



DRAFT DECISION
Australian Gas Networks (SA)
Access Arrangement

2021 to 2026

Attachment 10
Reference tariff variation
mechanism

November 2020

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Note

This attachment forms part of the AER's draft decision on the access arrangement that will apply to Australian Gas Networks (SA) ('AGN') for the 2021–2026 access arrangement period. It should be read with all other parts of the draft decision.

The draft decision includes the following documents:

Overview

Attachment 1 – Services covered by the access arrangement

Attachment 2 – Capital base

Attachment 3 – Rate of return

Attachment 4 – Regulatory depreciation

Attachment 5 – Capital expenditure

Attachment 6 – Operating expenditure

Attachment 7 – Corporate income tax

Attachment 8 – Efficiency carryover mechanism

Attachment 9 – Reference tariff setting

Attachment 10 – Reference tariff variation mechanism

Attachment 11 – Non-tariff components

Attachment 12 – Demand

Attachment 13 – Capital expenditure sharing scheme

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10 Reference tariff variation mechanism

This attachment sets out our consideration of the reference tariff variation mechanism and cost pass through mechanism proposed by Australian Gas Networks (AGN). The reference tariff variation mechanism:

- permits building block revenues to be recovered smoothly over the access arrangement period subject to any differences between forecast and actual demand
- accounts for actual inflation
- accommodates other reference tariff adjustments that may be required, such as for an approved cost pass through event
- sets administrative procedures for the approval of any proposed changes to reference tariffs—that is, updating tariffs each year.

The cost pass through mechanism allows us to vary reference tariffs following the occurrence of a specified event which materially increases or decreases the cost of providing the reference service.

The inclusion of a pass through mechanism recognises a service provider can face risks beyond its control, which may have a material impact on costs.

10.1 Annual reference tariff variation mechanism

10.1.1 Draft decision

We accept most aspects of AGN's proposed reference tariff variation mechanism for the 2021–26 access arrangement period. We consider one element of its proposed mechanism is not consistent with the National Gas Rules (NGR):

- the proposed initial reference tariffs and X factors must be revised to reflect the changes to the forecast total revenue identified in section 3 of the Overview of this draft decision

We discuss our reasons for this draft decision below.

10.1.2 AGN's proposal

AGN proposed a price variation mechanism that is consistent with that applying in the 2016–21 period.¹

AGN proposed to retain a weighted average price cap (WAPC) for its haulage reference service for the 2021–26 period. This approach is consistent with other gas distributors and AGN's current access arrangement applying in the 2016–21 period. It

¹ AGN, *Access Arrangement Proposal Attachment 13.1*, July 2020, p. 2.

includes a tariff variation mechanism to allow a series of annual adjustments to tariffs to account for cost pass throughs, unaccounted for gas (UAFG) and relevant updated debt costs.

10.1.3 Assessment approach

Under the NGR, a reference tariff variation mechanism for an access arrangement:²

- must be designed to equalise (in present value terms):
 - forecast revenue from reference services over the access arrangement period, and
 - the portion of total revenue allocated to reference services for the access arrangement period, and
- may provide for variation of a reference tariff:
 - in accordance with a schedule of fixed tariffs, or
 - in accordance with a formula set out in the access arrangement, or
 - as a result of a cost pass through for a defined event, or
 - by the combination of two or more of these operations.

A formula for varying reference tariffs may (for example) provide for variable caps on the revenue to be derived from a particular combination of reference services; or tariff basket price control; or revenue yield control; or a combination of all or any of these factors.³

We must have regard to various factors in deciding whether an access arrangement's reference tariff variation mechanism is appropriate.⁴ These are:

- the need for efficient reference tariff structures
- the possible effects of the reference tariff variation mechanism on administrative costs
- the regulatory arrangements (if any) applicable to the relevant reference services before the commencement of the proposed reference tariff variation mechanism
- the desirability of consistency between regulatory arrangements for similar services
- any other relevant factor.

Further, the reference tariff variation mechanism must give us adequate oversight and powers to approve reference tariff variations.⁵

² NGR, r. 92(2).

³ NGR, r. 97(2).

⁴ NGR, r. 97(3).

⁵ NGR, r. 97(4).

We made our decision on AGN's proposed reference tariff variation mechanism having regard to each of these factors, and their implications for natural gas consumers, potential users, AGN and other stakeholders. In doing so, we took into account the nature and scope of pipeline reference services to which reference tariffs are applicable. Our assessment also included a comparison of:

- the proposed reference tariff variation mechanism with those in AGN's current access arrangement
- consistency with other recent gas distribution access arrangement decisions (and electricity determinations under the National Electricity Rules (NER))
- consistency in AGN's approach across the provision of similar services.

