# DRAFT DECISION
# APA VTS Australia
# Gas access arrangement
# 2018 to 2022

# Attachment 11 – Reference tariff variation mechanism

July 2017

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# Note

This attachment forms part of the AER's draft decision on the access arrangement for APA VTS Australia for 2018-22. 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 - Value of imputation credits

Attachment 5 - Regulatory depreciation

Attachment 6 - Capital expenditure

Attachment 7 - Operating expenditure

Attachment 8 - Corporate income tax

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Attachment 12 - Non-tariff components

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# Shortened forms

| Shortened form | Extended form |
|---|---|
| AER | Australian Energy Regulator |
| ATO | Australian Tax Office |
| capex | capital expenditure |
| CAPM | capital asset pricing model |
| CPI | consumer price index |
| DRP | debt risk premium |
| ECM | (Opex) Efficiency Carryover Mechanism |
| ERP | equity risk premium |
| Expenditure Guideline | Expenditure Forecast Assessment Guideline |
| gamma | Value of Imputation Credits |
| MRP | market risk premium |
| NGL | National Gas Law |
| NGO | national gas objective |
| NGR | National Gas Rules |
| NPV | net present value |
| opex | operating expenditure |
| PTRM | post-tax revenue model |
| RBA | Reserve Bank of Australia |
| RFM | roll forward model |
| RIN | regulatory information notice |
| RPP | revenue and pricing principles |
| SLCAPM | Sharpe-Lintner capital asset pricing model |
| STTM | Short Term Trading Market |
| TAB | Tax asset base |
| UAFG | Unaccounted for gas |
| WACC | weighted average cost of capital |
| WPI | Wage Price Index |

# 11 Reference tariff variation mechanism

This attachment sets out our draft decision on the reference tariff variation mechanism in the Access Arrangement proposal for the VTS for 2018–22.

The proposed reference tariff variation mechanism includes:

- an annual reference tariff variation mechanism, and
- a cost pass through mechanism, including a number of cost pass through events.

## 11.1 Annual reference tariff variation mechanism

### 11.1.1 Draft decision

We approve the reference tariff variation mechanism proposed by APA VTS (APA) and as per the formulae set out below under reference tariff variation mechanism formula.

The tariff control formula is an average revenue yield. We approve the annual tariff variation process, by which APA will provide to us its proposed tariffs 50 business days before their commencement on 1 January each year. We will make our determination on approved tariffs no later than 20 business days after APA lodges it.

We do not approve the tariff levels for 2018 set out in the proposed access arrangement. APA is required to amend the levels of the tariffs taking into account other inputs to this draft decision, such as the approved forecast of capex and opex, among others.

### 11.1.2 APA's proposal

APA proposed that the existing reference tariff mechanism apply for the 2018–22 access arrangement but now also subject to annual updates for the return on debt used to calculate the rate of return each year.

The reference tariffs include:

- injection tariffs–the charge payable for injecting gas into the VTS
- withdrawal tariffs–the charge for withdrawing gas from the VTS.[1]

A zonal tariff structure is proposed to continue to apply. This means customers pay for the use of the gas transmission system depending on the length of the pipeline they use within certain zones and for the injection and/or withdrawal of gas from the pipeline. Non-system costs, such as the return of and on capital and corporate overheads are recovered on a postage stamp basis. Users also pay tariffs depending on whether they use cross-system assets.

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[1] APA, *Victorian transmission system, access arrangement,* 3 January 2017, p. 10.

Further, APA's access arrangement submission notes that it is now subject to considerable volume risk, given the changes underway in the east coast gas market.[2] Because of this, it observed the possibility of including a cap and collar mechanism in the tariff control formula. However, no such mechanisms were actually proposed in the access arrangement submission. It noted that its approved access arrangement for 2008 included a cap and collar mechanism but the current access arrangement did not. APA proposed annual variation of its tariffs will be via a proposal to the AER made 50 business days before the start of the next regulatory year, commencing every 1 January.[3]

### 11.1.3 Assessment approach

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

- 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.
- 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.[4]

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.[5] However, the reference tariff variation mechanism must give us adequate oversight and powers to approve reference tariff variations.[6]

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

- the need for efficient reference tariff structures
- the possible effects of the reference tariff variation mechanism on administrative costs

2 APA, *Victorian transmission system, access arrangement submission*, 3 January 2017, p. 48.
3 APA, *Victorian transmission system, access arrangement,* 3 January 2017, p. 14.
4 NGR, rr. 92(2), 97(1).
5 NGR, r. 97(2).
6 NGR, r. 97(4).

