DRAFT DECISION
ActewAGL Distribution
Access Arrangement
2016 to 2021

Attachment 11 – Reference tariff variation mechanism

November 2015

AUSTRALIAN ENERGY REGULATOR

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Note

This attachment forms part of the AER's draft decision on ActewAGL Distribution's access arrangement for 2016–21. 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 10 - Reference tariff setting

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Attachment 12 - Non-tariff components

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Contents

Shortened forms

Shortened form	Extended form
AA	Access Arrangement
AAI	Access Arrangement Information
AER	Australian Energy Regulator
ASA	Asset Services Agreement
ATO	Australian Tax Office
capex	capital expenditure
CAPM	capital asset pricing model
CCP	Consumer Challenge Panel
CESS	Capital Expenditure Sharing Scheme
CMF	construction management fee
CPI	consumer price index
DAMS	Distribution Asset Management Services
DRP	debt risk premium
EBSS	Efficiency Benefit Sharing Scheme
EIL	Energy Industry Levy
ERP	equity risk premium
Expenditure Guideline	Expenditure Forecast Assessment Guideline
gamma	Value of Imputation Credits
GSL	Guaranteed Service Level
GTA	gas transport services agreement
ICRC	Independent Competition and Regulatory Commission
MRP	market risk premium
NECF	National Energy Customer Framework
NERL	National Energy Retail Law
NERR	National Energy Retail Rules
NGL	national gas law
NGO	national gas objective
NGR	national gas rules
NPV	net present value
opex	operating expenditure

Shortened form	Extended form
PFP	partial factor productivity
PPI	partial performance indicators
PTRM	post-tax revenue model
RBA	Reserve Bank of Australia
RFM	roll forward model
RIN	regulatory information notice
RoLR	retailer of last resort
RSA	Reference Service Agreement
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
UNFT	Utilities Network Facilities Tax
WACC	weighted average cost of capital
WPI	Wage Price Index

11 Reference tariff variation mechanism

This attachment sets out the AER's consideration of the reference tariff variation mechanism proposed by ActewAGL Distribution (ActewAGL). 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.

11.1 Draft decision

We do not accept ActewAGL's proposed reference tariff variation mechanism for the 2016–21 access arrangement period. We consider that some elements of ActewAGL's proposed reference tariff variation mechanism are not consistent with the National Gas Law (NGL). In particular:

- the proposed initial reference tariffs and X factors must be revised to reflect the changes to the forecast total revenue approved in this draft decision
- we do not accept definitions for certain parameters within the control and rebalancing mechanisms
- we do not accept the proposal to vary reference tariffs during a financial year to apply at a date prior to the start of the next financial year
- we do not accept all of ActewAGL's proposed pass through events.

Our reasons for this decision are discussed below.

11.2 ActewAGL's proposal

ActewAGL proposed the following revisions to the reference tariff variation mechanism and cost pass through events to that in the current access arrangement:

- replace the fixed schedule of tariffs with a weighted average price cap tariff variation mechanism
- 'refresh' the cost pass through events
- streamline the process for adjusting tariffs due to changes in uncontrolled costs through an automatic adjustment factor in the weighted average price cap formula

- align the tariff variation process with other access arrangements and the National Electricity Rules.[1]

11.2.1 Cost pass through events

The inclusion of a pass through mechanism recognises a service provider can be exposed to risks beyond its control, which may have a material impact on costs. A cost pass through enables a service provider to recover (or pass through) the costs of defined unpredictable, high cost events.

ActewAGL's proposed pass through events are set out in Table 11.1.

Table 11.1 ActewAGL's proposed pass through events

Proposed event	Proposed definition
Regulatory Change Event	Regulatory Change Event means a change in a regulatory obligation or requirement that affects the manner in which the ActewAGL provides the Reference Service.
Service Standard Event	Service Standard Event means a legislative or administrative act or decision that has the effect of: (a) varying the manner in which ActewAGL is required to provide the Reference Service; or (b) imposing, removing or varying the minimum service standards applicable to the Reference Service; or (c) altering the nature or scope of the Reference Service provided by ActewAGL.
Short Term Trading Market Event	Short Term Trading Market Event occurs if ActewAGL participates in the Short Term Trading Market, resulting in: (a) changes in costs that ActewAGL incurs directly or indirectly (including under statute or contract); or (b) the need to change services provided to accommodate the market, leading to additional costs.
Supply Curtailment Event	Supply Curtailment Event means the occurrence of a period when insufficient gas is delivered to ActewAGL's gas network due to reasons beyond ActewAGL's control, and gas cannot be supplied to meet demand requirements as represented by ActewAGL's forecasts used to derive the Reference Tariffs in this Access Arrangement, resulting in: (a) supply restrictions directed under the Utilities (Gas Restrictions) Regulations 2005 (ACT); and/or (b) widespread domestic load shedding, gas rationing or curtailment within ActewAGL's Network.

1 ActewAGL, *Access arrangement information, Attachment 13: Reference tariff variation mechanism*, June 2015, p. 5.

Proposed event	Proposed definition
General Pass Through Event	General Pass Through Event means an event that: (a) was not reasonably foreseeable at the time this Access Arrangement is approved by the Relevant Regulator under the National Gas Rules; (b) could not have been efficiently and economically insured against on reasonable commercial terms or self-insured, at the time this Access Arrangement is approved by the Relevant Regulator under the National Gas Rules; (c) could not have been prevented, nor any increase in costs as a result thereof substantially mitigated, by ActewAGL using reasonable endeavours; and (d) does not fall within any other category of Cost Pass-Through Event. For the purposes of this definition, an event will be considered unforeseeable if, at the time the Relevant Regulator makes its final decision in respect of this Access Arrangement, regardless of whether the occurrence of the event was a possibility, there was no reasonable basis for the Relevant Regulator to conclude the event was more likely than not to occur during the Applicable Access Arrangement Period.
Insurance Cap Event	Insurance Cap Event means the occurrence of an event whereby: (a) ActewAGL makes a claim or claims under a relevant insurance policy that satisfies the conditions of insurance under that policy; and (b) ActewAGL incurs costs beyond the actual policy limit of the relevant insurance policy as a result of the event that gives rise to the relevant claim. For the purposes of this definition: (c) A relevant insurance policy is an insurance policy held during the Applicable Access Arrangement Period or a previous period in which access to the Network was regulated; and (d) ActewAGL will be deemed to have made a claim on a relevant insurance policy if a claim is made by a related party of ActewAGL in relation to any aspect of the Network or ActewAGL's business.
Insurer Credit Risk Event	Insurer Credit Risk Event means the occurrence of an event whereby an insurer becomes insolvent and, as a result, ActewAGL: (a) incurs higher or lower costs for insurance premiums than would have otherwise applied; (b) is subject to a materially higher or lower claim limit or a materially higher or lower deductible than would have otherwise applied under the relevant policy; or (c) incurs additional costs associated with self-funding an insurance claim, which would otherwise have been covered by the insolvent insurer. Note for the avoidance of doubt, in making a determination on an Insurer Credit Risk Event pursuant to clause 7.11 of this Access Arrangement, the AER will have regard to, amongst other things: (a) the Service Provider's attempts to mitigate and prevent the event from occurring by reviewing and considering the insurer's track record,

