DRAFT DECISION
Australian Gas Networks (SA) Access Arrangement

2021 to 2026

Attachment 9
Reference tariff setting

November 2020

AUSTRALIAN ENERGY REGULATOR

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Note

This attachment forms part of the AER's draft decision on the access arrangement that will apply to AGN ('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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9 Reference tariff setting

This attachment outlines our assessment of the reference tariffs proposed by AGN against the requirements of the National Gas Rules (NGR). Our assessment focuses on the structure of reference tariffs and takes into account the revenue and pricing principles.[1]

9.1 Draft decision

We are satisfied AGN's proposed structure of the reference tariffs for the 2021–26 access arrangement period complies with the requirements of the NGR.[2] While this is the case, the quantum of AGN's proposed reference tariffs must be amended to reflect our final decision on AGN's building block proposal.

We accept AGN's proposed ancillary reference services tariff structure and tariff levels.

We also accept AGN's proposed prudent discounts.[3] We note these are consistent with the prudent discounts we approved for AGN's past three access arrangements.

9.2 AGN's proposal

AGN's proposed reference tariff structures for the 2021–26 period are consistent with those applying in the current 2016–21 period. They are also consistent with our November 2019 decision on AGN's June 2019 reference service proposal.[4] The reference tariffs proposed by AGN are outlined in Table 9.1.

Table 9.1 AGN's proposed initial tariff classes and tariff charge components

Customer category	Tariff class	Tariff category	Charge components
Domestic	Tariff R – Residential	Residential (excluding Tanunda)	One fixed charge Three volume throughput block charges Ancillary reference charges
	Tariff R – Residential	Residential – Tanunda	One fixed charge Three volume throughput block charges Ancillary reference charges
Commercial	Tariff C – Commercial	Commercial (excluding Tanunda)	One fixed charge Four volume throughput block charges

1 NGL, ss. 24(2)–(7).

2 NGR, rr. 93, 94.

3 NGR, r. 96.

4 AER, *Final Decision – Australian Gas Networks (South Australia) Gas Distribution Determination 2021 to 2026 Reference Service*, November 2019.

			Ancillary reference charges
	Tariff C – Commercial	Commercial – Tanunda	One fixed charge Four volume throughput block charges Ancillary reference charges
Demand	Tariff D – Northern	Tariff D	Five capacity throughput block charges Ancillary reference charges
	Tariff D – Central	Tariff D	Five capacity throughput block charges Ancillary reference charges
	Tariff D – Southern	Tariff D	Five capacity throughput block charges Ancillary reference charges
	Tariff D – Peterborough	Tariff D	Five capacity throughput block charges Ancillary reference charges
	Tariff D – Port Pirie	Tariff D	Five capacity throughput block charges Ancillary reference charges
	Tariff D – Riverland	Tariff D	Five capacity throughput block charges Ancillary reference charges
	Tariff D – South East	Tariff D	Five capacity throughput block charges Ancillary reference charges
	Tariff D – Whyalla	Tariff D	Five capacity throughput block charges Ancillary reference charges

Source: AER analysis and AGN, *Access arrangement Plan*, July 2020, p. 115.

The ancillary reference tariffs proposed by AGN are outlined in Table 9.2.

Table 9.2 AGN ancillary reference service tariff structure

Ancillary reference service	Proposed charge ($2020-21)
Special meter reading	$11.00
Disconnection	$75.00
Reconnections	$75.00
Meter gas and installation test	$225.00
Meter removal	$75.00
Meter reinstallation	$81.00

Source: AGN, *Access arrangement attachment 6.1 AGN SA Reference Service Proposal*, July 2020, p. 5; AGN, *Access arrangement revisions proposal Attachment 7.1 opex forecast model, tab Input ARS*, July 2020.

AGN proposed to set ancillary reference services tariffs at the levels set out in Table 9.2 and to retain those tariff levels in real terms throughout the 2021-26 access arrangement period.[5] This is a continuation of AGN's approach to tariffing ancillary services in the current access arrangement period.

Additionally, AGN is proposing to continue providing prudent discounts to customers who, without the discount, may elect to bypass AGN's network, meaning that tariffs may be higher for all other customers on AGN's network.

9.3 Assessment approach

In an access arrangement, a service provider is required to specify for each reference service, the reference tariff and proposed approach to setting the reference tariff.[6] This is done by:

- explaining how revenues and costs are allocated, including the relationship between costs and tariffs[7]
- defining the tariff classes[8]
- comparing the revenue to be raised by each reference tariff with the cost of providing each individual reference service[9]
- explaining and describing any pricing principles it employed.[10]

Following our assessment of the proposed reference tariffs, if we decide to not accept them, we must determine the initial (in this case, 2021–22) reference tariffs to apply for each reference service.

In our assessment of the proposed reference tariffs, we reviewed AGN's 2021–26 access arrangement information and proposal.[11] We also had regard to submissions received in the course of our consultation on AGN's proposed access arrangement.[12]

Identifying the reference service

The NGR require service providers to specify a reference tariff for each reference service.[13] When undertaking our review, we first consider what is (or are) the reference service(s) for the purpose of the NGR. Our decision on what constitutes the reference service was published in November 2019 and is referenced in Attachment 1—Services covered by the access arrangement.