- 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.[7]

### 11.1.4 Interrelationships

The tariff variation mechanism converts the annual revenue requirement generated from the post–tax revenue model into annual tariffs and to adjust those tariffs each year. This is done to ensure that, in net present value terms, the expected revenues over the access arrangement period match the revenue requirement set out in our access arrangement final determination.

### 11.1.5 Reasons for draft decision

APA has operated under largely the same reference tariff control mechanism since the first access arrangement. It is a price control formula that adjusts for the effect of differences between actual and forecast volumes over the access arrangement, to ensure that the net present value of building block revenues equals the revenues forecast to be achieved in the current regulatory year and future regulatory years of the 2018–22 access arrangement. The control mechanism takes the form of an average revenue yield.

We have approved this reference tariff variation mechanism in previous access arrangements and continue to consider that it meets the requirements of r. 97 of the NGR at this time. We note that the tariff control mechanism for all other gas and electricity distributors that we regulate are either a weighted average price cap or a revenue cap for standard control services / direct control services (electricity) or reference services (gas). However, at this point in time we are satisfied that the particular mechanism APA has proposed meets the NGR requirements. Each year, we now update the return on debt calculation input to the rate of return for all gas transmission and distribution service providers that we regulate. We therefore approve APS VTS adopting this as part of its adjustment to reference tariffs for each year of the access arrangement.

Every year, APA will propose tariffs that attempt to ensure it recovers its allowed revenue requirement. A combination of actual tariffs for the forthcoming regulatory year and forecast tariffs for future years multiplied by the actual volumes and forecast volumes for those same respective years is set to match the allowed revenue requirement. Tariffs for the next regulatory year within each withdrawal and injection zone can be adjusted by CPI-X. They will additionally have a 2 precent side constraint applied each year. We have approved all these aspects of the proposal.

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7 NGR, r. 97(3).

We do not accept, however, APA's VTS proposal to update forecast inflation for actual inflation in the post-tax revenue model via a change each year to the x-factor and for this to flow through to the tariff model. The reasons for this are discussed in the rate of return attachment 3.

Regarding the process to propose tariffs, we accept 50 business days notification to the AER of a tariff variation proposal. This is the same timeframe as per previous access arrangements and ensures stakeholders are given ample notice about impending changes to transmission tariffs.

The AER will provide notification to APA of its approval of the proposed tariffs no later than 20 business days from the date they are proposed. This period may be extended by the AER in situations where additional information is required from APA to satisfy us that the tariff variation proposal should be approved, or for us to engage experts or seek submissions on the proposal if necessary.

We also accept the proposal that existing tariffs from the current regulatory year should continue to apply until the AER approves tariffs for the following year.

We note that APA considers that a cap and collar mechanism may be desirable for the 2018–22 access arrangement. The proposal is silent on the application of the cap and collar mechanism, other than to suggest that it will take the same form as in a previous access arrangement. Furthermore, it has not actually proposed a cap and collar mechanism for the access arrangement. Therefore, we have not considered the merits of one for this draft decision.

## Reference tariff variation mechanism formula

Our draft decision reference tariff variation mechanism formula is set out below.

***Scheduled Reference Tariff Variation Mechanism***

(a) Individual components of the Transmission Tariffs may be adjusted up or down for a given Regulatory Year after the First Regulatory Year provided that:

(i) the NPV of the actual revenues (AR) (determined as outlined below) achieved is no greater than the NPV of the adjusted target revenues (ATR) (determined as outlined below); and

(ii) no component of the Transmission Tariffs can be increased by more than (CPI - X)*(1 + Y) for any Regulatory Year, where:

(A) X is the tariff path factor prescribed for that Transmission Tariff component in the Access Arrangement; and

(B) Y is 2 per cent.

(b) All monetary calculations and figures used in calculations for the variation of the components of the Transmission Tariffs are to be expressed in real dollar values using a CPI indexed at December 2017, and using the best estimate of the CPI at December of each year of the Fifth Access Arrangement Period.