Proposed event	Proposed definition
	size, credit rating and reputation; and (b) in the event that a claim would have been made after the insurance provider became insolvent, whether the Service Provider had reasonable opportunity to insure the risk with a different provider.
Terrorism Event	Terrorism Event means an act (including, but not limited to, the use of force or violence, the threat of force or violence, attacks or other disruptive activities against, or the deliberate introduction of harmful code or viruses to, computer systems, computer networks, data and/or communication systems, or the threat of such attacks or disruptive activities, or of the deliberate introduction of such harmful code or viruses) 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). Note for the avoidance of doubt, in making a determination on a Terrorism Event pursuant to clause7.11 of this Access Arrangement, the AER will have regard to, amongst other things: (a) whether the Service Provider has insurance against the event; (b) the level of insurance that an efficient and prudent service provider would obtain in respect of the event; and (c) whether a declaration has been made by a relevant government authority that a terrorism event has occurred.
Natural Disaster Event	Natural Disaster Event means any fire, flood, earthquake or other natural disaster that increases the costs to the Service Provider in providing the Reference Service, provided the fire, flood or other event was not a consequence of the negligent acts or omissions of the Service Provider. For the purposes of this definition, the term 'major' means an event that is serious and significant. Note for the avoidance of doubt, in making a determination on a Natural Disaster Event pursuant to clause 7.11 of this Access Arrangement, the AER will have regard to, amongst other things: (a) whether the Service Provider has insurance against the event; (b) the level of insurance that an efficient and prudent service provider would obtain in respect of the event; and (c) whether a relevant government authority has made a declaration that a natural disaster has occurred.
Network User Failure Event	Network User Failure Event means the occurrence of an event whereby a User becomes insolvent or is unable to continue to supply gas to its customers, and those customers are transferred to another User. Notwithstanding the definition of Change in Cost, the Change in Cost associated with a Network User Failure Event is deemed to: (a) include amounts that ActewAGL is entitled to be paid (but which are or will be unpaid as a result of a Network User Failure Event) for the provision of the Reference Service, including the revenue impact ActewAGL sustains or will sustain as a result of those unpaid amounts;

Proposed event	Proposed definition
	and (b) exclude costs that could be the subject of a pass through amount pursuant to rule 531 of the National Gas Rules or section 167 of the National Energy Retail Law.

Source: ActewAGL Distribution, *2016–21 Access Arrangement Information*, Attachment 13, pp 19–21.

11.3 AER's assessment approach

Under the National Gas Rules (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.[2]

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] However, the reference tariff variation mechanism must give us adequate oversight and powers to approve reference tariff variations.[4]

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
- the regulatory arrangements (if any) applicable to the relevant reference services before the commencement of the proposed reference tariff variation mechanism

2 NGR, rr. 92(2), 97(1).
3 NGR, r. 97(2).
4 NGR, r. 97(4).

- the desirability of consistency between regulatory arrangements for similar services
- any other relevant factor. [5]

Having regard to these, we considered the implications of the proposed reference tariff variation mechanism for efficient tariff structures and administrative costs on natural gas consumers, potential users and ActewAGL. 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 arrangements with those in ActewAGL's current access arrangements
- other recent gas access arrangement decisions (and electricity determinations under the NER)
- consistency in approach across the provision of similar services.

We assessed the potential impact of ActewAGL's proposal on incentives for pipeline operation in a manner consistent with the national gas objectives and with the revenue and pricing principles.[6] We also judged the implications of ActewAGL's proposed reference tariff variation mechanism for effective risk management that would be in the long term interests of consumers of natural gas.

11.3.1 Cost pass through reference tariff variation mechanism

This section discussing our approach to assessing cost pass throughs should be read in conjunction with the information directly above in section 11.3.

Pass through events transfer financial risks from service providers to consumers. Generally, if we concur that any of the pass through events occurs during the access arrangement period, the approved costs of the event are passed through to consumers and network charges increase accordingly.

In deciding on the appropriateness of a proposed cost pass through event we must consider the factors in r. 97(3) and assess its consistency with the NGO. We have full discretion to withhold approval to an element of a reference tariff variation mechanism if we believe a preferable alternative exists.[7]

Our approach to assessing pass throughs includes taking into account the Revenue and Pricing Principles, providing the service provider with a reasonable opportunity to recover at least the efficient costs the operator incurs,[8] while also providing effective

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5 NGR, r. 97(3).

6 Including NGR, r. 97 (3)(e).

7 NGR, r. 40(3).

8 NGL, s. 24(2).

incentives to promote economic efficiency.[9] It promotes a balance between the economic costs and risks for promoting efficient investment.[10]

We had regard to the criteria used by us in previous decisions[11] to assess pass throughs against both the NGO and the National Electricity Objective (NEO).[12] In 2012 these criteria were incorporated into the National Electricity Rules (NER) as nominated pass through event considerations. We consider these same criteria remain relevant as general principles to help determine whether a proposed cost pass through event for a gas network is consistent with the NGO.[13]

The criteria to which we have had regard to (as adopted by the AEMC as nominated pass through event considerations in the NER) are:[14]

> The *nominated pass through event considerations* are:
>
> (a) whether the event proposed is an event covered by a category of *pass through event* specified in clause 6.6.1(a1)(1) to(4) (in the case of a distribution determination) or clause 6A.7.3(a1)(1) to(4) (in the case of a *transmission determination*);
>
> (b) whether the nature or type of event can be clearly identified at the time the determination is made for the service provider;
>
> (c) 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;
>
> (d) 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; or
>
> (2) whether the event can be self-insured on the basis that:
>
> (i) it is possible to calculate the self-insurance premium; and
>
> (ii) the potential cost to the relevant service provider would not have a significant impact on the service provider's ability to provide *network services*; and.
>
> (e) any other matter the *AER* considers relevant and which the *AER* has notified *Network Service Providers* is a nominated pass through event consideration.

Our approach to assessing proposed pass through events also considers whether it is good regulatory practice, in the context of a national regulatory framework, to achieve consistency across and between gas and electricity.[15] Our approach also considers whether the risk transferred to consumers via the pass through mechanism is appropriate.[16]

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9 NGL, s. 24(3).

10 NGL, s. 24(6).

11 For example, our June 2015 decision on the access arrangement for Jemena Gas Networks (NSW) Ltd, and our April 2015 decision on the distribution determination for ActewAGL Distribution's electricity network.

12 We consider the NGO and NEO are sufficiently similar for the same criteria to be relevant.

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

14 NER, glossary, definition of 'nominated pass through event considerations'.

15 NGR, r. 97(3)(d).

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

These considerations involve an assessment of the incentives on service providers to manage their risks efficiently. For systematic risks, service providers are compensated through the allowed rate of return. Service providers also face business-specific, or residual, risks. These activities are generally compensated through opex and capex allowances. Beyond this, and where possible, a service provider may manage other risks through a number of other strategies including:

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

An efficient service provider will manage its risk by employing the most cost effective combination of these strategies. For example, if a cost is reasonably predictable, a service provider should factor it into its proposed operating and capital expenditure. In addition, a service provider may invest in its networks to mitigate the impact of certain events occurring. Alternatively, if the probability of events occurring can be readily estimated then the event should be insurable.

Pass through events cover those limited circumstances for which the risks cannot be managed efficiently in these ways and for which the service provider should be able to recover its efficient costs.

A factor for us to consider, which is reflected in our approach to assessing pass throughs, is who is best placed to manage risk. It is acknowledged practice that the party who is best placed to manage the risk should bear the risk. If the service provider, or customers, are fully exposed to a risk this may lead to adverse outcomes.

For example, if insurance is not available on commercial terms or self-insurance is not appropriate, a service provider might invest too much in its network. Over the longer term, this is likely to affect efficient costs of operating the network and would not be in the long term interests of consumers. In such circumstances, the consumer may be in the best position to bear the risk if the unforeseen event occurs.[17] On the other hand, if the service provider is able to pass through all the costs of an unforeseen event, this may dilute the service provider's incentive to take prudent actions upfront to manage these risks.

We considered all of these issues when assessing ActewAGL's proposed pass through events with the aim of achieving the right balance, in the long term interests of consumers.

[17], AEMC 2012, *Cost pass through arrangements for Network Service Providers, Rule Determination, 2 August 2012, Sydney* p. 18.

11.3.2 Interrelationships

As mentioned above, pass through events are not the only mechanism in this decision by which ActewAGL can manage its risks. Pass through events are interrelated with other parts of this decision, in particular with the proposed opex and capex allowances and the rate of return. These interrelationships require the AER to balance the incentives under the various parts of its decision.