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5 For brevity we address in this attachment both AGN's proposed ancillary services tariff setting and tariff variation for the 2021-26 access arrangement period.

6 NGR, rr. 48(1)(d)(i), 72(1)(j).

7 NGR, rr. 72(1)(j)(i), 93(1)–(2).

8 NGR, r. 94(1)–(2).

9 NGR, r. 94(3).

10 NGR, r. 72(1)(j)(ii).

11 AGN, *Final Plan: Five year plan for our South Australian network, 2021–2026*, July 2020; AGN, *Access arrangement attachment 6.1 AGN SA Reference Service Proposal*, July 2020; AGN, *Access arrangement attachment 13.1 AGN SA Tariff Structure*, July 2020.

12 NGR, r. 59.

13 NGR, r. 48(1)(d)(i).

Assessing the tariff setting method for the reference service

The reference tariffs for an access arrangement must be designed to meet the requirements of the NGR.

We consider how the service provider, AGN, intends to charge for reference services by:

1. Assessing how AGN intends to allocate costs and revenues between reference services and other services. It must demonstrate that total revenue is allocated between reference and other services in the ratio in which costs are allocated between reference services and other services. Costs that are directly attributable to a service (including the reference service) must also be allocated to that service.[14]
2. Assessing how AGN grouped its customers into tariff classes. AGN is required to group together customers for reference services on an economically efficient basis and to avoid unnecessary transaction costs.[15] We consider whether the nature of the reference service is consistent with the need to group customers together on an efficient basis.
3. Assessing how:

   (a) the expected average revenue of a tariff class compares with the standalone cost and avoidable cost of providing the reference service to that tariff class

   (b) whether the tariff takes into account transaction costs associated with developing and applying the tariff

   (c) whether the tariffs take into account the long run marginal costs of providing reference services

   (d) whether customers belonging to the relevant tariff class are able, or likely, to respond to price signals.[16]

We assess any proposed new fixed principles seeking to promote consistency with the National Gas Objective (NGO), and with regard to the revenue and pricing principles.[17] We consider whether they are consistent with the requirements of the NGR.

For existing fixed principles that were approved before the commencement of the NGR, these are binding on the AER and AGN for the period for which the principle is fixed and these may only be varied or revoked with AGN's consent.[18]

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[14] NGR, r. 93(2).

[15] NGR, r. 94(2).

[16] NGR, rr. 94(3)–(4).

[17] NGL, s. 28(2); NGR, r. 100(1).

[18] NGR, r. 99.

9.3.1 Interrelationships

AGN’s tariffs have an interrelationship with the services it provides, our approved total revenue requirement for AGN and the application of annual tariff variation mechanisms.

AGN’s haulage reference tariffs are adjusted annually by applying a weighted average price cap formula. Its haulage reference tariffs are derived from the total revenue requirement after demand for each tariff class is considered. 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.

After the first year (i.e. 2021–22) of the 2021–26 access arrangement period, tariffs for AGN’s haulage reference services and ancillary reference services are set by applying the tariff variation formula.

Our draft decision on:

- AGN’s total revenue requirement—is set out in the Overview of this draft decision
- the services AGN will offer to customers over the 2021–26 period are set out in Attachment 1—Services covered by the access arrangement
- the annual tariff variation mechanisms are set out in Attachment 10—Reference tariff variation mechanism.

9.4 Reasons for draft decision

We accept AGN’s proposed reference service tariff structures because we are satisfied they comply with the NGR requirements, discussed in section 9.3.

The tariff structures are consistent with those which applied in the current, 2016–21 access arrangement. While we are satisfied with the tariff structures, the quantum of the proposed initial reference tariffs must be amended to reflect our 2021–26 draft decision forecast demand and revenue allowance.

The remainder of this section sets out the reasons for our draft decision under the following headings:

- allocation of revenues and costs to reference tariffs
- establishment of tariff classes
- tariff classes and revenue limits, including prudent discounts
- tariff and price level strategy.

9.4.1 Allocation of revenues and costs to reference tariffs

AGN’s proposal included information outlining its standalone costs, long run marginal costs and incremental costs. On reviewing this, we are satisfied AGN’s approach to allocating revenue and costs between reference services and non-reference services complies with the NGR for the following reasons:

- we are satisfied AGN's proposed costs relating to its reference services do not include costs incurred (and recovered) from the provision of its non–reference services
- AGN has not allocated non–reference service revenue to a reference service because the underlying costs have not been included in AGN's building block revenues.

9.4.2 Establishment of tariff classes

AGN groups its customers by the nature of the haulage reference service (residential, commercial or demand tariff categories) and classifies them by their location on the distribution network. We consider that these characteristics are likely to be the driver of costs within AGN's gas distribution network. Therefore, using them to group customers into tariff class is appropriate. We note AGN's proposed tariff classes are consistent with the tariff classes in the current access arrangement.