We assessed the potential impact of AGN's proposal for meeting the National Gas Objective (NGO) and the revenue and pricing principles (RPP).

We have taken into account the expected changes in gas demand over the 2021–26 period, the impact this can have on price stability over the period, and incentives on the service provider to develop efficient tariffs.

We have also taken into account submissions provided to us by stakeholders, including our Consumer Challenge Panel (CCP24).

10.1.4 Interrelationships

The haulage reference tariff variation mechanism has interrelationships across other key parts of our draft decision. For example, it interrelates with the total revenue AGN can earn, the services AGN provides to its customers to recover those revenues, and the tariffs it charges for the use of those services.

AGN's haulage reference tariffs are adjusted annually by the application of a weighted average price cap formula. The X factor in the formula is revised annually to reflect the updates to the return on debt as a result of the adoption of a trailing average approach to determining the cost of debt.

AGN's haulage reference tariffs are derived from the total revenue requirement after consideration of demand for each tariff category. Specific automatic adjustments occur on an annual basis to adjust AGN's total revenue requirement as certain expenses are 'trued-up' to reflect actual outcomes. This means the tariffs we determine (including the means of varying the tariffs from year to year) are the binding constraint across the 2021–26 period, rather than the total revenue requirement set out in our decision.

10.1.5 Reasons for draft decision

We accept AGN's proposed reference tariff variation mechanism for the 2021–26 period. We are satisfied with AGN's proposal to maintain the tariff variation mechanism described above in section 10.1.2. This mechanism is consistent with the current access arrangement period and other gas distributors.

10.2 Weighted average price cap formula

10.2.1 Draft decision

Our draft decision is to approve the weighted average price cap formula within AGN's 2021–26 access arrangement proposal, subject to the changes to the automatic adjustment factor calculations discussed above in section 10.1.

10.2.2 AGN's proposal

AGN is proposing a weighted average price cap (or 'WAPC') tariff basket form of control. This mechanism also includes a cost pass through and a series of automatic adjustments to allow for certain 'true-ups'.

10.2.3 Reasons for draft decision

We are satisfied that the weighted average price cap formula within AGN's 2021–26 access arrangement proposal is appropriate. This mechanism is consistent with the current access arrangement period and other gas distributors. We note that we assess compliance with the price cap control formulae as part of the annual tariff variation mechanism and apply the assessment approach set out in section 10.1.3 above.

10.3 Cost pass through mechanism

10.3.1 Draft decision

Our draft decision is to:

- accept AGN's proposed deletion of the Network User Failure Event
- not accept AGN's proposed change to the Terrorism Event
- make minor amendments to the definition of Insurance Credit Risk Event, Natural Disaster Event and Terrorism Event as set out in Table 10.1, so that they are consistent with our recent decisions.⁶

10.3.2 AGN's proposal

AGN proposed the following cost pass through events for the 2021–26 period:

- Terrorism event
- Natural disaster event
- Insurance cap event

⁶ E.g. AER, *Draft Decision, SA Power Networks Distribution determination 2020–25, Attachment 14 Pass through events*, June 2020, pp. 12–14; AER, *Draft decision – Energex distribution determination 2020–25 – Attachment 14 Pass through events*, October 2019, pp. 10–12.

- Insurer credit risk event
- Regulatory change event
- Service standard event.⁷

All of these cost pass through events are in AGN's current access arrangement. AGN's current access arrangement also contains a 'Network User Failure' event. AGN has not re-proposed this event, as it considers it is no longer necessary as rule 531 has been removed from the NGR.⁸

AGN proposed an adjustment to the terrorism event definition, from the existing definition in their current access arrangement, to align with relevant legislation such as the Criminal Code Act 1995 (Cth).

10.3.3 Assessment approach

The NGR state that a reference tariff variation mechanism may provide for the variation of a reference tariff:⁹

...as a result of a cost pass through for a defined event (such as a cost pass through for a particular tax).

As a component of the reference tariff variation mechanism, a cost pass through mechanism must be assessed having regard to the matters in rule 97(3)¹⁰ of the NGR and must give us adequate oversight and power to approve reference tariff variations.¹¹

We must approach this assessment in a manner likely to contribute to the achievement of the NGO,¹² which states that the purpose of the National Gas Law (NGL) is to promote efficient investment, operation and use of natural gas services for the long term interest of consumers with regard to price, quality, safety and security of supply.¹³

In addition, we must take into account the RPP whenever we exercise discretion in approving or making those parts of an access arrangement relating to a reference tariff.¹⁴ The RPP include a principle that the service provider should be provided with a reasonable opportunity to recover at least the efficient costs incurred in providing

⁷ AGN, *2020–25 Access Arrangement Proposal – Attachment 13.1 Tariff Variation Mechanisms and Tariff Structure*, June 2019, pp. 10–15.

