DRAFT DECISION
AusNet Services
Gas access arrangement
2018 to 2022

Attachment 10 – Reference tariff setting

July 2017

AUSTRALIAN
ENERGY
REGULATOR

Note

This attachment forms part of the AER's draft decision on the access arrangement for AusNet 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

Attachment 9 - Efficiency carryover mechanism

Attachment 10 - Reference tariff setting

Attachment 11 - Reference tariff variation mechanism

Attachment 12 - Non-tariff components

Attachment 13 - Demand

Attachment 14 - Other incentive schemes

Contents

Shortened forms

Shortened form	Extended form
AER	Australian Energy Regulator
ATO	Australian Tax Office
capex	capital expenditure
CAPM	capital asset pricing model
CESS	Capital Expenditure Sharing Scheme
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

10 Reference tariff setting

This attachment outlines the AER's assessment of AusNet's proposed reference tariffs 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]

10.1 Draft decision

While we generally approve AusNet's proposed reference tariff structure for the 2018-22 access arrangement period, there is one aspect that we do not approve.

We are satisfied the proposed reference tariff structure complies with the requirements of the NGR.[2] However, we do not approve AusNet's proposal to introduce, vary or remove tariffs during a calendar year.

Further, the quantum of the proposed reference tariffs must be amended to reflect the revised revenue allowance set out in this draft decision.

10.2 AusNet's proposal

AusNet's proposed reference tariffs for the 2018-22 access arrangement period are consistent with those in the current access arrangement. AusNet's proposed haulage reference tariffs are outlined in Table 10.1 and its proposed ancillary reference services are outlined in Table 10.2.

Table 10.1 AusNet's tariff classes and tariff charge components

Customer category	Tariff class	Charging components
Residential	Tariff V central	One fixed charge
	Tariff V west	Three peak volume throughput block charges
	Tariff V adjoining central	Three off-peak volume throughput block charges
	Tariff V adjoining west	Ancillary reference charges
Non-residential	Tariff V central	One fixed charge
	Tariff V west	Three peak volume throughput block charges
	Tariff V adjoining central	Three off-peak volume throughput block charges
	Tariff V adjoining west	Ancillary reference charges

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[1] NGL, ss. 24(2)–(7).

[2] NGR, rr. 93, 94.

Customer category	Tariff class	Charging components
Demand	Tariff M central Tariff M west Tariff M adjoining central Tariff M adjoining west	Three stepped variable demand charges Ancillary reference charges
Demand	Tariff D central Tariff D west Tariff D adjoining central Tariff D adjoining west	Three stepped variable demand charges Ancillary reference charges

Table 10.2 AusNet's ancillary reference services

Ancillary reference service
Meter and gas installation test
Disconnection service
Reconnection service
Special meter reading service

10.3 Assessment approach

In an access arrangement, a service provider is required to specify the reference tariff and proposed approach to setting the reference tariff for each reference service.[3] This is done by:

- explaining how revenue and costs are allocated, including the relationship between costs and tariffs[4]

- defining the tariff classes[5]

- comparing the revenue to be raised by each reference tariff with the costs of providing each individual reference service[6]

- explaining and describing any pricing principles employed.[7]

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[3]   NGR, rr. 48(1)(d)(i), 72(1)(j).
[4]   NGR, rr. 72(1)(j)(i), 93(1)–(2).
[5]   NGR, r. 94(1)–(2).
[6]   NGR, r. 94(3).
[7]   NGR, r. 72(1)(j)(ii).

The AER is required to assess AusNet's proposed reference tariffs.[8] Where we do not accept them, we must determine the initial (i.e. 2018) reference tariffs to apply for each reference service.

In our assessment of the proposed reference tariffs, we reviewed AusNet's:

- access arrangement information[9]
- access arrangement proposal.[10]

We also had regard to submissions received in the course of our consultation on the proposed access arrangement.[11]

Identifying the reference service

The NGR requires service providers to specify a reference tariff for each reference service.[12] 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 is set out in Attachment 1.

