Draft decision

Roma to Brisbane Pipeline
Access Arrangement 2022 to 2027

Attachment 10
Reference tariff variation mechanism

November 2021

AUSTRALIAN
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REGULATOR

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Note

This attachment forms part of the AER's draft decision on the access arrangement that will apply to APT Petroleum Pipelines Pty Limited's (APTPPL) Roma to Brisbane Pipeline (RBP) for the 2022–2027 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

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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 APT Petroleum Pipelines Pty Limited (APTPPL) for its Roma to Brisbane Pipeline (RBP). 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 for 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 APTPPL's proposed reference tariff variation mechanism for the RBP for the 2022–27 access arrangement period (2022–27 period). We require two amendments to APTPPL's proposed reference tariff variation mechanism to better comply with the National Gas Rules (NGR):

- amend the inflation adjustment from the March quarter to the December quarter consumer price index (CPI)
- revise the proposed initial reference tariffs and X factors to reflect the changes to the forecast total revenue identified in section 3 of the Overview to this draft decision.

We discuss our reasons for this draft decision below.

10.1.2 APTPPL's proposal

The reference tariff variation mechanism in APTPPL's RBP access arrangement allows annual variation of the reference tariff for:

- X factors
- current inflation
- a change in the rate of return on debt (as required by the 2018 Rate of Return Instrument)

- a material increase in costs attributable to one or more of a small number of specified events (including regulatory change, tax change, terrorism and natural disaster).

APTPPL proposed retaining this mechanism for the RBP. It can be applied, essentially unchanged, to vary annually the firm service reference tariff.[1]

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):
  1. forecast revenue from reference services over the access arrangement period, and
  2. the portion of total revenue allocated to reference services for the access arrangement period, and
- may provide for variation of a reference tariff:
  1. in accordance with a schedule of fixed tariffs, or
  2. in accordance with a formula set out in the access arrangement, or
  3. as a result of a cost pass through for a defined event, or
  4. 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 a number of 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.

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1 APTPPL, *Roma to Brisbane Pipeline 2022–27 Access arrangement, Overview,* July 2021, p. 17.

2 NGR, r. 92(2).

3 NGR, r. 97(2).

4 NGR, r. 97(3).

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

We have made our draft decision on APTPPL's proposed reference tariff variation mechanism for the RBP having regard to each of these factors, and their implications for natural gas consumers, potential users, APTPPL 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 the current RBP access arrangement
- consistency with other recent gas distribution access arrangement decisions (and electricity determinations under the National Electricity Rules (NER))
- consistency in APTPPL's approach across the provision of similar services.

We assessed the potential impact of the 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 2022–27 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.

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 that can be earned by APTPPL , the services it provides to its RBP customers to recover those revenues, and the tariffs it charges for the use of those services.

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 calculated for the relevant financial year in accordance with our final decision. The X factors also reflect our annual revenue determinations which in turn reflect our assessment of APTPPL's efficient costs.

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 APTPPL'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 2022–27 period, rather than the total revenue requirement set out in our decision.

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[5] NGR, r. 97(4).

10.1.5 Reasons for draft decision

We accept most of APTPPL's proposed reference tariff variation mechanism for the RBP for the 2022–27 period. We are satisfied with APTPPL's proposal to maintain the tariff variation mechanism described above in section 10.1.3. This mechanism is consistent with the current access arrangement period and other gas distributors.

We have amended the inflation adjustment from the March quarter to the December quarter CPI to make it consistent with other network service providers. There is a conflict between CPI data availability for the March index and the annual pricing submission date of 50 business days. Moving to a December CPI ensures data is available before 50 business days submission.

10.2 Cost pass through mechanism

10.2.1 Draft decision

We accept all of APTPPL's proposed cost pass through events in relation to the RBP, with amendments to three of the definitions as set out in Table 10.1 below.

10.2.2 APTPPL's proposal

APTPPL proposed no changes to the cost pass through events that we approved for the current RBP access arrangement.[6] Under the current RBP access arrangement, APTPPL may seek our approval to pass through costs arising from the occurrence of a pass through event. It has 90 business days from a cost pass through event occurring to notify the AER. When the costs of the cost pass through event are known (or able to be estimated to a reasonable extent), then the costs shall be notified to the AER. The AER must then make a decision to approve or reject the cost pass through event proposal.

To qualify for a cost pass through, the costs APTPPL has incurred, or is likely to incur, as a result of the relevant pass through event must exceed one per cent of APTPPL's smoothed total revenue for the financial year in which the costs were incurred.

The RBP access arrangement provides that we must notify APTPPL of our decision as to whether a cost pass through event has occurred, and the amount that should be passed through in APTPPL's RBP reference tariffs, within 90 business days unless the time limit is extended.

APTPPL proposed the following pass through events for the 2022–27 period:

- Insurance cap event
- Insurer credit risk event

6 APTPPL, *Roma to Brisbane Pipeline 2022–27 – Reset RIN response Schedule 2* (public), July 2021, p. 81.

- Natural disaster event
- Regulatory change event
- Service standard event
- Tax change event
- Terrorism event

All of these events are in the current RBP access arrangement.[7]

10.2.3 Assessment approach

The NGR state that a reference tariff variation mechanism may provide for the variation of a reference tariff:[8]

> …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)[9] of the NGR and must give us adequate oversight and power to approve reference tariff variations.[10]

We must approach this assessment in a manner likely to contribute to the achievement of the NGO,[11] 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.[12]

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.[13] 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 reference services and complying with a regulatory obligation or requirement.[14] They also provide incentives to promote economic efficiency.[15] The RPP require us to have

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7 AER, *Approved access arrangement for the RBP 2017–22 - final decision revisions marked,* November 2017, p. 22.