⁸ AGN, *2020–25 Access Arrangement Proposal – Attachment 13.1 Tariff Variation Mechanisms and Tariff Structure*, June 2019, p. 10.

⁹ NGR, r. 97(1)(c)

¹⁰ In summary: efficient reference tariff structures; administrative costs; prior regulatory arrangements; consistency between regulatory arrangements; any other relevant factor.

¹¹ NGR, r. 97(4).

¹² NGL, s. 28(1)(a).

¹³ NGL, s. 23.

¹⁴ NGL, s. 28(2)(a).

reference services and complying with a regulatory obligation or requirement.¹⁵ They also provide incentives to promote economic efficiency.¹⁶ The RPP require us to have regard to the economic costs and risks of the potential for under- and over-investment by a service provider, to promote efficient investment.¹⁷

In the context of pass through events, we interpret the NGO as requiring us to have particular regard to the impact on price, quality, safety, reliability and security of supply that may arise as a result of any change in the efficient operation of, and ability and incentive of, a service provider to invest in its network.¹⁸

Our decision on the cost pass through mechanism includes a decision on what categories of event to approve.¹⁹ In approaching this part of our task, we also take into account the following relevant factors:²⁰

- whether the type of event is covered by another category of pass through event
- whether the nature or type of event can be clearly identified at the time the access arrangement is approved for the service provider
- whether a prudent service provider could reasonably prevent an event of that nature or type from occurring or substantially mitigate the cost impact of such an event
- whether the relevant service provider could insure against the event, having regard to:
 1. the availability (including the extent of availability in terms of liability limits) of insurance against the event on reasonable commercial terms
 2. whether the event can be self-insured on the basis that: it is possible to calculate the self-insurance premium; and the potential cost to the relevant service provider would not have a significant impact on the service provider's ability to provide network services.

These factors also appear in the National Electricity Rules (NER), where they guide our decision on whether to approve additional categories of pass through event beyond those already included in the NER.²¹ We consider they are consistent with the factors referred to in the NGR (r. 97(3)), and pertinent to our examination of the degree to which a proposed category of event is likely to contribute to the achievement of the NGO.²²

¹⁵ NGL, s. 24(2).

¹⁶ NGL, s. 24(3).

¹⁷ NGL, s. 24(6).

¹⁸ NGL, s. 23; See also AEMC 2012, *Cost pass through arrangements for Network Service Providers, Rule Determination*, 2 August 2012, p. 6.

¹⁹ NGR, r. 97(1)(c).

²⁰ NGR, r. 97(3)(e).

²¹ NER, cll. 6.5.10(b), 6A.6.9(b); NER Chapter 10: Glossary, definition of 'nominated pass through event considerations'.

²² NGR, r. 100(1).

The Australian Energy Market Commission (AEMC) described the purpose of these considerations as:

...to incorporate and reflect the essential components of a cost pass through regime. It was intended that in order for appropriate incentives to be maintained, any nominated pass through event should only be accepted when event avoidance, mitigation, commercial insurance and self-insurance are unavailable. That is, a cost pass through event is the least efficient option for managing the risk of unforeseen events.²³

...that a pass through event should only be accepted when it is the least inefficient option and event avoidance, mitigation, commercial insurance and self-insurance are found to be inappropriate. That is, it is included after ascertaining the most efficient allocation of risks between a service provider and end customers.²⁴

We consider that viewing pass throughs as a 'last resort' and accepting them only when event avoidance, mitigation and avoidance are unavailable, is consistent with the RPP and will contribute to the achievement of the NGO. This approach maintains the incentives on service providers to use market based mechanisms to mitigate the cost impacts that would arise if the event is triggered.²⁵ In turn, this promotes the efficient investment in, and efficient operation and use of, natural gas services for the long term interests of consumers with respect to price.²⁶

We also look to promote consistency in our approach to pass through categories across our electricity determinations and gas access arrangement decisions.²⁷

10.3.4 Interrelationships

Except as provided by a reference tariff variation mechanism, a reference tariff is not to vary during the course of an access arrangement period.²⁸ In assessing and approving a reference tariff variation mechanism, we consider the potential impact of the proposed mechanism on the service provider's incentives under the access arrangement to operate its network—and manage its risks—in a manner consistent with the NGO and RPP.²⁹

²³ AEMC 2012, *Cost pass through arrangements for Network Service Providers, Rule Determination*, 2 August 2012, p. 19.