11.4 Reasons for draft decision

We do not approve ActewAGL's proposed reference tariff variation mechanism for the 2016–21 access arrangement period.

The reasons for our decision are set out below.

11.4.1 Annual reference tariff variation mechanism

Revenue equalisation

The annual reference tariff variation mechanism must be designed to equalise (in present value terms) the building block costs associated with reference services and the portion of total revenue allocated to reference services.

We consider ActewAGL's proposed annual reference tariff variation formula complies in principle with rule 92(2) but the initial reference tariffs must be revised to reflect the draft decision on forecast total revenue and forecast demand. The changes in total revenue and forecast demand are outlined in their respective sections of this draft decision.[18]

Reference tariff variation mechanism

We accept ActewAGL's proposal to replace the current fixed schedule of tariffs with a weighted average price cap reference tariff variation mechanism. We note a weighted average price cap is a form of tariff basket price control which is compliant with NGR.[19] Weighted average price caps are commonly applied by gas distribution networks in other jurisdictions. We wish to ensure consistency in regulatory approach.

We note the proposed weighted average price cap includes:

- an automatic adjustment factor to account for differences between forecast and actual costs for the following specified uncontrollable events
    - license fees
    - benchmark unaccounted for gas costs

[18] NGR, r. 92(2).

[19] NGR, r. 97(2).

    - carbon costs
    - relevant taxes.
- pass through adjustment factor.[20]

This proposal is consistent with weighted average price cap adjustment factors we approved for other gas distribution networks. The mechanisms for these adjustments are set out below.

Rebalancing constraint

We also accept ActewAGL's proposal to include a side constraint (or rebalancing control) in its access arrangement. As noted by ActewAGL, a rebalancing constraint is not required by the NGR but is often applied by the AER when the applicable tariff variation mechanism is a weighted average price cap.[21] We agree with ActewAGL the application of a rebalancing constraint reduces price volatility and provides additional certainty to customers on annual price movements.

However, we do not accept ActewAGL's proposal to include an annual 10 per cent adjustment in the rebalancing constraint. ActewAGL proposed 10 per cent as it was approved by the AER for Jemena Gas Networks (New South Wales)(JGN).[22]

Our acceptance of 10 per cent for JGN was due to specific historical circumstances where we considered that 10 per cent was required to allow it to set its reference tariffs on a cost–reflective basis. We considered as a 10 per cent adjustment was allowed in the previous access arrangement it could be applied again because JGN was still in the process of moving tariffs to cost reflective levels. Moreover, rule 97(3) of the NGR seeks consistency between regulatory arrangements where possible. Our JGN decision met this rule.

However, ActewAGL does not have the same circumstances as JGN and we consider 10 per cent is a significant adjustment that could allow price volatility and reduce certainty in customers' prices. Instead, our draft decision for ActewAGL applies a 2 per cent adjustment in the balancing constraint which is consistent with the rebalancing constraints applied by other gas distribution networks.[23] We consider

[20] ActewAGL, *Access arrangement information, Attachment 13: Reference tariff variation mechanism*, June 2015, pp. 12–14.

[21] ActewAGL, *Access arrangement information, Attachment 13: Reference tariff variation mechanism*, June 2015, p. 13.

[22] ActewAGL, *Access arrangement information, Attachment 13: Reference tariff variation mechanism*, June 2015, p. 13.

[23] See for example: SP AusNet, *Gas access arrangement revision 2013–2017: Part B of the access arrangement for the distribution system–reference tariffs and reference tariff policy*, April 2013, clause 3.5(c); AGN, (proposed) *Access arrangement for AGN's South Australian gas distribution network 1 July 2016 – 30 June 2021*, July 2015, clause 4.4 and Annexure E.

2 per cent a reasonable adjustment and it has regulatory precedence as it is the rebalancing constraint adopted for electricity networks as set out in the NER.[24]

Intra–year variations to reference tariffs

We do not accept ActewAGL's proposal to vary reference tariffs during a financial year to apply at a date prior to the start of the next financial year, including for the purpose of passing through an amount relating to a cost pass through event.[25]

Intra–year variations to tariffs create uncertainty for customers on annual price movements, which is undesirable. Once tariffs are set, it is best they are not adjusted until commencement of the following financial year. ActewAGL seems to acknowledge the importance tariff certainty for via inclusion of a rebalancing constraint.[26] Permitting intra-year tariff variations would undermine that very certainty.

We acknowledge that in the past we have approved intra–year variations to reference tariffs. However, this has only ever been done in exceptional circumstances when judged to be in the long term interests of customers—such as the removal of the carbon tax from tariffs, where special legislative requirements dictated the necessity for the tax's prompt removal.

Moreover, we also consider that the pass through factor and automatic adjustment factor in ActewAGL's weighted average price cap allows annual tariff adjustments for uncontrollable costs and cost pass throughs. These adjustments include accounting for the time value of money so that neither ActewAGL nor customers are impacted by the delay in recovering these costs. Therefore, we do not consider it prudent or necessary to include provision for intra–year variations to reference tariffs in ActewAGL's access arrangement.

Annual haulage reference tariff variation formula

ActewAGL's proposed annual haulage reference tariff variation formula is consistent with that applied by other gas distribution networks. While we generally accept ActewAGL's proposal, we have amended the tariff variation formula…

The draft decision approved annual haulage reference tariff variation mechanism is set out in Figure 11.1. The approved side constraint is set out in Figure 11.2.

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24 NER, cl. 6.18.6.

25 ActewAGL, *Access arrangement information, Attachment 13: Reference tariff variation mechanism*, June 2015, p. 15.

26 ActewAGL, *Access arrangement information, Attachment 13: Reference tariff variation mechanism*, June 2015, p. 13.

Figure 11.1 Annual haulage reference tariff variation formula

$$(1+CPI_t)(1-X_t)(1+A_t)(1+PT_t) \geq \frac{\sum_{i=1}^{n}\sum_{j=1}^{m} p_t^{ij} q_{t-2}^{ij}}{\sum_{i=1}^{n}\sum_{j=1}^{m} p_{t-1}^{ij} q_{t-2}^{ij}} \qquad x = 1,\ldots,n.$$

where:

CPI_t is the annual percentage change in the Australian Bureau of Statistics (ABS) CPI All Groups, Weighted Average of Eight Capital Cities from the December quarter in year t-2 to the December quarter in year t-1, calculated using the following method:

> The ABS CPI All Groups, Weighted Average of Eight Capital Cities for the December quarter in financial year t-1
>
> divided by
>
> The ABS CPI All Groups, Weighted Average of Eight Capital Cities for the December quarter in financial year t-2
>
> minus one.

If the ABS does not, or ceases to, publish the index, then CPI will mean an index which the AER considers is the best available alternative index.

t is the financial year for which tariffs are being set.

X_t is the X factor for each financial year of the 2016–21 access arrangement period as determined in the PTRM as approved in the AER's final decision, and annually revised for the return on debt update calculated for the relevant financial year during the access arrangement period in accordance with that approved in the AER's final decision

A_t is the automatic adjustment factor for financial year t calculated as outlined below

PT_t is the cost pass through factor for financial year t calculated as outlined below

n is the number of different reference tariffs

m is the different components, elements or variables ("components") comprised within a reference tariff

p_t^{ij} is the proposed component j of reference tariff i in year t

p_{t-1}^{ij} is the prevailing component j of reference tariff i in year t-1

q_{t-2}^{ij} is the audited quantity of component j of reference tariff i that was sold in year t-2 (expressed in the units in which that component is expressed (e.g. GJ)).