(c) All calculations and figures for determination of any price control formula component at any particular time must be the best estimate of that component at the relevant time using reported or actual (as the case may be) values where available and the best estimates of forecast values where required. For the purposes of this paragraph (c), the price control formula components include revenues, volumes, CPI, EDDs, costs passed through under the Cost Pass-through Reference Tariff Adjustment Mechanism, etc).

(d) The NPV is to be calculated using a discount rate equal to the Real Vanilla WACC as approved for the Fifth Access Arrangement Period.

(e) Separately report actual injection volume under of the price control model.

**AR**

Each determination of AR will be equal to the best estimate of the actual revenues received for the whole of the Fifth Access Arrangement Period at the time of calculation, using both actual data (Actual Revenues) (where available) and best estimates of forecast revenues (Forecast Revenues) where required.

For example, for a determination of AR in November 2018, the best estimate of actual revenues will be the Actual Revenues in 2017 and the Forecast Revenues expected for the remainder of the Fifth Access Arrangement Period. A determination of AR in subsequent years will use the Actual Revenues received where available, and the best revised forecasts for the remaining years, where the revised forecasts may differ from those forecasts made at earlier determinations.

**ATR**

For the price control formula, the target revenue (TR) for First Regulatory Year is $105.5 million in nominal 2018 dollars. Further, the total volume withdrawn from the VTS for the First Regulatory Year, excluding NRRV, is PJ.

ATR = VATR + RODA + PTA +CFA

where:

| | |
|---|---|
| VATR | is volume adjusted target revenue calculated as outlined below; |
| RODA | is the return on debt adjustment for the Regulatory Year for which the components of the Transmission Tariffs are to be adjusted; |
| PTA | is the approved pass through amount from a Cost Pass-through Event; and |
| CFA | is, for the First Regulatory Year, the second carry-forward amount SCA calculated in accordance with clause D.7 of the access arrangement for the VTS applicable during the Fourth Access Arrangement Period, and is, for all other Regulatory Years in the Fifth Access Arrangement Period, zero. |

Notes:

1. RODA = NPVDIFF*(1 + RVWACC)n where:

   (a) NPVDIFF is the difference between:

      (i) the net present value of the total revenue from the Post-Tax Revenue Model after updating the Trailing Average Portfolio Return on Debt for the Regulatory Year for which the components of the Transmission Tariffs are to be varied; and

      (ii) the net present value of the total revenue from the Post-Tax Revenue Model immediately prior to updating the Trailing Average Portfolio Return on Debt for the Regulatory Year for which the components of the Transmission Tariffs are to be varied;

   (b) RVWACC is the Real Vanilla WACC as approved for the Fifth Access Arrangement Period; and

   (c) n is the number of Years between the start of the Fifth Access Arrangement Period and the Regulatory Year for which the components of the Transmission Tariffs are to be varied.

2. The best estimates of the CFA costs are included in the forecast of operating expenditure for the Fifth Access Arrangement Period, but the correct values for these factors will not be known until the first year of the Fifth Access Arrangement Period.

3. CFA and PTA may be positive or negative.

**VATR**

$$\mathbf{VATR} = \frac{\mathbf{TR}}{\mathbf{TV}} \times \mathbf{WAAV}$$

where:

TR is the target revenue as set out in Table 12.1 of the Access Arrangement Information, excluding NRRV;

TV is the total volume withdrawn from the VTS as set out in section 4 of the Access Arrangement Information, excluding NRRV;

WAAV is the weather adjusted actual volume, calculated as outlined below; and

NRRV is, for the purposes of TR, the target revenue and for the purposes of TV, the volume, associated with:

(i) any transmission refills at WUGS or the LNG Storage Facility; and

(ii) the incremental Murray Valley tariff.

**WAAV**

$$\mathbf{WAAV} = (\mathbf{VW} + \mathbf{TS} \times (\mathbf{Target\ EDD} - \mathbf{Actual\ EDD}))$$

where:

| | |
|---|---|
| VW | is the actual withdrawal from the VTS excluding NRRV; |
| TS | is the weather sensitivity, being the increase in annual gas volumes for an increase of one in the annual EDD, as set out in Table 4.7 of the Access Arrangement Information; |
| Target EDD | is the measure of annual EDD as expected in a Regulatory Year as set out in Table 4.7 of the Access Arrangement Information; and |
| Actual EDD | is the actual measured EDD for a Regulatory Year, as reported in the AEMO APR or otherwise made available by AEMO. |

**First Carry-Forward Amount FCA**

The first carry forward amount (FCA) will be calculated in the last year of the Fifth Access Arrangement Period. It will be included as a building block component in the first year of the Sixth Access Arrangement Period.