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. Our discretion on tariff design is limited.[13] Consequently, we consider how the service provider intends to charge for reference services by:

1. Assessing how AusNet intends to allocate costs and revenue 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 these services. Costs must also be allocated to the reference service and other services to which the cost is directly attributable.[14]

2. Assessing how AusNet groups its customers into tariff classes. For reference services, AusNet is required to group customers together on an economically efficient basis and to avoid unnecessary transaction costs.[15] We consider if the nature of the reference service (e.g. volume and demand tariff classes) is consistent with the need to group customers together on an economically efficient basis and avoid unnecessary transaction costs.

3. Assessing:

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8   NGR, r. 97(4).
9   AusNet, Access arrangement information, December 2016, pp. 294-304.
10   AusNet, Part B of the access arrangement for the distribution system, December 2016.
11   NGR, r. 59.
12   NGR, r. 48(1)(d)(i).
13   NGR, r. 94(6).
14   NGR, r. 93(2).
15   NGR, r. 94(2).

(a) how the expected average revenue of a tariff class compares with the stand alone and avoidable costs of providing that 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 each reference service

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

Prudent discounts

AusNet has not proposed any prudent discounts during the 2018-22 access arrangement period.

10.3.1 Interrelationships

AusNet's tariffs have an interrelationship with the services it provides to recover its revenue, the AER's total revenue requirement for AusNet and the application of annual tariff variation mechanisms.

AusNet'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 2018–22 access arrangement period, rather than the total revenue requirement set out in our decision.

After the first year of the access arrangement period, AusNet's ancillary reference service prices are set by applying the ancillary reference service tariff variation formula.

Our draft decision on:

- AusNet's total revenue requirement is set out in the Overview

- the services AusNet will offer to customers over the 2018–22 access arrangement period is set out in attachment 1—Services covered by the access arrangement

- the annual tariff variation mechanisms are set out in attachment 11—Reference tariff variation mechanism.

10.4 Reasons for draft decision

We accept AusNet's proposed reference tariff structure because we are satisfied that it complies with the NGR requirements.[17]

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[16] NGR, r. 94(3)–(4).
[17] NGR, rr. 94(6).

The tariff structure is consistent with that applied in the current access arrangement and its continuation has been supported by some stakeholders.[18] However, we consider the quantum of the proposed initial reference tariffs must be amended to reflect the draft decision forecast demand and revised revenue allowance.

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

- ability to introduce, vary or remove tariffs

- allocation of revenue and costs to reference tariffs

- establishment of tariff classes

- tariff classes and revenue limits.

10.4.1 Ability to introduce, vary or remove tariffs

While we accept the ability for AusNet to introduce, vary or remove tariffs over the access arrangement period, we do not accept the ability to make these tariff changes within a calendar year (intra-year tariff variations).

AusNet stated that the ability to make intra-year tariff variations is to address practical issues that have arisen during the current access arrangement period.[19] However, AusNet's proposal did not provide any discussion or indication as to what those practical issues have been.

We do not accept intra-year tariff variations because they create uncertainty for customers on annual price movements, which is undesirable. Further, intra-year tariff variations are not in the long-term interests of customers as they can lead to price shocks. We consider that once tariffs are set, it is best they are not adjusted until the following financial year commences. We consider tariff stability is in the long-term interest of customers and should be the priority over the 2018-22 access arrangement period.

10.4.2 Allocation of revenue and costs to reference tariffs

We are satisfied AusNet's approach to allocating revenue and costs between reference services and non-reference services comply with the NGR[20] because:

- AusNet's proposed costs relating to its reference services do not include costs incurred and recovered by providing non-reference services

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18   Origin Energy - *Victorian gas access arrangement review 2018-22 - Response to gas distribution businesses' proposals* - 10 March 2017.

