

**2008/9 to 2012/13 Gas Distribution
Price Control Review**

**A report prepared by Willis Insurance Brokers for
Wales & West Utilities**

**Reviewing those aspects of LECG's Draft Report for
Ofgem relating to Insurance Cost Forecasts**

April 2007

We are pleased to present our response to the LECG draft report for WWU. We comment on the efficiency of the WWU insurance programme, potential future savings and market premium forecasts for the price control period 2008 to 2013.

Summary

Having reviewed the report, we believe that:-

- WWU's current programme appears efficiently structured and aggressively priced against its peers,
- the basis on which potential efficiency savings have been calculated within the report does not seem equitable, and
- the LECG report premium forecasts understate the likely increase in premium over the pricing review period.
- SGN's uninsured loss figures appear extremely low and further work should be undertaken by Ofgem to ensure these are a fair reflection of their costs.

We have produced a spreadsheet showing cyclical premium forecasts based on Willis's and Marsh's view of future market movements, which support our conclusions. The Willis spreadsheet also reflects the long term agreements to which WWU has committed.

Programme Structure

Uninsured Losses

WWU's insurance costs as a percentage of adjusted revenue are the lowest of all the GDN's. However, WWU's uninsured claims are higher than NGN's and significantly higher than SGN's. As a result the cost of WWU's insured and uninsured losses as a percentage of its adjusted revenue is above that of SGN.

Having considered the LECG Report we believe that contrary to that report's findings:-

- WWU's programme structure remains highly efficient in comparison to its peers,
- varying degrees of outsourcing exist between the GDN's with their retained exposures varying accordingly - LECG's basis for calculating efficiency savings targets through the comparison of GDN loss experiences is therefore flawed, and
- SGN's uninsured loss figures appear extremely low and cannot be a fair reflection of their costs.

This last point above is critical as we believe that it is SGN's figure for uninsured losses which drives the "High Savings" benchmark ratio in Table 47 of the LECG report to an artificially low 0.98%. We do not believe that the £0.12m of further efficiency savings identified by LECG are reasonable given the circumstances.

In arriving at the above view we have taken the following factors into account: -

- WWU's retentions are set at efficient (market tested) levels in relation to cost of cover and are as low as reasonably possible given the loss experience.
- Risk management and safety standards will be the same across the GDN's and WWU should not therefore be suffering disproportionately high (or SGN low) loss levels in comparison to adjusted revenue.

- SGN's retention levels are unlikely to be significantly lower than WWU or sufficiently low to transfer to insurers the low severity/high frequency type losses driving the uninsured loss values.
- SGN's low severity/high frequency loss experience cannot be only 20% of WWU's experience given the profile/geographic location of their GDN's – SGN's uninsured losses as a percentage of revenue figure of 0.07% is therefore highly questionable.
- NGN outsource much of the operation and maintenance of their network to external contractors and with this will go much of the low level/high frequency claims activity – their uninsured loss data is not therefore comparable.
- WWU have not experienced any losses (other than “own damage” motor losses) that have been uninsured due to breadth of cover – therefore this cannot be a significant factor in the level of WWU's uninsured losses.
- WWU's existing coverage limits were set following extensive risk analysis - no losses have exceeded current limits or could reasonably be expected to in future and WWU's limits have clearly not lead to an increase in its uninsured losses.

Options Available to WWU

On the basis that WWU is not being outperformed on risk management/condition of its network, the scope for WWU to improve its performance on uninsured losses and overall cost efficiencies against its peers has to be considered against it's loss profile and what additional cover is available from the market and the cost of this.

WWU simply does not have uninsured losses that exceed a level that could be passed to the insurance market at commercially acceptable rates.

WWU's programme structure is that of a prudent operator, having been specifically designed to generate the greatest level of cost efficiency. Limits, coverage levels and Insurers' attachment points have been set following extensive risk and loss analysis by WWU and Willis prior to the agreement of the programme structure:-

- Loss retentions are above predictable loss levels enabling Insurers to charge the lowest premium possible for potentially larger, although much rarer, losses.
- The worst case scenarios arising from key exposures e.g. third party exposures or the potential consequential losses arising from isolating, purging and relighting following the loss of a major AGI, will vary considerably between GDN's. It is not the case therefore that a lower limit is an indication that WWU is retaining greater risk than its peers.
- WWU's coverage levels are considered broad and in line with best practice. We believe all appropriate covers and policy extensions are in place.