FCA will be determined according to the following formula:

$$\mathbf{FCA = ATR - AR}$$

where AR and ATR are to be calculated using the best estimates and available data at the time of the determination of FCA.

For inclusion in the building block calculation for 2023, the FCA will be escalated for inflation from December 2017 to December 2023.

**Second Carry-Forward Amount SCA**

The second carry forward amount (SCA) will be calculated in the first year of the Sixth Access Arrangement Period as a correction to the determination of the FCA, using the correct actual values of all factors required in the determination of FCA. It will be included as a CFA in the determination of tariffs for 2023.

SCA will be determined according to the following formula:

$$\mathbf{SCA = Recalculated\ FCA - FCA}$$

where Recalculated FCA is the same calculation as for FCA, except that it is to use the actual values for AR, ATR, AV, EDD, CPI and PTA.

For inclusion in the building block calculation for 2024, the SCA will be escalated for inflation from December 2017 to December 2024.

## Fixed principle

APA proposed to retain the fixed principle 8.1 carry forward amount that applied in the 2013–2017 access arrangement. This fixed principle is relevant to the annual tariff variation formula. APA proposed,

> The AER must include in the Reference Tariffs for the Sixth Access Arrangement period:

a. An allowance for FCA (as defined in Schedule D); and

b. An allowance for SCA (as defined in Schedule D).[8]

We accept the inclusion of this fixed principle. This is a continuation of the 2013–17 access arrangement. It allows for any differences between target revenue and actual revenue for the last year of the fifth access arrangement period to be accounted and reflected in either an upwards or downwards adjustment to tariffs in the first year of the sixth access arrangement period.

8 APA, Revised Access Arrangement marked changes public, p.30

## 11.2 Cost pass through mechanism

### 11.2.1 Draft decision

APA proposed few changes to the cost pass through mechanism in its current access arrangement, and our draft decision is to accept it with the following amendments:

- restore to clause 4.6.3 the factors the AER must take into account in making its decision on whether to approve a proposed cost pass through event adjustment
- delete the Carbon Cost Event and the New Gas Market Structure Development Event ('New Gas Market Event'),
- clarify the definition of 'materiality'
- amend the clause dealing with time limits for assessing a pass through application.

### 11.2.2 APA's proposal

The cost pass through mechanism provides for the AER to approve a variation of reference tariffs after one or more pass through event has occurred, each of which individually causes a material increase or decrease in the cost of providing the reference service. Any approved adjustment takes effect from the start of the calendar year after the event occurred.

Under its proposed access arrangement, APA must notify us within 90 business days of a pass through event occurring, and advise whether it is likely to lead to an increase or decrease in reference tariffs. The costs must be notified when they are known or can be reasonably estimated, and an authorised officer of APA must verify the costs are net of any offsetting payments (e.g. insurance). The access arrangement provides that we will notify APA of our decision within 90 business days or such additional period as we require to obtain information or expert advice, or to consult about the notification.[9]

The materiality threshold is expressed as follows:[10]

> … an event is considered to materially increase or materially decrease costs where that event is reasonably expected to have an impact of one per cent of the smoothed forecast revenue specified in the Access Arrangement Information in the years of the Access Arrangement Period in which the costs are incurred.

APA proposed the following pass through events:[11]

[9] APA, *Victorian Transmission System access arrangement 2018-22,* 3 January 2018, cl. 4.6.5.

[10] APA, *Victorian Transmission System access arrangement 2018-22,* 3 January 2018, cl. 4.6.4.

[11] APA, *Victorian Transmission System access arrangement 2018-22,* 3 January 2018, cl 4.6.3.

- Carbon Cost Event
- Insurance Cap Event
- Insurer Credit Risk Event
- Natural Disaster Event
- New Gas Market Event
- Regulatory Change Event
- Service Standard Event
- Tax Change Event
- Terrorism Event.

All of these events are in the current access arrangement except for the New Gas Market Event.