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

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

10 NGR, r. 97(4).

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

12 NGL, s. 23.

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

14 NGL, s. 24(2).

15 NGL, s. 24(3).

regard to the economic costs and risks of the potential for under- and over-investment by a service provider, to promote efficient investment.[16]

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.[17]

Our decision on the cost pass through mechanism includes a decision on what categories of event to approve.[18] In approaching this part of our task, we also take into account the following relevant factors:[19]

- 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 appear in the NER, where they guide our decision on whether to approve additional categories of pass through event beyond those already included in the NER.[20] We consider they are consistent with the factors referred to in the NGR (rule 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.[21]

16 NGL, s. 24(6).

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

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

19 NGR, r. 97(3)(e).

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

21 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."[22]

> "…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."[23]

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.[24] 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.[25]

We also look to promote consistency in our approach to pass through categories across our electricity determinations and gas access arrangement decisions.[26]

10.2.4 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.[27] 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.[28]

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

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

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

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

[26] See NGR r. 97(3)(d).

[27] NGR, r. 97(5).

[28] NGL, ss. 23 and 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 operating expenditure (opex)[29] and capital expenditure (capex)[30] and rate of return[31] 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.[32]

For smaller expenditure, a service provider should generally utilise its existing expenditure allowance or reprioritise its work program rather than seek approval of a pass through.[33] This is reflected in the materiality threshold that applies to applications for cost pass through under the approved access arrangement.[34]

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

[29] See Attachment 6 (Operating expenditure) to this draft decision: AER, *Draft decision, Roma to Brisbane Pipeline 2022–27, Attachment 6 – Operating expenditure*, November 2021.

[30] See Attachment 5 (Capital expenditure) to this draft decision: AER, *Draft decision, Roma to Brisbane Pipeline 2022–27, Attachment 5 – Capital expenditure*, November 2021.

[31] See Attachment 3 (Rate of return) to this draft decision: AER, *Draft decision, Roma to Brisbane Pipeline 2022–27, Attachment 3 – Rate of return*, November 2021.

[32] 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.

[33] 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.

[34] AER, *Draft decision, Roma to Brisbane Pipeline access arrangement 2022–27, Approved access arrangement,* November 2021, cl. 4.5.7.

under the efficiency carryover mechanism (ECM) in the approved access arrangement.[35]

10.2.5 Reasons for draft decision

APTPPL's proposed pass through events and their definitions are largely consistent with those we approved in the 2017–22 period for the RBP and in our recent decisions with respect to other network service providers.

Overall, for the proposed cost pass through events, 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.

We have made some minor amendments to the definitions of APTPPL's Insurer Credit Risk Event, Natural Disaster Event and Terrorism Event, as set out in Table 10.1, to provide greater drafting consistency between APTPPL and other network service providers.[36] The minor amendments of these definitions included:

- Insurer Credit Risk Event definition - replaced "in the event that a claim would have been made after the insurance provider become insolvent" with "in the event a claim would have been covered by the insolvent insurer's policy".
- Natural disaster and Terrorism events – replaced "increases in costs" with "changes in cost" to reflect the symmetry between positive and negative cost pass through events.
- Natural disaster – adopted an additional explicit reference to "cyclone" and "earthquake".

Table 10.1 Cost pass through event definitions which we have amended

Pass through event	Amended Definition
Insurer credit risk	An insurer credit risk event means an event where an insurer of the Service Provider becomes insolvent, and as a result, in respect of an existing or potential claim for a risk that was insured by the insolvent insurer, the Service Provider:

[35] AER, *Draft decision, Roma to Brisbane Pipeline access arrangement 2022–27, Approved access arrangement,* November 2021, cl. 8.1(i); See Attachment 8 (Efficiency carryover mechanism) to this draft decision.

[36] 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	Amended Definition
	○ 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 ○ incurs additional costs associated with funding an insurance claim, which would otherwise have been covered by the insolvent insurer. Note: In making a determination on an insurer credit risk event pursuant to clause 4.5.7 of this Access Arrangement, the AER will have regard to, amongst other things: • The Service Provider'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 covered by the insolvent insurer's policy, whether the Service Provider had reasonable opportunity to insure the risk with a different insurer.
Natural disaster	Natural disaster event means any natural disaster including but not limited to cyclone, fire, flood or earthquake that occurs during the 2022–27 access arrangement period that changes the costs to the Service Provider in providing the Firm Service, provided the cyclone, fire, flood, earthquake or other event was: • 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. Note: In making a determination on a natural disaster event pursuant to clause 4.5.7 of this Access Arrangement, the AER will have regard to, amongst other things: • whether the Service Provider 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	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: • 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 • changes the costs to the Service Provider in providing the Reference Service. Note: In making a determination on a terrorism event pursuant to clause 4.5.7 of this Access Arrangement, the AER will have regard to, amongst other things: • whether the Service Provider 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.

Source: AER analysis.

10.3 Revisions

We require the following revisions set out in Table 10.2 to make the access arrangement proposal acceptable:

Table 10.2 APTPPL's reference tariff variation mechanism revisions

Revision	Amendment
Revision 10.1	Make all necessary amendments to reflect the draft decision to use the December CPI under clause 4.5.2.
Revision 10.2	Amend pass through event definitions under clause 4.5.5 to the definitions set out in Table 10.1 of this attachment.

A. Shortened forms

Shortened form	Extended form
AEMC	Australian Energy Market Commission
AER	Australian Energy Regulator
APTPPL	APT Petroleum Pipelines Pty Limited
Capex	Capital expenditure
ECM	Efficiency carryover mechanism
NER	National Electricity Rules
NGL	National Gas Law
NGO	National Gas Objectives
NGR	National Gas Rules
Opex	Operating expenditure
RBP	Roma to Brisbane Pipeline
RPP	Revenue and pricing principles