Figure 11.2 Rebalancing control formula

$$(1+CPI_t)(1-X_t)(1+A_t)(1+PT_t)(1+0.02) \geq \frac{\sum_{i=1}^{n}\sum_{j=1}^{m} p_t^{ij} q_{t-2}^{ij}}{\sum_{i=1}^{n}\sum_{j=1}^{m} p_{t-1}^{ij} q_{t-2}^{ij}} \qquad x = 1,\ldots,n.$$

CPI_t is the annual percentage change in the ABS CPI All Groups, Weighted Average of Eight Capital Cities from the December quarter in year t-2 to the December quarter in year t-1, calculated using the following method:

> The ABS CPI All Groups, Weighted Average of Eight Capital Cities for the December quarter in financial year t-1
>
> divided by
>
> The ABS CPI All Groups, Weighted Average of Eight Capital Cities for the December quarter in financial year t-2
>
> minus one.

If the ABS does not, or ceases to, publish the index, then CPI will mean an index which the AER considers is the best available alternative index.

X_t means the X factor for each financial year of the 2016–21 access arrangement period as determined in the PTRM as approved in the AER's final decision, and annually revised for the return on debt update calculated for the relevant financial year during the access arrangement period in accordance with that approved in the AER's final decision

A_t is the automatic adjustment factor for financial year t calculated as outlined below

PT_t is the cost pass through factor for financial year t calculated as outlined below

n is the number of different reference tariffs

m is the different components, elements or variables ("components") comprised within a reference tariff

p_t^{ij} is the proposed component j of reference tariff i in year t

p_{t-1}^{ij} is the prevailing component j of reference tariff i in year t-1

q_{t-2}^{ij} is the audited quantity of component j of reference tariff i that was sold in year t-2 (expressed in the units in which that component is expressed (e.g. GJ))

t is the financial year for which tariffs are being set.

Automatic adjustment factor

We accept the inclusion of a symmetrical automatic adjustment factor in ActewAGL's weighted average price cap to allow it to pass through annual costs or savings across a number of uncontrollable cost categories. This adjustment will lower administrative costs because ActewAGL will not have to lodge annual cost pass through applications for licencing fees, benchmark unaccounted for gas costs, carbon costs and relevant taxes.[27] Our draft decision formula is set out in Figure 11.3.

Figure 11.3 Automatic adjustment factor formula

$$A_t = \frac{(1 + A'_t)}{(1 + A'_{t-1})} - 1$$

where:

A_{t-1} is:

(a) zero when t–1 refers to financial years 2016–17 or 2017–18;or

(b) value of $A_t^{'}$ determined in the financial year *t-1* for all other years

and

$$A'_t = \frac{(L_{t-2} + U_{t-2} + C_{t-2} + T_{t-2})[(1 + realWACC_t)^2(1 + CPI_{t-1})]}{(1 - X_t)\sum_{i=1}^{n}\sum_{j=1}^{m} p_{t-1}^{ij} q_{t-2}^{ij}}$$

where:

t is the financial year for which tariffs are being set

L_{t-2} is the licence fee factor amount, as defined below, for financial year *t-2*

$realWACC_t$ is as per that set out in this draft decision and updated annually within the PTRM

U_{t-2} is the UAG factor amount, as defined below, for financial year t-2

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27 NGR, r. 97(3)(a), 97(3)(b).

C_{t-2} is the carbon cost factor amount, as defined below, for financial year t-2

T_{t-2} is the change in tax factor amount, as defined below, for financial year t-2

CPI_t is the annual percentage change in the ABS CPI All Groups, Weighted Average of Eight Capital Cities from the December quarter in year t-2 to the December quarter in year t-1, calculated using the following method:

The ABS CPI All Groups, Weighted Average of Eight Capital Cities for the December quarter in financial year t-1

divided by

The ABS CPI All Groups, Weighted Average of Eight Capital Cities for the December quarter in financial year t-2

minus one.

If the ABS does not, or ceases to, publish the index, then CPI will mean an index which the AER considers is the best available alternative index.

CPI_{t-1} is the value of CPI_t determined for financial year t-1

X_t means the X factor for each financial year of the 2016–21 access arrangement period as determined in the PTRM as approved in the AER's final decision, and annually revised for the return on debt update calculated for the relevant financial year during the access arrangement period in accordance with that approved in the AER's final decision

p_{t-1}^{ij} is the prevailing component j of reference tariff i in year t-1

q_{t-2}^{ij} is the audited quantity of component j of reference tariff i that was sold in year t-2 (expressed in the units in which that component is expressed (e.g. GJ)).

Licence fee factor amount

The licence fee factor amount for financial year t-2 is to be calculated as follows:

(a) the actual cost incurred by ActewAGL as a result of any IPART, AEMO, EWON, Independent Competition and Regulatory Commission, AER or any other relevant regulator, authority or State or Commonwealth Government's authorisation fees, licence fees or statutory charges imposed on ActewAGL which is related to the ownership or operation of the Network in financial year t-2 including, without limitation, the AEMO Fee, the Energy Industry Levy and the Utilities (Networks Facilities) Tax,

minus

(b) the forecast of the cost incurred by ActewAGL as a result of any IPART, AEMO, EWON, Independent Competition and Regulatory Commission

Relevant Regulator or any other relevant regulator, authority or State or Commonwealth Government's authorisation fees, licence fees or statutory charges imposed on ActewAGL which is related to the ownership or operation of the Network included in the AER's relevant final decision for financial year t–2 including, without limitation, the AEMO Fee, the Energy Industry Levy and the Utilities (Network Facilities) Tax.

UAG factor amount

The UAG factor amount for financial year t-2 is to be calculated as follows:

(a) the benchmark cost incurred by ActewAGL for purchases of gas as UAG, calculated as the product of:

i. gas receipts in gigajoules for financial year t-2;

ii. the UAG Cost for financial year t-2 in $/gigajoule; and

iii. the UAG target rate of 1.96 per cent,

minus

(b) the forecast of the total UAG costs included in the AER's relevant final decision for financial year t-2.

Reference tariffs will be adjusted in the event that total UAG costs cease to be a network cost during the 2016–20 access arrangement period.

The forecast UAG costs are as follows:

Table 11.1 AER draft decision forecast of the total UAG costs

	2016–17	2017–18	2018–19	2019–20	2020–21
Forecast UAG Cost ($million,2014/15)	1.25	1.24	1.22	1.21	1.21

Source: AER analysis, see Attachment 7, Table 7.9.

Carbon Cost factor amount

The Carbon Cost factor amount for financial year *t-2* is to be calculated as follows:

(a) the actual cost incurred by the Service Provider as a result of the operation of a Carbon Scheme as approved by the AER, in Financial Year t-2,

minus

(b) the forecast of the cost incurred by the ActewAGL as a result of the operation of a Carbon Scheme as approved by the AER and included in the AER's relevant final decision, in financial year t-2.

Relevant Tax factor amount

The Relevant Tax factor amount for financial tear *t-2* is to be calculated as follows:

(a) the actual cost incurred by the ActewAGL in paying any Relevant Tax, in financial year t-2,

minus

(b) the forecast of the cost incurred by the ActewAGL in paying any Relevant Tax included in the AER's relevant final decision, in financial year t-2.

Pass through factor formula

We approve cost pass through via the tariff basket in the reference tariff control formula using the pass through factor. Our draft decision pass through factor formula is set out in Figure 11.4.

Figure 11.4 Pass through factor formula

$$PT_t = \frac{(1+PT'_t)}{(1+PT'_{t-1})} - 1$$

where:

PT_t is:

(a) zero when financial year t–1 refers to financial year 2016–17

(b) the value of PT'_t determined in the financial year t-1 for all other financial years in the access arrangement period

and

$$PT'_t = \frac{AP_t}{(1+CPI)(1-X_t)(1+A_{t)})\sum_{i=1}^{n}\sum_{j=1}^{m} p_{t-1}^{ij} q_{t-2}^{ij}}$$

where

AP_t is:

(a) any determined pass through amount that the AER approves in whole or part in financial year t; and/or

(b) any pass through amounts arising from pass through events (as that termed is defined in the access arrangement applying to ActewAGL in the immediately prior access arrangement period) occurring in the immediately prior access arrangement period that ActewAGL proposed to pass through in whole or in part in financial year t,

that includes an amount to reflect the time vale of money between incurring the costs and recovering the costs, and excludes any amounts already passed through in reference tariffs.