### 11.2.3 Assessment approach

The NGR state that a reference tariff variation mechanism may provide for the variation of a reference tariff:[12]

> 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(2)[13] and must give us adequate oversight and power to approve reference tariff variations.[14]

We must approach this assessment in a manner likely to contribute to the achievement of the National Gas Objective (NGO),[15] which states that the purpose of the 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.[16]

In addition, we must take into account the Revenue and Pricing Principles (RPPs) whenever we exercise discretion in approving or making those parts of an access arrangement relating to a reference tariff.[17] The RPPs state that the service provider should be provided with a reasonable opportunity to recover at least the efficient costs incurred in providing reference services and complying with a regulatory obligation or requirement.[18] They also provide incentives to promote economic efficiency.[19]

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12 NGR, r. 97(1)(c)

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

14 NGR, r. 97(3).

15 NGL, s. 28(1)(a).

16 NGL, s. 23.

17 NGL, s. 28(2)(a).

18 NGL, s. 24(2).

Together, the RPPs promote a balance between the economic costs and risks of the potential for under and over investment by a service provider, to promote efficient investment.[20]

In the context of pass through events, the RPPs require 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.[21]

In deciding what pass through events to approve we take into account the following considerations:[22]

- whether the type of event 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:
    - the availability (including the extent of availability in terms of liability limits) of insurance against the event on reasonable commercial terms; or
    - 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 considerations appear in the National Electricity Rules (NER), where they guide the regulator's decision on whether to approve additional categories of pass through event beyond those already included in the NER.[23] We consider they are consistent with the factors referred to in NGR (r. 97(2)), 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.[24]

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

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[19] NGL, s. 24(3).

[20] NGL, s. 24(6).

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

[22] NGR, r. 97(3)(e).

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

[24] NGR, r. 100(1).

> 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.[25]

> 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.[26]

We consider this approach, of viewing pass throughs as a 'last resort' and accepting them only when event avoidance, mitigation and avoidance are unavailable, is consistent with the RPPs 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.[27] 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.[28]

We also look to promote consistency in our approach pass through categories across our electricity determinations and gas access arrangements.[29]

### 11.2.4 Interrelationships

Tariffs are derived from the total revenue requirement after consideration of demand for each tariff category. APA operates under a weighted average tariff cap. This means the tariffs we determine (including the means of varying the tariffs from year to year) are the binding constraint across the entire access arrangement period, rather than the total revenue requirement set in our decision.[30] Except as provided by a reference tariff variation mechanism, a reference tariff is not to vary during the course of an access arrangement period.[31]

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

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

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

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

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

29 See NGR r. 97(2)(d) and (e).

30 Where actual demand across the 2016–21 access arrangement period varies from the demand forecast in the access arrangement, APTNT's actual revenue will vary from the revenue allowance determined in our decision. In general, if actual demand is above forecast demand, APA's actual revenue will be above forecast revenue, and vice versa.

31 NGR, r. 97(5).

the access arrangement to operate its network—and manage its risks—in a manner consistent with the NGO and RPPs.[32]

The pass through component of the reference tariff variation mechanism is also interrelated with other parts of this decision, in particular with the forecast opex[33] and capex[34] and rate of return[35] 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.[36]

For smaller expenditure a service provider should generally utilise its existing approved expenditure or reprioritise its work program rather than seeking approval of a pass through.[37] This is reflected in the materiality threshold that applies to applications for cost pass through under the approved access arrangement.[38]

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32 NGL, ss. 23, 24.

33 See Attachment 7 (Operating expenditure) to this draft decision.

34 See Attachment 6 (Capital expenditure) to this draft decision.

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

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

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

38 AER, *Approved Access Arrangement for the Amadeus Gas Pipeline - 1 July 2016 to 30 June 2021*, May 2016, cl. 4.7.3, Definition of 'materiality threshold'.