²⁴ AEMC 2012, *Cost pass through arrangements for Network Service Providers, Rule Determination*, 2 August 2012, p. 20.

²⁵ NGL, s. 24(3); AEMC 2012, *Cost pass through arrangements for Network Service Providers, Rule Determination*, 2 August 2012, p. 8.

²⁶ NGL, s. 23; AEMC 2012, *Cost pass through arrangements for Network Service Providers, Rule Determination*, 2 August 2012, p. 8.

²⁷ See NGR r. 97(3)(d).

²⁸ NGR, r. 97(5).

²⁹ NGL, ss. 23, 24.

The pass through component of the reference tariff variation mechanism is also interrelated with other parts of this decision, in particular with the forecast opex³⁰ and capex³¹ and rate of return³² included in our forecast revenue requirement. These interrelationships require us to balance the incentives in the various parts of our decision.

Pass through events are one way, but not the only way, in which service providers can manage their risks under an access arrangement. For systemic risks, service providers are compensated through the allowed rate of return. Service providers also face business-specific, or residual, risks. Service providers are compensated for the prudent and efficient management of these risks through the forecast opex and capex we include in our forecast revenue requirement for strategies such as:

- prevention (avoiding the risk)
- mitigation (reducing the probability and impact of the risk)
- insurance (transferring the risk to another party)
- self-insurance (putting aside funds to manage the likely costs associated with a risk event).

An efficient business will manage its risk by employing the most cost effective combination of these strategies. In order to maintain appropriate incentives under an access arrangement, we only accept pass through events where we are satisfied that event avoidance, mitigation, commercial insurance and self-insurance under approved forecasts of prudent and efficient opex and capex are either unavailable or inappropriate.³³

For smaller expenditure, a service provider should generally utilise its existing expenditure allowance or reprioritise its work program rather than seeking approval of a pass through.³⁴ This is reflected in the materiality threshold that applies to applications for cost pass through under the approved access arrangement.³⁵

³⁰ See Attachment 6 (Operating expenditure) to this draft decision.

³¹ See Attachment 5 (Capital expenditure) to this draft decision.

³² See Attachment 3 (Rate of return) to this draft decision.

³³ This is consistent with the AEMC's conclusions in its review of the NER pass through arrangements. See: AEMC 2012, *Cost pass through arrangements for Network Service Providers, Rule Determination*, 2 August 2012, pp. 19–20.

³⁴ This is consistent with the AEMC's conclusions in its review of the NER pass through arrangements. See: AEMC 2012, *Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services, Final Rule Determination*, 29 November 2012, p. 186.

³⁵ AER, *Approved Access Arrangement for the JGN's NSW gas distribution networks - 1 July 2015 to 30 June 2020*, June 2015, cl. 3.4(b) and 3.4(c).

Opex cost pass through amounts approved in an access arrangement period are added to forecast opex for the purpose of calculating efficiency carryover amounts under the ECM in the approved access arrangement.³⁶

10.3.5 Reasons for draft decision

AGN's proposed pass through events are consistent with those we approved in the 2016–21 period.

Overall, for the proposed cost pass through events we have accepted, we are satisfied that these events:

- are not covered by another category of pass through event
- can be clearly identified at the time when we are approving the access arrangement
- are of the nature or type that a prudent service provider could not reasonably prevent from occurring or substantially mitigate their cost impact
- are prohibitively costly to cover by full insurance or that there is no available insurance cover on reasonable commercial terms.

10.3.5.1 Network User Failure Event

We accept the deletion of the Network User Failure Event as the need to have this event in the first instance has been addressed by the Australian Energy Market Commission's approved rule change in February 2017.³⁷ This rule change enhanced the operation of the retailer insolvency cost pass through provisions in the Rules to enable distributors to collect unpaid network charges and any costs associated with a retailer default, regardless of the size of the retailer default, thus removing the need for a cost pass through event. While we accept the proposed change, we consider the approach to effect this change is not as drafted by AGN. We consider the deletion of the Network User Failure Event in the Access Arrangement is the simplest way to achieve it. This approach is consistent with our recent decision with Jemena Gas Networks.³⁸

10.3.5.2 Terrorism event

We do not consider the proposed minor amendments to the Terrorism Event definition to align with the Criminal Code Act 1995 necessary. Updating the definition for

³⁶ AER, *Approved Access Arrangement for the JGN's NSW gas distribution networks - 1 July 2015 to 30 June 2020*, June 2015, cl. 12.1(i); See Attachment 8 (Efficiency carryover mechanism) to this draft decision.