CPI_t is the annual percentage change in the Australian Bureau of Statistics (ABS) CPI All Groups, Weighted Average of Eight Capital Cities from the December quarter in year t-2 to the December quarter in year t-1, calculated using the following method:

> The ABS CPI All Groups, Weighted Average of Eight Capital Cities for the December quarter in financial year t-1
>
> divided by
>
> The ABS CPI All Groups, Weighted Average of Eight Capital Cities for the December quarter in financial year t-2
>
> minus one.

If the ABS does not, or ceases to, publish the index, then CPI will mean an index which the AER considers is the best available alternative index.

X_t means the X factor for each financial year of the 2016–21 access arrangement period as determined in the PTRM as approved in the AER's final decision, and annually revised for the return on debt update calculated for the relevant financial year during the access arrangement period in accordance with that approved in the AER's final decision

A_t is the automatic adjustment factor for financial year t calculated as outlined above

p_{t-1}^{ij} is the prevailing component j of reference tariff i in year t-1

q_{t-2}^{ij} is the audited quantity of component j of reference tariff i that was sold in year t-2 (expressed in the units in which that component is expressed (e.g. GJ)

t is the financial year for which tariffs are being set.

11.4.2 Cost pass through events

This section sets out our reasons for:

- not approving ActewAGL's proposed regulatory change event as currently defined, and requiring amendments to the definition
- not approving ActewAGL's proposed service standard event as currently defined, and requiring amendments to the definition
- not approving ActewAGL's proposed insurance cap event as currently defined, and requiring amendments to the definition
- not approving ActewAGL's proposed insurer credit risk event as currently defined, and requiring amendments to the definition
- not approving ActewAGL's proposed terrorism event as currently defined, and requiring amendments to the definition

- not approving ActewAGL's proposed natural disaster event as currently defined, and requiring amendments to the definition
- not approving ActewAGL's proposed network user failure event as currently defined, and requiring amendments to the definition
- not approving the short term trading market event
- not approving the supply curtailment event
- not approving the general pass through event.

As set out below we have taken into account each of the considerations discussed in section 11.4.2 in assessing the pass through events proposed by ActewAGL.

11.4.2.1 Regulatory Change Event and Service Standard Event

We do not approve the service standard event and regulatory change event in the form ActewAGL proposed. For the reasons below, we require amendments to the definitions of these events.

These events allow ActewAGL to recover the costs associated with legislative and regulatory changes.

We consider in principle these events meet the criteria in our assessment approach. They would not be covered by another category, the nature or type of event can be clearly identified and ActewAGL often has limited ability to prevent or mitigate the event.

As noted in section 11.3, how much the service provider controls the event or the impact of the event is a factor in our pass through decision. Where the service provider has little control over whether or not the risk occurs or the cost impact of the event, it is generally desirable to insulate that party from the risk.

Events of this nature have also been consistently approved in other gas access arrangement reviews[28] and are prescribed pass throughs events in the NER.[29]

ActewAGL submitted that it had replaced the definitions of these events to enhance consistency with the access arrangement approved by the AER for Jemena Gas Networks (NSW) Ltd (JGN), to lower the administrative burden on ActewAGL and on us.[30] However, the definitions ActewAGL has proposed for these events are not consistent with those approved for JGN, or those prescribed in the NER for ActewAGL's electricity network. The latter were developed by the AEMC to achieve consistency with the NEO. The NEO and NGO are sufficiently similar that a regulatory change event or service standard event that is consistent with the NEO will also be

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[28] For example, our June 2015 final decision on the access arrangement for Jemena Gas Networks (NSW) Ltd.

[29] NER, cll. 6.6.1(a1)(1), 6.6.1(a1) (2).

[30] ActewAGL, *Access arrangement information, Attachment 13: Reference tariff variation mechanism*, June 2015, p. 23.

consistent with the NGO. Where a pass through event is approved for multiple service providers to address the same risk, we also consider it preferable that the event be defined consistently.[31]

We therefore require ActewAGL to amend its definitions of the regulatory change event and service standard event as follows:

> **Regulatory change event**
>
> A change in a regulatory obligation or requirement that:
>
> (a) falls within no other category of pass through event; and
>
> (b) occurs during the course of an access arrangement period; and
>
> (c) substantially affects the manner in which the Service Provider provides the Reference Service; and
>
> (d) materially increases or materially decreases the costs of providing those services.
>
> **Service standard event**
>
> A legislative or administrative act or decision that:
>
> (a) has the effect of:
>
> (i) substantially varying, during the course of an access arrangement period, the manner in which a Service Provider is required to provide the Reference Service; or
>
> (ii) imposing, removing or varying, during the course of an access arrangement period, minimum service standards applicable to the Reference Service; or
>
> (iii) altering, during the course of an access arrangement period, the nature or scope of the Reference Service, provided by the service provider; and
>
> (b) materially increases or materially decreases the costs to the service provider of providing the Reference Service.

We consider these definitions preferable to those proposed by ActewAGL, and consistent with the NGO and NGR.

They provide the consistency between regulatory decisions for ActewAGL's electricity and gas distribution networks. This provides consistent treatment of the same risk within ActewAGL's distribution business, and in turn the reduction in administrative burden ActewAGL refers to in its proposal.

In both cases, these amendments have the effect of requiring that the impact of the event on the manner in which the reference service is provided is *substantial*. In the case of the regulatory change event, ActewAGL argued that the inclusion of this requirement under the NER adds uncertainty, and is unnecessary given the application

31 NGR, r. 97(3)(d).

of a materiality threshold. It cited JGN's response to this issue in response to our draft decision on this event in support of its argument.[32] As we explained in our response to JGN,[33] 'substantially' in this definition refers to the effect the change in regulatory obligation has on the manner in which the Service Provider provides the reference service. That is, the event occurs when a change in regulatory obligation or requirement *substantially affects the manner in which the Service Provider provides the reference service*. Where that requirement is satisfied, the materiality threshold that applies to pass through events is used to determine whether the resultant change in costs can be passed through. It is clear that there is a requirement both for a substantial effect on the manner in which a service is provided *and* a material cost impact.

To this end, and also in both cases, the amendments we require to these events explicitly require that the change in costs resulting from the event is material as a requirement that applies *in addition to* the requirement for a substantial change in the manner in which a service is provided. We note that this will not alter the application of a materiality threshold under the AA.[34]

For the regulatory change event, the amended definition clarifies that the regulatory obligation or requirement 'falls within no other category of pass through event'. ActewAGL argued that this restriction could not apply to more than one pass through event, and that as it was included in its proposed general pass through event it could not apply here. For reasons outlined below, we have rejected ActewAGL's proposed general event so that this element of ActewAGL's argument falls away.

For the service standard event, the amended definition clarifies that the variation to the manner in which services are provided must be 'during the course of an Access Arrangement Period'. This is consistent with the prescribed pass through event that applies to ActewAGL's electricity distribution network under the NER, and with our decision for JGN. We discuss our assessment of ActewAGL's proposed fixed principle for the inter-period consideration of pass throughs in section 11.4.3, below.

11.4.2.2 Insurance Cap Event

The insurance cap event allows ActewAGL to make a pass through application if it makes a claim under an insurance policy, and the actual costs to ActewAGL exceed its policy limit. We accept an insurance cap event would protect ActewAGL from high cost impact events which would be uneconomical to insure against. We consider consumers benefit because they are not required to fund excessive premiums where

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[32] ActewAGL Distribution, *2016–21 Access arrangement information, Attachment 13: Reference tariff variation mechanism*, June 2015, p. 22.