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 efficiency carryover mechanism in the approved access arrangement.[39]

### 11.2.5 Reasons for draft decision

### Considerations relevant to a pass through application

APA proposed to delete the reference in the access arrangement to certain considerations which we must take into account in deciding whether to approve a proposed pass through adjustment. The considerations APA proposed to delete are:

(a) whether the costs to be passed through are for the delivery of pipeline services

(b) whether the costs are incremental to costs already allowed for in reference tariffs

(c) whether the total costs to be passed through are building block components of Total Revenue

(d) whether the costs to be passed through meet the relevant NGR criteria for determining the building block components of Total Revenue

(e) the efficiency of the Service Provider's decisions and actions in relation to the risk of the event occurring, including whether the Service Provider has failed to take any action that could reasonably be taken to reduce the magnitude of the costs incurred as a result of the pass through event and whether the Service provider has taken or omitted to take any reasonable action where such action or omission has increased the magnitude of the costs, and

(f) any other factors the AER considers relevant and consistent with the NGR and NGL.[40]

Identical or similar considerations appear in numerous access arrangements, including APT Petroleum Pipelines Pty Limited's (APTPPL) proposal for the Roma to Brisbane Pipeline (RBP) for 2017-22.[41] APA submitted these factors are not consistent with the NGR, and that the only relevant considerations are the NGO and the RPPs. APA further submitted that as the NGO and RPPs are stated in the NGL it is unnecessary to include them in the access arrangement.[42]

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39 AER, *Approved Access Arrangement for the Amadeus Gas Pipeline - 1 July 2016 to 30 June 2021*, May 2016, cl. 8.1(i); See Attachment 9 to this draft decision.

40 APA, *Victorian Transmission System access arrangement submission,* 3 January 2017, pp. 248-249.

41 APTPPL, *Roma to Brisbane Pipeline proposed revised access arrangement 2017 – 22*, September 2016, cl. 2.5.2; APTNT, *Access Arrangement for the Amadeus Gas Pipeline 1 July 2016 – 30 June 2021*, May 2016, cl. 4.7.3; Australian Gas Networks, *Access Arrangement for AGN's South Australian Distribution System 1 July 2016 – 30 June 2021*, May 2016, cl. 4.5; ActewAGL, *Access Arrangement for the ACT, Queanbeyan and Palerang Gas Distribution Network 1 July 2016 – 30 June 2021*, May 2016, cl 7.12.

42 APA, *Victorian Transmission System access arrangement submission,* 3 January 2017, pp. 246-247.

We do not agree that these considerations are irrelevant and we consider there is no inconsistency with the reference tariff variation mechanism considerations in NGR rule 97(2), the NGO or the RPPs. Including these considerations in an access arrangement is beneficial to service providers and network users as it provides clarity and predictability about how we will assess any pass through application. Our draft decision is to require APA to restore these considerations to the access arrangement.

## Definition of materiality

Our draft decision is to require minor amendments to the definition of 'materiality' in the proposed access arrangement.

The definition proposed by APA provides in part:

> an event is considered to materially increase or materially decrease costs where that event is reasonably expected to have an impact of one per cent of the smoothed forecast revenue specified in the Access Arrangement Information, in the years of the Access Arrangement Period that the costs are incurred.[43]

We consider this should be amended to clarify that the relevant starting point for the calculation of the materiality threshold is the smoothed forecast revenue specified in the AER's final decision on the access arrangement, not the forecast submitted to us by APA in its Access Arrangement Information. It should also clarify that the calculation of one per cent applies to the smoothed revenue in each year in which the costs are incurred (not the smoothed revenue over all years). Our required amendments are set out in section 11.3 of this Attachment.

## Carbon costs

Our draft decision is to require APA to delete the Carbon Cost Event and associated references from its proposal.

The current VTS access arrangement includes a pass through event for the costs of complying with the carbon pricing mechanism established under the now repealed *Clean Energy Act 2011* (Cth). APA proposed to retain the carbon cost event, with an amendment to remove the reference to the Clean Energy Act. The proposed definition, with APA's revisions marked, is as follows:[44]

> Carbon Cost Event – means:
>
> An event that occurs if, for a given Regulatory Year of the Access Arrangement Period, the Service Provider becomes liable for a carbon cost (part of which may be an estimate) in complying with <u>a mechanism that is designed or intended to reduce or manage carbon emissions, or to otherwise reduce or manage greenhouse gas emissions</u>, ~~the carbon pricing mechanism~~

[43] APA, *Victorian Transmission System access arrangement 2018-22,* 3 January 2018, cl. 4.6.4.

[44] APA, *Victorian Transmission System access arrangement 2018-22,* 3 January 2018, cl. 4.6.3.

