

29 April 2021

Sebastian Roberts
General Manager, Transmission and Gas
Australian Energy Regulator

Submitted electronically



Dear Mr Roberts,

Submission to draft guidance note on insurance cost pass through events

The Public Interest Advocacy Centre (PIAC) is an independent, non-profit legal centre based in New South Wales. Established in 1982, PIAC tackles systemic issues that have a significant impact upon people who are marginalised and facing disadvantage. We ensure basic rights are enjoyed across the community through litigation, public policy development, communication and training. The Energy + Water Consumers' Advocacy Program represents the interests of low-income and other residential consumers, developing policy and advocating in energy and water markets.

PIAC welcomes the opportunity to respond to the AER's draft guidance note on insurance cost pass through events.

Managing extreme weather impacts

The impact of bushfires on the use and cost of network insurance has been demonstrated in several recent cost pass-through applications. It highlights the importance of risk management for extreme weather events and how standards for reliability consider such events. With a changing climate and projections of more frequent and more severe weather, mechanisms are needed that deliver a resilient energy system where risks and costs are distributed fairly.

Risks are most efficiently allocated to parties that are best able to manage them. This principle is central to PIAC's consideration of this issue and underlies how risk should be shared between network businesses (or more specifically their shareholders) and consumers.

There are two complementary approaches businesses must balance to efficiently manage the risk to infrastructure caused by extreme weather events:

- spending to prevent or mitigate the impact of extreme weather events; or
- accept they may occur and pass through the costs if they do.

Network Service Providers (NSP) must consider the probability and consequence of different types of events and different types of assets to determine the combination of each approach to optimally manage these risks and meet consumers' interests.

In the first approach network businesses could be expected to internalise the risk of extreme weather events itself through their planning and decision making. They may justify (or seek to justify) that the cost of a slight increase in spending to mitigate climate risk is actually less expensive overall than the impacts that would be avoided. For example, for a small additional cost infrastructure could be made significantly more resilient, preventing loss of supply and saving the cost of replacement or major repair should it be impacted by extreme weather. In this case, the businesses may be able to justify

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augmenting certain infrastructure to withstand more extreme weather events with the expense included in their revenue allowances.

Alternatively, the expense of augmenting some infrastructure to withstand extreme weather events might be deemed inefficient due to the risk or uncertainty being too high. For example, it may be impractical to predict where an extreme weather event will strike and how it would impact infrastructure. In this case, consumers would carry the risk of repair or replacement costs being passed through as damage occurs.

Additional guiding principle

PIAC considers an additional guiding principle is needed requiring NSPs to demonstrate how they have determined and employed the optimal balance of the two complementary approaches described above. NSPs must consider and demonstrate which approach is more appropriate to use in certain cases as this will depend on a number of factors including: the type of asset, the type of risk and the NSP's overall exposure to different extreme weather risks given their portfolio of assets and geography of their jurisdiction.

Response to proposed guiding principles

Efficient allocation of risks between NSPs and end consumers

- PIAC agrees that, where it is shown to be part of the most efficient overall decision, NSPs are well placed to manage risks through commercial and self-insurance decisions and mitigation measures.
- The balance between sharing risks with consumers, even if in extreme circumstances, or locking in higher costs must be founded on a clear, well-informed and robust understanding of what consumers' preferences and interests are. This is discussed further below in Customer engagement.

Recovery of efficient costs

- PIAC agrees that NSPs must seek to "determine the optimal, most efficient and least cost way to manage their risks through commercial and/or self insurance in combination with other mitigation activities."¹

Extent to which events are unexpected and outside the NSPs control

- PIAC agrees it is reasonable to expect NSPs to anticipate and manage certain risks as part of good business practice. In keeping with the risk allocation principle, it is not in consumers' interests to cover NSP shareholders from risks they should have prudently managed themselves.
- However, this is not a static exercise. There must be regular reassessment of the changing likelihood and consequences of various risks. (See below in Corporate and risk governance.)

Response to proposed information provision

Customer engagement

- PIAC supports requiring this information be provided.
- It is essential that decisions to share risk between the NSP and consumers are founded on a clear, well-informed and robust understanding of what consumers' preferences and interests are. Engagement with consumers and their representatives or advocates is an important part of this.
- While some specifics of these discussions may be detailed and technical in nature, this is not a valid reason to avoid having them with consumers. PIAC agrees with the AER that "it

¹ AER, *Draft guidance note on insurance coverage cost pass through events*, February 2021, 10.

is possible to have broader level engagement with consumers so they can provide input on the high level risk and benefit trade-offs that a NSP is considering as part of its insurance policy and coverage.”²

- In addition to discussion at a broader level, it is possible to also have detailed and nuanced discussions with consumers and their representatives given adequate time and support to inform participants so they can provide considered feedback.
- Building (and retaining) this detailed understanding will also become easier as NSPs move towards more regular and deeper engagement with consumers and their representatives as business-as-usual rather than one-off events when preparing a regulatory proposal.
- In addition to demonstrating the outcomes of these engagements, NSPs must also show the context in which these discussions were conducted to establish confidence that consumers’ preferences were well-informed and well-considered. For instance, NSPs should demonstrate that:
 - discussions were conducted in an open and deliberative forum;
 - questions were not asked in a leading manner; and
 - participants were provided with necessary, unbiased information.

Risk mitigation

- PIAC supports requiring this information be provided.
- NSPs must prove they have considered the range of options available to manage risks, including mitigation, in order to demonstrate their proposal is optimised and any costs to be passed through to consumers is prudent and efficient.

Appropriateness of cover, structure and premiums

- PIAC agrees that NSPs should have the flexibility to choose an appropriate level of cover and structure given the range of options available and considered.
- However, as the AER propose, the NSPs must justify why anything above the least cost option is in consumers’ interests. Effective consumer engagement should be an important part of demonstrating this.

Analysis of possible losses from insured events

- PIAC supports requiring this information be provided.
- It is essential that NSPs provide the AER and stakeholders with confidence that their proposed decision regarding insurance and risk exposure is backed by robust, quantitative analysis including stress testing of assumptions and probabilities.

Historical information

- PIAC agrees that providing historical information and market conditions prior to a pass through event may help explain the level of insurance NSPs have in place and to prove that a material change in circumstance warranting a pass through has occurred.

Corporate and risk governance

- PIAC supports requiring NSPs to provide information on their overarching risk management frameworks to demonstrate that the balance of risk-sharing between shareholders and consumers, is part of an overall framework that is in the long-term interests of consumers.
- PIAC expects NSPs to provide the AER with evidence of how and why particular risk tolerance levels were determined and what processes they have in place to regularly reassess these and ensure they reflect changing conditions. These changes must consider:
 - changes in consumer preferences or priorities;

² Ibid, 12.

- developing understanding and experience of infrastructure exposure to expected climate change;
- new opportunities to mitigate infrastructure exposure to climate change; and
- movements in insurance or financial markets that affect the cost of coverage.

Benchmarking

- PIAC agrees that the unique characteristics of each NSP mean using benchmarking to determine insurance coverage cost allowances is not a valid approach.
- However, examining such information across NSPs or for the same NSP over time may still be a useful tool to provide context and help understand where and why businesses differ.

Continued engagement

PIAC would welcome the opportunity to meet with the AER and other stakeholders to discuss these issues in more depth.

Yours sincerely,

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