[33] AER, *Final decision, Jemena Gas Networks (NSW) Ltd Access Arrangement 2015–20, Attachment 11 – Reference tariff variation mechanism*, June 2015, p. 11-13

[34] ActewAGL, *Access arrangement for the ACT, Queanbeyan and Palerang gas distribution network 1 July 2016 - 30 June 2021*, Schedule 1: Definitions, cl. 1.1 - definition of Administrative Cost Impact.

insurance, if available, would be uneconomic. Consumers then only bear the risk should an insurance cap event occur.

We therefore consider the inclusion of an insurance cap event in ActewAGL's 2016–21 Access Arrangement is consistent with the NGO and RPP. However, we require ActewAGL to amend the definition of this event as follows:

Insurance Cap Event

Insurance Cap Event means an event where:

(a) the Service Provider makes a claim or claims and receives the benefit of a payment or payments under a relevant insurance policy;

(b) the Service Provider incurs costs beyond the relevant policy limit; and

(c) the costs beyond the relevant policy limit increase the costs to the Service Provider of proving the Reference Service.

For this Insurance Cap Event:

(a) the relevant policy limit is the greater of:

i. the Service Provider’s actual policy limit at the time of the event that gives, or would have given rise to the claim; and

ii. the policy limit that is explicitly or implicitly commensurate with the allowance for insurance premiums that is included in the forecast operating expenditure allowance approved in the AER’s final decision for the Access Arrangement Period;

(b) a relevant insurance policy is an insurance policy held during the Access Arrangement Period or a previous period in which access to the pipeline services was regulated; and

(c) the Service Provider will be deemed to have made a claim on a relevant insurance policy if the claim is made by a related party of the Service Provider in relation to any aspect of the Network or the Service Provider’s business

Note for the avoidance of doubt, in making a determination on an Insurance Cap Event, the AER will have regard to, amongst other things:

i. the insurance policy for the event, and

ii. the level of insurance that an efficient and prudent Service Provider would obtain in respect of the event.

This definition is consistent with that approved in our recent decisions for JGN, which ActewAGL supports in the context of other pass through events, and is consistent with regulatory decision for ActewAGL’s electricity distribution network. This provides consistent treatment of the same risk between service providers, and in turn the reduction in administrative burden ActewAGL promotes elsewhere in proposing pass through events.

There are two key differences between our preferred definition and that proposed by ActewAGL for its gas network.

First, our preferred definition measures the amount that can be passed through against the greater of: the level of insurance ActewAGL has purchased; and that assumed or provided for in determining its approved operating forecast operating expenditure (opex) under the access arrangement.

Second, our preferred definition explicitly clarifies that both ActewAGL's actual insurance policy and the level of insurance that an efficient and prudent service provider would obtain are relevant to the assessment of an application under this event.

Insurance is funded through ActewAGL's approved opex, which allows ActewAGL to acquire and maintain an appropriate level of insurance coverage. In allowing a pass through of costs in excess of a service provider's actual level of insurance, care must be taken to ensure the service provider does not have a perverse incentive to reduce its expenditure on insurance (and therefore its opex relative to the approved forecast), by transferring the risk of insurable events to customers. We expect ActewAGL to acquire prudent and efficient levels of insurance coverage commensurate with its business risk, as reflected in its approved forecast opex.

ActewAGL's proposal correctly noted that our decision on total forecast opex is not an approval of specific projects. It argued that this would make it difficult to identify what the insurance policy limit implicitly or explicitly commensurate with its approved opex was. Instead, it proposed we rely on the controls in the pass through mechanism to take into account the efficiency of its actions relating to the event.

This argument correctly notes that, if a pass through event of this kind were to occur, our assessment of an application to pass through costs would consider the efficiency of ActewAGL's decisions and actions in relation to the risk of the event. We would consider, amongst other things, the level of insurance actually purchased for the event and that which an efficient and prudent service provider could obtain. The level of insurance an efficient and prudent service provider could obtain is necessarily determined, in part, by the amount of total opex we have approved in its access arrangement. Our preferred definition makes these considerations explicit in the context of this event, and provides transparency and increased regulatory certainty around how we will assess an application.

Applied to the supporting definition of the relevant policy limit for this event, it allows us to measure the level of insurance actually purchased with that assumed by the service provider and/or approved by us in the total forecast opex for the period. For example, to the extent that a change in approved opex was informed by an assessment that an increase in the level of insurance was prudent and efficient, we would take into account the service provider's reasons for not proceeding with that increased amount. This does not preclude a finding that a decision not to proceed was appropriate, and that the actual policy limit should prevail. It simply balances the incentive to reduce opex through underspending rather than through genuine efficiencies.

As in our recent decision for ActewAGL's electricity network, we therefore consider this definition preferable to that proposed by ActewAGL, and consistent with the NGO and NGR.

11.4.2.3 Insurer credit risk event

This event is intended to provide for circumstances in which an insurance provider becomes insolvent and, as a result, ActewAGL:

- incurs higher or lower costs for insurance premiums that would have applied;
- is subject to a materiality higher or lower claim limit or a materially higher or lower deductible than would have otherwise applies under the relevant policy; or
- incurs additional costs associated with self-funding an insurance claim, which would otherwise have been covered by the insolvent insurer.

In its proposal ActewAGL argued that it takes a number of precautions to mitigate to an insurer credit risk event, including looking at:[35]

- market development;
- insurer reputation; and,
- credit rating and financial stabilities of potential insuring entities.

Despite these efforts, an insurer may fail and leave ActewAGL exposed in circumstances beyond its ability to control. We accept the options available to service providers to manage these risks are limited, and given the rarity of such events, may in fact result in greater expenditure on insurance than is prudent or efficient.

ActewAGL's proposed insurer credit risk event is broader in two respects than that we have approved in recent decisions, including for ActewAGL's electricity distribution network and for JGN.

First, in its proposed definition for this event, ActewAGL sought to include provision for it to pass through costs associated with changes to insurance premiums as a result of an insurer becoming insolvent.[36] We consider insurance premiums are a typical business expense, subject to ordinary market factors in the economy. This is a risk businesses are best placed to manage, rather than customers. This view is consistent with our approach in recent decisions.[37]

Second, where our recent decisions approved an insurer credit risk event that goes to costs specific to existing or potential claims to the failed insurer, ActewAGL's proposed

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35 ActewAGL Distribution, *2016–21 Access arrangement information, Attachment 13: Reference tariff variation mechanism*, June 2015, p. 28

36 ActewAGL Distribution, *2016–21 Access arrangement information, Attachment 13: Reference tariff variation mechanism*, p. 28.

37 AER, *Final decision: Jemena Gas Networks 2015–20*, Attachment 11 – Reference tariff variation mechanism, p. 19.

definition does not include that limitation. We consider this important so that service providers do not have the incentive to delay the purchase of alternative insurance, thereby transferring the risk of insurable events to customers.

We therefore do not accept ActewAGL's proposed definition of this event, and require it to amend that definition as follows:

Insurer Credit Risk Event

Insurer Credit Risk Event means an event where:

(a) A nominated 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:

i. 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

ii. incurs additional costs associated with self-funding an insurance claim, which would otherwise have been covered by the insolvent insurer.

Note for the avoidance of doubt, in making a determination on an Insurer Credit Risk Event pursuant to clause 7.11 [of ActewAGL's Access Arrangement] , the AER will have regard to, amongst other things:

i. the Service Provider's attempts to mitigate and prevent the event from occurring by reviewing and considering the insurer's track record, size, credit rating and reputation, and
ii. in the event that a claim would have been made after the insurance provider became insolvent, whether the Service Provider had reasonable opportunity to insure the risk with a different provider.

11.4.2.4 Terrorism event

A terrorism pass through event would allow ActewAGL to apply to pass through costs resulting from an act of terrorism. We consider the inclusion of a terrorism event in ActewAGL's 2016–21 Access Arrangement supports the NGO and RPP. However, we require ActewAGL to amend its definition of this event.