19   AusNet Services - *Access Arrangement Information 2018-2022* - 20161221, p. 293.

20   NGR, rr. 93(1), (2).

- AusNet has not allocated the non-reference service revenue to a reference service, as the underlying costs of the former have not been included in its building block revenue

- AusNet's proposal included information outlining its stand alone, avoidable and long run marginal costs.[21]

10.4.3 Establishment of tariff classes

AusNet groups its customers by size (small or large), tariff class (residential, non-residential and demand) and location on the distribution network (central, west, adjoining central and adjoining west). These tariff classes are consistent with those in the current access arrangement. We consider that these characteristics are likely to drive costs within AusNet's gas distribution network and are therefore appropriate. As a result, we are satisfied that the proposed tariff classes are consistent with the requirements of the NGR.[22]

10.4.4 Tariff classes and revenue limits

We have assessed AusNet's tariff classes and revenue limits against the following NGR[23] considerations:

- the expected average revenue of a tariff class compared with the stand alone cost and avoidable cost of providing the reference service to that tariff class

- whether the tariffs take into account the long run marginal costs of the reference services

- whether the tariff takes into account transaction costs associated with developing and applying the tariff

- whether customers belonging to the relevant tariff class are able or likely to respond to price signals.

Stand alone and avoidable costs

We are satisfied AusNet's proposed reference tariffs are consistent with the NGR[24] because the expected revenue to be recovered lies on or between:

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

- a lower bound representing the avoidable cost of not providing the reference service to these customers.[25]

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[21] AusNet Services - *Access Arrangement Information 2018-2022* - 20161221, pp. 294-304.

[22] NGR, rr. 94(1), (2).

[23] NGR, r. 94.

[24] NGR, r. 94(3).

[25] AusNet Services - *Access Arrangement Information 2018-2022* - 20161221, pp. 297-299.

We had regard to quantitative material AusNet submitted to us, which indicated the above criteria were met.[26] The methodology used to calculate stand alone and avoidable costs is consistent with the methodology in AusNet's current access arrangement. AusNet demonstrated that for each tariff, the expected revenue fell on or between the stand alone and avoidable costs. We note our discretion on stand alone and avoidable cost calculation is limited under the NGR.[27]

Long run marginal costs

AusNet used the Average Incremental Cost approach to calculate the long run marginal cost (LRMC) by tariff class.[28] However, AusNet stated that although its LRMC are considered reasonable estimates, the calculations are sensitive to input assumptions.[29] As a result, the LRMC should only be used as a guide when assessing price levels and structures, rather than being considered definitive.

We note our discretion on LRMC is limited under the NGR.[30] However, we consider AusNet's approach is generally consistent with the approach of other gas distribution networks and this approach has historical precedent in past access arrangements.

Transaction costs

We are satisfied AusNet's proposed reference tariffs have taken into account transaction costs associated with the tariffs and the need to avoid these costs where possible.[31] We consider that continuing the current access arrangement tariff classes and structures will minimise any additional transaction costs across access arrangement periods.

Response to price signals

We are satisfied AusNet's proposed reference tariffs have been designed with regard to whether customers are able or likely to respond to price signals.[32] We consider the existing tariff structures are well known to AusNet's customers, which allows them to respond to the prices within each block (or band) by adjusting their consumption.

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26 AusNet Services - *Access Arrangement Information 2018-2022* - 20161221, pp. 297-299.

27 NGR, r. 94(6).

28 AusNet Services - *Access Arrangement Information 2018-2022* - 20161221, pp. 296.

29 AusNet Services - *Access Arrangement Information 2018-2022* - 20161221, pp. 296.

30 NGR, r. 94(6).

31 NGR, rr. 94(2), 94(4).

32 NGR, r. 94(4)(b)(ii).

10.5 Revisions

The required revisions are set out in Table 10.3 below.

Table 10.3 AusNet's reference tariff revisions

Reference	Amendment
Part B, clause 4.1	Amend clause 4.1(b) and clause 4.1(c) of Part B of AusNet's proposed access arrangement to remove AusNet's ability to introduce, vary or remove tariffs within a calendar year.