³⁷ AEMC, *Rule Determination – National Electricity Amendment (Retailer-distributor credit support requirements) Rule 2017, National Gas Amendment (Retailer-distributor credit support requirements) Rule 2017*, 2 February 2017, p. ii.

³⁸ AER, *Draft Decision, Jemena Gas Networks 2020–25, Attachment 10 Reference tariff variation mechanism*, November 2019, p. 14.

terrorism to more closely align with the Criminal Code Act 1995 does not alter anything of substance in the operation of the Terrorism Event. We prefer to retain the current wording as this is consistently defined for all network service providers and minimise any confusion about the Terrorism Event with introduction of minor definitional differences.

10.3.5.3 Other minor amendments

We have made some minor amendments to the definitions of AGN's Insurer Credit Risk Event, Natural Disaster Event and Terrorism Event, as set out in Table 10.1 to provide greater drafting consistency between AGN and other network service providers.³⁹

Table 10.1 Accepted cost pass through definitions consistent with our recent decisions

Pass through event	Approved Definition
Insurer credit risk	<p>An insurer credit risk event means an event where an insurer of AGN becomes insolvent, and as a result, in respect of an existing or potential claim for a risk that was insured by the insolvent insurer, AGN:</p> <ol style="list-style-type: none"> 1. is subject to a higher or lower claim limit or a higher or lower deductible than would have otherwise applied under the insolvent insurer's policy; or 2. incurs additional costs associated with funding an insurance claim, which would otherwise have been covered by the insolvent insurer. <p>Note: In making a determination on an insurer credit risk event pursuant to clause 4.6.2 of this Access Arrangement, the AER will have regard to, amongst other things:</p> <ul style="list-style-type: none"> • AGN's attempts to mitigate and prevent the event from occurring by reviewing and considering the insurers track record, size, credit rating and reputation, and • in the event that a claim would have been made after the insurer became insolvent, whether AGN had reasonable opportunity to insure the risk with a different insurer.
Natural disaster	<p>Natural disaster event means any natural disaster including but not limited to cyclone, fire, flood or earthquake that occurs during the 2021–26 access arrangement period that increases the costs to AGN in providing the Reference Service, provided the fire, flood or other event was:</p> <ul style="list-style-type: none"> • a consequence of an act or omission that was necessary for the service provider to comply with a regulatory obligation or requirement or with an applicable regulatory instrument; or • not a consequence of any other act or omission of the service provider. <p>Note: In making a determination on a natural disaster event pursuant to clause 4.6.2 of this Access Arrangement, the AER will have regard to,</p>

³⁹ E.g. AER, *Draft Decision, SA Power Networks Distribution determination 2020–25, Attachment 14 Pass through events*, June 2020, pp. 12–14; AER, *Draft decision – Energex distribution determination 2020–25 – Attachment 14 Pass through events*, October 2019, pp. 10–12.

Pass through event	Approved Definition
	<p>amongst other things:</p> <ul style="list-style-type: none"> • whether AGN has insurance against the event; and • the level of insurance that an efficient and prudent service provider would obtain in respect of the event.
Terrorism	<p>Terrorism event means an act (including, but not limited to, the use of force or violence or the threat of force or violence) of any person or group of persons (whether acting alone or on behalf of or in connection with any organisation or government), which:</p> <ul style="list-style-type: none"> • from its nature or context is done for, or in connection with, political, religious, ideological, ethnic or similar purposes or reasons (including the intention to influence or intimidate any government and/or put the public, or any section of the public, in fear), and • increases the costs to AGN in providing the Reference Service. <p>Note: In making a determination on a terrorism event pursuant to clause 4.6.2 of this Access Arrangement, the AER will have regard to, amongst other things:</p> <ul style="list-style-type: none"> • whether AGN has insurance against the event; • the level of insurance that an efficient and prudent service provider would obtain in respect of the event; and • whether a declaration has been made by a relevant government authority that a terrorism event has occurred.

Shortened forms

Shortened form	Extended form
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
AGN	Australian Gas Networks (SA)
capex	Capital expenditure
CCP24	Consumer Challenge Panel, sub-panel 24
CESS	Capital expenditure sharing scheme
CPI	Consumer price index
EBSS	Efficiency benefit sharing scheme
ECM	Efficiency carryover mechanism
EWON	Energy & Water Ombudsman NSW
NER	National Electricity Rules
NGL	National Gas Law
NGO	National Gas Objective
NGR	National Gas Rules
opex	Operating expenditure
RPP	Revenue and pricing principles
UAFG	Unaccounted for gas
WAPC	Weighted average price cap