ActewAGL's proposal incorporates a similar terrorism pass through event to that approved by us in our recent decisions for ActewAGL's electricity network and for JGN. It differs in two respects.

First, ActewAGL's proposed definition expands on the examples provided of what might constitute an act of terrorism, with the intent of clarifying that cyber terrorism is included.[38] We consider the risk of cyber-related attacks—which under ActewAGL's proposed definition would include the introduction of harmful code or viruses—can and should be managed primarily through prudent and efficient steps to protect its IT systems. Consistent with the regulatory incentive framework, we consider that if there is too much reliance on ex-post measures ActewAGL has disincentives to take prudent actions to manage the risk in the first place. ActewAGL is provided an allowance for IT expenditure that should be used, in part, for securing its assets from such an event. The potential to recover costs by way of a pass through rather that within its approved expenditure forecasts should not form the basis of any risk management decision by ActewAGL.

Second, terrorism events approved by us in recent decisions explicitly require that the event increase the cost to the service provider of providing the reference service. ActewAGL's proposed definition does not. It is the change to the cost in provision of reference services that the pass through mechanism seeks to address. We therefore consider it preferable that the definition recognise this. This is consistent with the terrorism events approved for ActewAGL's electricity network and for JGN.

We therefore require ActewAGL to amend the definition of the terrorism event as follows.

> **Terrorism Event**
>
> 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 which increases the cost to the Service Provider in providing the Reference Service.
>
> Note for the avoidance of doubt, in making a determination on a Terrorism Event pursuant to clause 7.11 [of ActewAGL’s Access Arrangement], the AER will have regard to, amongst other things:
>
> i. whether the Service Provider has insurance against the event;
>
> ii. the level of insurance that an efficient and prudent service provider would obtain in respect of the event; and
>
> iii. whether a declaration has been made by a relevant government authority that a terrorism event has occurred.

[38] ActewAGL Distribution, *2016–21 Access arrangement information, Attachment 13: Reference tariff variation mechanism*, June 2015, p. 29.

11.4.2.5 Natural disaster event

This pass through event would allow ActewAGL to apply to pass through to consumers costs associated with ActewAGL's actions in response to natural disasters. We consider inclusion of a natural disaster event is consistent with the NGO and RPP. As ActewAGL has noted, we have accepted events similar to that it has proposed in our recent decisions for ActewAGL's electricity network and for JGN.

Again, however, ActewAGL has proposed a different definition to that we have approved in those decisions. In its draft proposal ActewAGL stated its definition sought to:[39]

- clarify only natural disaster costs *negligently* caused by ActewAGL are excluded; and
- to ensure the cost pass through event is not restricted to the 2016–21 access arrangement period.

Natural disaster events approved for ActewAGL's electricity network and for JGN allow recovery of costs provided the fire, flood or other event was not a consequence of the acts or omissions of the Service Provider. ActewAGL's proposed definition for its gas network reduces this to negligent acts or omissions. We consider clause 7.12 of ActewAGL's proposed access arrangement already provides an appropriate level of accountability in this respect, and reinforces the importance of ActewAGL taking appropriate steps to prevent and mitigate loss resulting from natural disasters. That clause requires us to take the efficiency of acts or omissions by ActewAGL in relation to the risk of the event into account in assessing an application to pass through costs.

ActewAGL has not provided arguments as to why the cost pass through event should not be restricted to the 2016–21 access arrangement period. This is the period for which any approved event would apply. This restriction is consistent with the prescribed pass through event that applies to ActewAGL’s electricity distribution network under the NER, and with our decision for JGN. We discuss our assessment of ActewAGL’s proposed fixed principle for the inter-period consideration of pass throughs in section 11.4.3, below.

We therefore require ActewAGL to amend the definition of the natural disaster event as follows:

> **Natural Disaster Event**
>
> Natural Disaster Event means any major fire, flood, earthquake or other natural disaster that occurs during the 2016–21 Access Arrangement Period and increases the costs to the Service Provider in providing the Reference Service, provided the fire, flood or other event was not a consequence of the acts or omissions of the Service Provider.

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[39] ActewAGL Distribution, *2016–21 Access arrangement information, Attachment 13: Reference tariff variation mechanism*, June 2015, p. 29.

> The term ‘major’ in the above paragraph means an event that is serious and significant.
>
> Note for the avoidance of doubt, in making a determination on a Natural Disaster Event pursuant to clause 7.11 [of ActewAGL’s Access Arrangement], the AER will have regard to, amongst other things:
>
> i. whether the Service Provider has insurance against the event;
>
> ii. the level of insurance that an efficient and prudent service provider would obtain in respect of the event; and
>
> iii. whether a relevant government authority has made a declaration that a natural disaster has occurred.

11.4.2.6 Network user failure event

Rule 531 of the NGR allows ActewAGL to pass through costs associated with a RoLR event that is triggered by retailer insolvency. ActewAGL relied on arguments put to us by JGN in support of an additional 'network user failure event'. It noted that the same obligations that apply to JGN apply to ActewAGL.[40] It submitted that it had acted efficiently to avoid the cost of system changes to automate the retailer of last resort (RoLR) transfer process as the low probability of occurrence does not justify the significant cost of doing so.[41] It argued that while both the NGL and NGR have reduced the range of circumstances in which an additional cost pass through is needed, those changes only extend to retailer insolvency (and not to other triggers for a retailer of last resort event) and therefore a network user failure event is needed.

However, the network user failure event that ActewAGL has proposed is (with minor structural differences) that put to us in JGN's revised proposal, not the event we approved in our final decision on JGN's access arrangement. Absent any new arguments on this matter, we do not accept ActewAGL's proposed network user failure event and require that it amend its definition of the event to that approved for JGN.

Our reasons for this are as follows.

We consider including a network user failure event in ActewAGL's 2016–21 Access Arrangement would, if appropriately defined, support the NGO and the RPP.

ActewAGL may be in a position to manage and mitigate the costs associated with an insolvency, including undertaking steps to recover debts. However, we consider a Network User Failure Event could provide an efficient alternative to ActewAGL investing an automated system solely for transferring customers in a RoLR event. Where such systems significantly exceed what ActewAGL would otherwise require to

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[40] ActewAGL Distribution, *2016–21 Access arrangement information – Attachment 13: reference tariff variation mechanism*, p.30.

[41] ActewAGL Distribution, *2016–21 Access arrangement information – Attachment 13: reference tariff variation mechanism*, p.30.

process customer transfers in accordance with the NERL, NERR, NGR and retail market procedures, this expenditure may not be prudent or efficient, particularly given the low frequency of RoLR events.

For avoidance of doubt, our preferred definition notes that when assessing an application under a network user failure event we will have regard to, amongst other things the extent to which the service provider has taken steps to minimise the costs associated with its responsibilities if a User becomes insolvent.

Application where failed retailer is not insolvent

Rule 531 of the NGR allows ActewAGL to pass through costs associated with a RoLR event that is triggered by retailer insolvency. However, ActewAGL noted a RoLR event may be triggered under the NERL in circumstances where the retailer is not insolvent.[42]

We consider the costs that ActewAGL would incur in meeting its obligations under the NERL and the RoLR procedures in a RoLR event are likely to be the same regardless of the trigger for that event. As discussed above, we consider a Network User Failure Event could provide an efficient alternative to ActewAGL investing an automated system solely for transferring customers in a RoLR event.

Consistent with ActewAGL's proposal, our preferred definition therefore allows recovery of costs resulting from any RoLR event under section 122 of the NERL, where those costs are not recoverable by the service provider under other provisions of the NERL, NERR, NGL or NGR as in force at the time of the event, including but not limited to rule 531 of the NGR and other pass through events in the access arrangement.

Recovery of foregone revenue

ActewAGL's proposed network user failure event includes provision for the recovery of foregone revenue. Key to our consideration of this event are the appropriate allocation of risk between ActewAGL and its customers, and the incentives that would flow from a pass through event that allowed ActewAGL to recover amounts unpaid by a failed retailer directly from its customers.