> ~~established under the Clean Energy Act 2011 (Cth) and associated legislation relating to the management of greenhouse gas for that Regulatory Year~~. The carbon cost event is taken to have occurred at the time liability for carbon costs is established. Actual carbon costs and associated revenues are to be reconciled at the time that it is possible for Service Provider to calculate the carbon cost it has incurred for a Regulatory Year without the use of estimates.

As with the current carbon cost event, APA is expressly required to apply for a pass through if a carbon cost event materially decreases the cost of providing the reference service.[45] The access arrangement states that the materiality threshold does not apply to the carbon cost event.[46]

The AER's Consumer Challenge Panel sub-panel 11 (CCP11) submitted that, while the existing definition is clearly focussed on a specified piece of legislation, the amendment proposed by APA provides a much wider definition of what might be a pass through. CCP11 stated:[47]

> This imprecise and unproven pass through does not appear necessary as there are the existing tax change event and regulator change event (both common to NSP's Access Arrangements and well understood), which are likely to apply should government policy change to impose any meaningful form of carbon pricing.

CCP11 submitted that pass throughs are subject to limited scrutiny and consumer consultation, and that consumer interests are best served by keeping the events to a limited range of proven and predictable definitions applying across NSPs which have precedents of application and are familiar to the AER.[48]

Carbon cost pass through events were included in a number of access arrangements that came into effect around the time of the Clean Energy Act,[49] which has now been repealed. The new definition proposed by APA is unclear in its scope. It does not refer to a particular carbon or greenhouse gas management scheme. We cannot assess at whether the cost impact of a future scheme will best be managed by a service provider or its customers. Likewise we cannot assess the degree to which those costs can be foreseen, prevented or mitigated.

The Regulatory Change Event and the Tax Change Event potentially allow for pass through of costs of a carbon abatement scheme, subject to the AER's assessment and meeting the materiality threshold. While some earlier decisions did not apply a materiality threshold to carbon cost pass throughs, we are no longer persuaded this is appropriate. As with all other pass throughs, these costs should be subject to the

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45 APA, *Victorian Transmission System access arrangement 2018-22,* 3 January 2018, cl. 4.6.3.

46 APA, *Victorian Transmission System access arrangement 2018-22,* 3 January 2018, cl. 4.6.4.

47 CCP11, *Response to proposal from APA VTS for the 2018-22 access arrangement,* 3 March 2017, p. 39.

48 CCP11, *Response to proposal from APA VTS for the 2018-22 access arrangement,* 3 March 2017, p. 39.

49 The current access arrangements for the RBP and the VTS are two examples.

materiality threshold, with service providers expected to utilise existing allocations or reprioritise its work program for smaller expenditure.[50]

## New gas market structure development event

Our draft decision is to require APA to delete the New Gas Market Event.

APA submitted that if a decision is made to develop new market arrangements in Victoria there will be a significant period of policy and market development, causing it to incur significant costs before the new market arrangements are enacted. APA gave as examples the costs of investing in new systems, developing new procedures, and developing new market arrangements through representation on working groups and panels.

APA submitted that such costs, including costs incurred prior to the commencement of the new market arrangements, should be able to be passed through during the access arrangement period. Its proposed pass through event is as follows:[51]

> New gas market structure development event – means an event whereby:
>
> (a) a decision is made to develop and/or implement a new gas market structure in Victoria; and
>
> (b) Service Provider incurs costs in developing and/or implementing systems, processes and procedures made necessary by the decision to develop and/or implement a new gas market structure.
>
> Costs to be passed through are limited to prudent and efficient costs for the development and/or implementation of systems, processes and procedures made necessary by the decision to develop and/or implement a new gas market structure in Victoria.

CCP11 submitted that this definition is wide, and would capture all costs associated with developing systems, processes and procedures once a 'decision is made to develop' a new market structure. CCP11 notes this may include APA 'lobbying for its interests in the process,' and suggests its involvement should be considered as business as usual operating expenses on the basis that:[52]

> NSPs are routinely involved in panels, working groups and lobbying across the whole range of their businesses including matters like market and rule changes, development of technical standards, health and safety and industry representative bodies.