We are satisfied the proposed tariff classes are consistent with the requirements of the NGR.[19]

9.4.3 Tariff classes and revenue limits

We have assessed AGN's tariff classes and revenue limits against the requirements in the NGR.[20] Specifically:

(a) the expected average revenue of a tariff class compares with the standalone cost and avoidable cost of providing the reference service to that tariff class

(b) whether the tariff takes into account transaction costs associated with developing and applying the tariff

(c) whether the tariffs take into account the long run marginal costs of reference services

(d) whether customers belonging to the relevant tariff class are able, or likely, to respond to price signals.

Standalone and avoidable costs

We are satisfied that AGN's proposed reference tariffs are consistent with the NGR requirement that the expected revenue to be recovered lies on or between:

- an upper bound representing the standalone cost of providing the reference service to customers who belong to that tariff class

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19 NGR, r. 94(4).

20 NGR r. 94.

- a lower bound representing the avoidable cost of not providing the reference service to those customers.[21]

AGN's proposal includes detailed appendices discussing how it estimates standalone and avoidable costs. We reviewed AGN's definitions of avoidable and standalone costs for the volume and demand tariff classes, and consider these definitions comply with the NGR.

We have also reviewed the methodology applied by AGN to demonstrate that, for each tariff, the expected tariff revenue lies on or between the avoidable and standalone costs.

Transaction costs

We are satisfied AGN's proposed reference tariffs take into account transaction costs associated with the tariff and the need to avoid them where possible.[22] We consider the continuation of the current access arrangement tariff classes and tariff structures will minimise any additional transaction costs across the 2016–21 and 2021–26 access arrangement periods. As we discuss below, we are also satisfied that AGN's approach to estimating long run marginal costs appropriately accounts for transaction costs.

Long run marginal cost

The NGR requires that AGN must take into account long run marginal cost (LRMC) when determining its tariffs.[23]

LRMC is equivalent to forward looking variable costs—more specifically, as measured over a period of time sufficient for all factors of production to be varied. When tariffs accurately reflect the marginal, or forward-looking, cost of increasing (or decreasing) demand, consumers can make informed choices about their gas usage. Under such tariffs, customers would increase their use of the network only when they value it more than the costs. This, in turn, signals to distributors to invest in additional capacity to the extent that customers value it.[24]

AGN noted it used the Average Incremental Cost approach to calculate the long run marginal cost (LRMC) by tariff class.[25] However, AGN considered that given data limitations it is not possible to obtain reasonable LRMC outcomes at the tariff class level, by geographical region or even at a whole–of–network level.[26]

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21 NGR r. 94(3).

22 NGR, 94(2) and 94(4).

23 NGR, r. 94(4)(a).

24 Alternatively, customers may reduce their use of the network if the benefit they derive is less than the costs. This in turn signals to distributors the potential to reduce capacity in the network.

25 AGN, *Access arrangement attachment 13.1 AGN SA Tariff Structure*, July 2020, p. 18.

26 AGN, *Access arrangement attachment 13.1 AGN SA Tariff Structure*, July 2020, p. 19.

We note our discretion under the NGR on LMRC is limited.[27] However, we consider the approach taken by AGN is generally consistent with that applied by other gas distribution networks and has historical precedent in past access arrangements. At any rate we observe that the calculated values of LRMC are sensitive to the assumptions made around a number of different variables. As such, these should only be used as a guide when assessing price levels and structures, rather than be considered definitive.

Prudent discounts

We consider that the prudent discounts AGN proposed to offer are necessary to respond to competition from other providers of pipeline services or alternative energy sources and to ensure the ongoing efficient use of its pipeline. Further, AGN has demonstrated that the negotiated revenue from prudent discount services exceeds the estimate of the avoidable costs. Without a prudent discount, a customer may elect to bypass the network, with the consequence that tariffs may be higher for all remaining users on the network. Therefore, we are satisfied that AGN's proposed prudent discounts are consistent with the NGR.[28]

We note that with respect to prudent discounts, our role is limited to assessing whether AGN's proposal is compliant with the NGR. Service providers (in this case, AGN) initially determine whether a discount should apply to a particular user.

9.5 Revisions

We require the following revisions to make the access arrangement proposal acceptable:

Table 9.3 AGN reference tariff revisions

Revision	Amendment
Revision 9.1	Amend the quantum of reference tariffs to reflect our draft decision on total revenue.

27 NGR, r. 94(6).

28 NGR, r. 96.

Shortened forms

Shortened form	Extended form
AER	Australian Energy Regulator
AGN	Australian Gas Networks (SA)
capex	Capital expenditure
CESS	Capital expenditure sharing scheme
CCP24	Consumer Challenge Panel, sub-panel 24
CPI	Consumer price index
EBSS	Efficiency benefit sharing scheme
ECM	Efficiency carryover mechanism
LRMC	Long run marginal cost
NGL	National Gas Law
NGO	National Gas Objective
NGR	National Gas Rules
opex	Operating expenditure