacts caused by changes to the market
- Our own observations about the current market and future of the market and the impact of changes to various factors on the capacity of the market.
- Relevant Australian insurance/reinsurance placement data
- The distribution of insurance premium rate changes for General Liability cover
- A comparison between SAPN's current premiums and a comparable benchmark.

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

Conclusions

Our conclusions with regards to the insurance liability structure and capacity are:

- SAPN has made claims that they are a relatively low risk business compared to other distributors. Whilst this may be the case, given the prevailing insurance liability market conditions, we consider that the nature of the insurance that SAPN requires is relatively immune to the risk faced by an individual organisation. The risk associated with an individual business is likely to have a greater impact on the ability to attract capital, and a minimal impact on the ability to find a lower premium rate. In essence, the insurance provided reflects the insurers' view of an efficient return on capital. An increased insurance risk cost (e.g. double the underlying insurance risk) will have a moderate impact on the return on capital required by insurers. For example, if the insurance risk doubles from 0.01% of sum insured to 0.02% of sum insured, the cost of reinsurance would not be expected to double.
- We consider that it is very likely that there will be a reduction in the capacity of the insurance market over the next five years. The reduction in capacity will impact the premiums imposed on SAPN and we anticipate a step change in their premium for the 2020/21 year.

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

- Based on current market conditions and their obligations, SAPN's public liability insurance cover/liability limit is commercially prudent.
- The higher insurance premiums proposed by SAPN over the period 2020-25 are directionally consistent with prevailing insurance liability market conditions and the current outlook for the next five years. We note that our estimates are within the range of estimates forecast by SAPN's insurance broker.
- In comparison to the current insurance premium (2019/20) we consider that the 2020/21 premium can be expected to be higher.
- The current market focus on efficient use of capital means that SAPN has limited options to moderate the higher premium costs – particularly in relation to lower policy limits and deductible schedules.
- Even if capital were available, the magnitude of the impact it would have on premium levels would be expected to be immaterial – certainly in comparison to the additional risk that SAPN would be required to be absorbed. This is due to the premium rates being primarily driven by the insurer's required return on their capital, rather than the assessed risk.
- We consider that our recommended budget for 2020/21 to be a reasonable expected premium, albeit subject to considerable uncertainty. Forecasts of premiums beyond 2020/21 are extremely uncertain. Nevertheless, we consider that it is more likely that premiums will continue to increase (in real terms) than remain at 2020/21 levels.

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

- Savings from alternative arrangements are unlikely to be material without a change to insurance requirements under SAPN's lease agreement.
- Any saving in premiums would be expected to introduce greater volatility to SAPN's financials following an event. For example, if the deductible was increased, SAPN would have a small decrease in premium expense in each year but a potentially significant increase in retained claims costs in years where an event occurs.