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

51 APA, *Victorian Transmission System access arrangement submission,* 3 January 2017, p. 249.

52 CCP11, *Response to proposal from APA VTS for the 2018-22 access arrangement,* 3 March 2017, p. 38.

As with the Carbon Cost Event, CCP11 submitted the New Gas Market Event is not in the interest of consumers due to its imprecision and risk of pass through of inappropriate costs. CCP11 also stated the risk to APA should be covered by the existing Regulatory Change Event.[53]

We share the view expressed by CCP11 that participating in the development of new market arrangements is a business as usual activity. When a decision is made on the new structure, the costs of making ready for it (e.g. investing in new technologies) may be covered— to the extent this is appropriate—by the Regulatory Change Event. We consider it unnecessary and undesirable to approve a new event to deal with these costs separately.

## Other pass through events

APA proposed changes to the remaining pass through events to reflect those approved for the Amadeus Gas Pipeline access arrangement in 2016. APA stated that this brings consistency and administrative simplicity that lowers costs while also ensuring APA has a reasonable opportunity to recover its efficient costs in providing reference services.[54] Our draft decision is to accept these revisions.

## Time limit on assessment

The end of clause 4.6.2 of APA's proposed access arrangement reads: "however, the AER must assess a cost pass through application within 90 days, including any extension of the decision making time". For greater clarity, our draft decision is to require an amendment to clause 4.6.2 to read "however, the AER must assess a cost pass through application within 90 days of receiving a notification, *subject to* any extension of the decision making time."

## Fixed principle

APA proposed to retain the fixed principle 8.3 pass through carry forward that applied in the 2013–2017.

We accept the carry forward amount. This is a continuation of the 2013–17 access arrangement.  We accept the inclusion of this fixed principle as it applies to any pass through amounts relating to the fifth access arrangement period.

[53] CCP11, *Response to proposal from APA VTS for the 2018-22 access arrangement,* 3 March 2017, p. 38.

[54] APA, *Victorian Transmission System access arrangement submission,* 3 January 2017, p. 250.

## 11.3 Revisions

We require APA to make the following revisions to its proposed access arrangement for the VTS:

| Clause | Subject | Amendment required |
|---|---|---|
| D.4 | Tariff variation formula | In the revised proposal make all changes necessary, such that the tables referred to for the calculation of VATR, give effect to our draft decision. |
| D.7 | Tariff variation formula | For the calculation of SCA change the year 2023 to 2024. Amend as follows, *For inclusion in the building block calculation for 2023 2024, the SCA will be escalated for inflation from December 2017 to December 2024.* |
| 4.6.2 | Assessment period | …<br><br>However, the AER must assess a cost pass-through application within 90 business days, ~~including~~ subject to any extension of the decision making time. |
| 4.6.3 | Considerations | *Restore the following text:*<br><br>In making its decision on whether to approve the proposed  Cost Pass through Event adjustment, the AER must take into account the following:<br><br>Whether:<br><br>(a) the costs to be passed through are for the delivery of pipeline services;<br><br>(b) the costs are incremental to costs already allowed for in reference tariffs;<br><br>(c) the total costs to be passed through are building block components of Total Revenue;<br><br>(d) the costs to be passed through meet the relevant National Gas Rules criteria for determining the building block for total revenue in determining Reference Tariffs;<br><br>(e) the efficiency of Service Provider's decisions and actions in relation to the risk of the Cost Pass-through Event occurring, including whether Service Provider has failed to take any action that could reasonably be taken to reduce the magnitude of the costs incurred as a result of the |

| Clause | Subject | Amendment required |
|---|---|---|
| | | <ins>Cost Pass-through Event and whether Service Provider has taken or omitted to take any reasonable action where such action or omission has increased the magnitude of the costs; and</ins><br><br><ins>(f) any other factors the AER considers relevant and consistent with the National Gas Rules and National Gas Law.</ins> |
| | Carbon cost event | *Delete definition and all references to this event from the access arrangement.* |
| | New gas market structure development event | *Delete definition and all references to this event from the access arrangement.* |
| 4.6.4 | Materiality | *Amend as follows:*<br><br>…<br><br>an event is considered to materially increase or materially decrease costs where that event is reasonably expected to have an impact of one per cent of the smoothed forecast revenue ~~specified in the Access Arrangement Information~~, <ins>approved by the AER in its final decision on the Access Arrangement,</ins> in the ~~years~~ <ins>year</ins> of the Access Arrangement Period that the costs are incurred<br><br>… |