Aon New Zealand

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Grant Weston
Chief Advisor, Regulation
Commerce Commission New Zealand
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Dear Grant

Orion & Risk Financing

Our Expert Opinion, provided in May 2013, was in response to the paper issued by Marsh in October 2012.

The Introduction within the Aon report described.

> *"The Marsh report generically addresses the insurance market perception of Transmission and Distribution (T&D) risks and the general unwillingness of underwriters to provide cost-effective coverage for these assets. The report does not specifically address Orion's assets, strong risk management processes, loss history or the potential for further catastrophic losses from a range of events".*

The introduction of our report also noted:

> *"We note that additional information on Orion's insurance programme and the earthquake losses sustained by Orion to its network and any loss estimates available of potential damage to the major network components (overhead lines, underground cables, switchgear/transformers) is required for a more detailed response to be provided".*

Without this detail, our response was necessarily generic in terms of the insurance market conditions for Material Damage/Business Interruption risks for all NZ insurance buyers – namely, sharp increases immediately post the Canterbury earthquakes but now levelling and in many instances reducing – and specifically (in respect of T&D coverage) that subject to detailed analysis, insurance is available.

We remain confident in the findings in our May 2013 report. In stating this we have noted that the Marsh, Orion and Unison responses to our report make various comments regarding our findings with respect to insurance availability for T&D coverage and the cost effectiveness of such coverage. Unison also commented that although their captive provides some risk financing capability, it is limited in its ability to respond for large or frequent events. The only caveat we would apply to our report is that it was not required to address Orion's proposed pricing analysis as that was not part of our terms of reference.

In response to the recent comments that have been received, we note that our May 2013 report included the following key findings:

1. T&D coverage is available subject to appropriate limits, deductibles and identification of perils to be insured.

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2. The recommendation that a detailed risk analysis is completed following the risk management standard ISI31000:2009 to identify key risks and limits required for the various T&D asset types before considering insurance. Our preliminary thoughts were:
    a. **Substations/switchgear/pole mounted transformers**
        - "Full" insurance for Material Damage/Business Interruption
    b. **Above ground distribution lines**
        - The purchase of insurance coverage for named perils but excluding windstorm ; reference to comments in the Civil Defence Emergency Management Response June Review that "overhead network damage was light" and Orion's 2012 and 2013 AMPs that earthquake damage to the overhead reticulation system should be easily repaired
    c. **Underground cables**
        - Cover for underground assets is currently available with the premiums and policy excesses determined based on factors such as assets to be insured, their location, agreement on a suitable limit, deductible, coverage required and gaining underwriters understanding of Orion's risk management practices.

It needs to be noted that our report identified that Business Interruption insurance for overhead distribution lines and underground cables would not likely be available.

In relation to the possible use of a captive, we do not envisage this being the sole risk financing mechanism for T&D assets. Our approach is based on first identifying the size and type of risks for the various T&D asset types, then approaching (re)insurance markets for possible placement only then and based upon the responses of the market would we consider utilising a captive to supplement the reinsurance protection. The introduction of our report did comment: "*A* (captive) *feasibility study will be required but with reinsurance protection being available for a range of risks to these assets, the merits should be explored".* Whilst we were not explicit in our report, a captive could also be utilised to finance the otherwise uninsurable Business Interruption exposure to overhead distribution lines and underground cables.

By way of an observation, we have noticed that the submissions and responses by Orion, Marsh and Unison all have one thing in common, namely they base their case on the use of insurance (external or captive) as the "sole" means of risk financing. Whilst there is no doubt that insurance can be a means of risk transfer, it is by no means the only such mechanism.

Enterprises face many risks that are simply not insurable. But that is not to say that they cannot be financially provisioned for. Take for example, the exchange rate of the NZ$. That cannot be insured, but hedging is a very common method of gaining certainty for enterprises that have identified significant changes in the exchange rate as a significant risk to their enterprise. Our point is that just as risks are holistic, therefore a holistic approach is required to be taken in relation to risk financing them. This is especially so for those risks which have been identified as having a high impact but low probability (HI/LP). Some HI/LP risks will be unique to the sector or enterprise and be uninsurable.

Differing risk financing approaches will be appropriate for enterprises with differing positions in their life own cycle (or the life cycle of their sector in which they operate). Enterprises that are mature (such as Orion) could reasonably be expected to have set aside capital reserves from their profits over the years in order to (at least in part) risk finance for HI/LP risks. Insurance cover would only be needed in excess of such reserves up to an (independently) calculated estimated maximum loss limit. The dependency on insurance as a risk financing mechanism will start to tail off once enterprises have achieved a scale that will allow day to day losses to be funded from cash flows. Day to day losses can be calculated as a known

constant and are funded by incorporating their cost into price margins. That approach is taken for example in instances of stock shrinkages (which are uninsurable). From provisioning for day to day losses, it is a simple step to making such provisions for HI/LP risks.

Those enterprises that are in start –up mode are not able to create reserves quickly enough. They will want to reinvest their surpluses back in to their business. In consequence they will think (at least initially) that external risk financing (insurance) is an attractive option. But if their enterprise is successful then there will come a point that they too will have created reserves to the extent that external insurance is not necessary. There is a need for all enterprises to be street savvy in their risk financing requirements. Where the cost of capital outweighs the cost of risk transfer, then the option is to transfer risk to an insurer or other financial institution. Clearly though in determining such pros and cons, close consideration must be taken of the risk analysis that has been undertaken especially as to the maximum possible loss and the maximum retention (deductible) that the enterprise can bear safely. Only then will the most cost effective risk financing solution be achieved. That solution has to be continuously reviewed. Risk profiles continue to evolve and develop over time.

It is our observation that neither Orion nor Unison have developed their risk financing mechanisms to this sophisticated level but we see no reasons why they should not have adopted such risk financing practise before now. In fact we are surprised that these companies are still using risk financing solutions more appropriate for organisations a fraction of their size. In summary, Aon stands by the comments of our May report. The findings of that report are based on our knowledge of the insurance market, best practice risk management approaches to analysing risks and a full exploration of the resultant risk financing options.

Yours sincerely

Russell Bell
EXECUTIVE DIRECTOR