We conclude therefore that current levels of cover are efficient and that the efficiency saving of £0.12m suggested by LECG are unachievable.

Insurance Premium Costs

Market Cycles

The 5% year on year insurance premium increases proposed by WWU are higher than the figures proposed by Marsh and WWU's peers. Whilst we understand why OFGEM would prefer the cyclical growth pattern advised by Marsh we do not however believe that their forecast presents an acceptable reflection of future insurance market movements. Historic evidence indicates that the current annual

reductions in insurance premiums are very unlikely to continue throughout the next price control period, and that at some time during that period catastrophic events are likely to occur which could lead to a significant increase in premiums over a short period.

This is clearly not an exact science. However, we believe that the Marsh Index greatly understates the potential for future market movements and that:-

- the scenario the index paints is unprecedented in recent market downturns,
- the last two market reversals came strong and fast following major and sudden triggers such as the events of 9/11, major stock market losses and significant catastrophe losses (all squeezing insurer liquidity ratios to the limit following lengthy periods of market softening such as we are currently seeing), and
- in many cases rates and retentions more than doubled with premium increases being applied indiscriminately among good and bad risks - risks with less favourable experiences performed even worse.
- Marsh's underlying annual rate of increase is based on experience over a number of years, presumably taking in a full cycle – we believe however that the next price control period will come in at a time when the market is turning so that premiums are only likely to see significant hardening – Marsh's underlying annual rate of increase of 3.95% is therefore likely to be exceeded by some margin.

Therefore, we recommend that a more cautious approach be adopted to the cyclical forecast of rate increases than proposed by LECG. We suggest that a 5% year on year increase is not unreasonable, given that history shows that a reversal of the current reduction in premiums can be expected in the next five years, and that the Willis cyclical forecast should be considered an absolute minimum..

Current Programme Pricing

We have already stated that we do not believe that the market will continue to soften for the period 08/09. We believe this is particularly the case for WWU where the existing programme is efficiently structured and aggressively priced.

In any circumstance the Marsh Index cost trends are less applicable to WWU than other less keenly priced programmes for the following reasons:-

- The market will not reduce/increase at the same rate for all. The insured programme, as the efficiency rating suggests, is aggressively priced. Scope for further reductions for WWU is limited as WWU are starting from a lower premium base than the other GDN's. Savings forecast by Marsh for 2007 and 2008 are unlikely therefore to be fully available to WWU.
- Modest reductions of approximately 10% are expected in liability costs during 2007/8. Further savings are unlikely to be achieved in year two.
- The Property premium has been fixed for three years with an excellent reduction at the last renewal through the Macquarie facility. Consequently WWU will not see the benefit of reductions factored into Table 58 for next year. This cost will therefore remain at 100% for this year and next year, rather than dropping to 86% and 73% as forecast by Marsh (table 58). This has been reflected in the attached spreadsheet.
- It is expected that WWU will come out of the existing long term insurance agreement on property into a hardening market with:-
 - no guarantee that the Macquarie facility, providing the current rates, will still be in place,

- the potential for higher than average increases (even from the facility) as the market seeks corrections in ratings for risks with lower than average ratings.

As such, we strongly argue that the trends within the Willis cyclical forecast must be amended to reflect the above.

Insurance Facilities

Regarding comparison of programme costs between GDN's it should be noted that SGN is part owned by SSE who will have a major insurance programme based on strong market relationships. SGN will no doubt benefit from these relationships whether it is directly insured by the programme or not.

Uninsured Loss Increases

In the LECG report, the assumptions on which the decision to apply the "derived index" to total insurance costs rather than just the cost of the insurance premium are flawed. Claims cost inflation attached to costs such as vehicle repair costs, bodily injury awards, cost of care etc are not cyclical, they just rise in line with the cost of other comparable goods and services. Neither is the frequency of claims cyclical. Increased litigiousness and an expanding network will ensure that frequency of losses is also likely to rise over the price control period.

Market cycles are driven by many factors, not just claims activity as the LECG report suggests. Market capacity, new insurers entering the market and insurers' drive for premium income all impact on the cycle. It is not unusual therefore for the market still to be softening while claims are rising. In this scenario it is merely a case of insurers margins being squeezed.