We have considered the following options available to ActewAGL to manage its exposure in a RoLR event, and to recover unpaid charges from the existing retailer:

- ActewAGL can and should make use of credit support arrangements under Part 21 of the NGR to limit its exposure to credit risk
- Should a retailer become insolvent, ActewAGL can and should pursue recovery of debts through the insolvency process under the *Corporations Act 2001 (Cth)*

[42] ActewAGL Distribution, *2016–21 Access arrangement information – Attachment 13: reference tariff variation mechanism*, p. 30.

- Where a RoLR event occurs and the failed retailer is not insolvent, ActewAGL can and should pursue recovery of debts directly from that retailer
- ActewAGL has not demonstrated any residual risk is uninsurable, such that it would be appropriate for consumers to insure ActewAGL against this risk rather than ActewAGL.

A pass through event that operates in addition to rule 531 of the NGR and allows the recovery of some or all revenue foregone in a RoLR event would weaken ActewAGL's incentives to pursue these options. There are means to recover the amounts owed from the relevant retailer. We do not consider it appropriate for ActewAGL to have consumers fund the unrecovered amounts.

We therefore do not accept that foregone revenue should be included in the costs that can be claimed under this pass through event. Our preferred definition refers to costs, and not the revenue impact ActewAGL sustains or will sustain as a result of amounts unpaid as a result of the RoLR event.

We note if a pass through event of this kind were to occur, in assessing ActewAGL's application to pass through costs, we would consider the efficiency of ActewAGL's decisions and actions in relation to the risk of the event. We would consider, amongst other things, the steps taken by ActewAGL to minimise the costs of this event. This gives ActewAGL an incentive to mitigate the risks associated with the event including through implementing practical risk minimisation strategies in its operations.

Application to non-retailer users

The arguments ActewAGL has raised in support of this event relate to RoLR processes triggered under the NERL. These are specific to energy retailers. However, its proposed definition of the Network User Failure Event refers to any User (not just users who are retailers), and does not reference the RoLR process.

Absent a RoLR event under the NERL, ActewAGL will not be required to perform its obligations under the NERL and the RoLR procedures to facilitate the transfer of customers in retail market systems. The costs of administering a RoLR event in accordance with those obligations do not arise.

Our preferred definition is therefore specific to the occurrence of a RoLR event as defined in section 122 of the National Energy Retail Law.

For the reasons above, we require ActewAGL to amend the definition of the network user failure event as follows:

> **Network User Failure Event**
>
> Network User Failure Event means the occurrence of an event where:
>
> (a) a Retailer of Last Resort (RoLR) Event as defined in section 122 of the National Energy Retail Law has occurred, and

(b) the Service Provider incurs costs in responding to the RoLR event in accordance with its obligations under the NERL, NERR, NGL or NGR (including Guidelines and procedures that are binding under those instruments), and

(c) the costs are not recoverable by the Service Provider under other provisions of the NERL, NERR, NGL or NGR as in force at the time of the event, including but not limited to rule 531 of the NGR and other pass through events in this Access Arrangement.

Note for the avoidance of doubt, in making a determination on a Network User Failure Event, the AER will have regard to, amongst other things, the extent to which the Service Provider has taken steps to minimise the costs associated with its responsibilities in a RoLR Event, both prior to, and after, the RoLR Event was triggered.

This definition is consistent with that approved for JGN.

11.4.2.7 Short Term Trading Market event

This pass through event was included in ActewAGL's current access arrangement, and would arise if ActewAGL participates in the Short Term Trading Market (STTM), resulting in changes to costs or services.

In its submission on ActewAGL's proposal, Origin Energy (Origin) suggested this event be removed for two reasons:[43]

- It is no longer necessary. Origin referred to the conclusions of AEMO's review of STTM operations in 2011–12 (after the commencement of the current access arrangement) that absent commitment from relevant jurisdictions it was more productive for STTM reviews to focus on the design and operation of existing hubs that the potential for new ones.
- Should the ACT government decide to implement an STTM hub in the ACT, this would require a regulatory change, and therefore be covered by the regulatory change event.

Our own assessment supports these views. There has been no work on establishing a Canberra hub over the past five years. Further, ActewAGL has not provided any evidence that a trading hub is likely to be developed in Canberra in the foreseeable future. This casts sufficient doubt about the relevance of the proposed STTM event to the ACT, Palerang and Queanbeyan distribution networks that we no longer consider it necessary for it to be considered a pass through event.

For these reasons we do not approve this event. We therefore require ActewAGL to amend its access arrangement to remove this event.

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[43] Origin Energy, *Submission on ActewAGL Distribution 2016–21 Access Arrangement Proposal for ACT*, 10 August 2015, p. 7.

11.4.2.8 Supply Curtailment event

This pass through event would allow ActewAGL to pass through costs in a situations where there is insufficient gas delivered to ActewAGL's network, due to reasons beyond ActewAGL's control. This was a pass through event in ActewAGL's 2010–15 access arrangement. In more recent decisions, including our decision on the access arrangement for JGN, we have rejected such events for the following reasons:

- Accepting a pass through event for gas shortfalls would weaken ActewAGL's incentives to properly mitigate the risk, and minimise the costs, of a gas shortfall. There are several potential risk mitigation strategies ActewAGL can undertake to help prevent a gas supply shortfall and minimise its costs in the event of one. ActewAGL is best placed to manage this risk and should not be permitted to pass the risk directly onto consumers.
- Adequate gas supply is fundamental to ActewAGL's business. Properly managing the risk of low supply is vital for ActewAGL to be an effective gas distributor. Therefore, we consider managing this risk is a typical business expense for ActewAGL, and should not be passed through to consumers.

This view is consistent with our decision in recent access arrangements.[44]

For the reasons above, we require ActewAGL to amend its access arrangement to remove this event.

11.4.2.9 General Pass Through event

The general pass through event would enable ActewAGL to recover costs from events unable to be forecast. This event was included in ActewAGL's 2010–15 access arrangement. Again, in more recent decisions—including our decision on the nominated pass through events that will apply to ActewAGL's electricity network—we have rejected such events for the following reasons.

We note ActewAGL's argument that it is in the long term interests of consumers for service providers to have the opportunity to recover at least efficient costs.[45] The accepted pass through events (discussed above) support this by providing ActewAGL with the opportunity to recover the costs of unforeseen, defined events, which we consider is in the long term interests of customers.

In contrast, the general pass through event cannot be clearly identified or defined. The exclusions from this event that ActewAGL has identified do not, of themselves, serve as a definition. The event proposed could still be triggered in a broad range of situations that cannot be clearly identified at this time. We consider that specifying the

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[44] AER, *Final decision: Jemena Gas Networks 2015–20, Attachment 11 – Reference tariff variation mechanism*, pp. 24–25.

[45] ActewAGL Distribution, *2016–21 Access arrangement information – Attachment 13: reference tariff variation mechanism*, June 2015, p. 23.

situations in which an otherwise undefined event may not apply does not, of itself, provide sufficient clarity or certainty about the application of an event.

Because the event cannot clearly identified, it is difficult to assess whether a prudent service provider could reasonably prevent an event of that nature occurring or substantially mitigate the cost impact of the event. It is also difficult to assess whether a service provider could insure or self-insure against such an event occurring. ActewAGL's proposal sought to address this by excluding from the general pass through event any event for which prevention or mitigation is possible, or against which ActewAGL can insure. This requires assessment of a largely unlimited range of situations against these criteria on an ex post basis—first by ActewAGL and then by us—after an event has occurred. We do not consider this provides sufficient certainty as to the potential application of the event. For the reasons above, we require ActewAGL to amend its access arrangement to remove this event.

11.4.3 Fixed principles for cost pass through events

ActewAGL has proposed a mechanism to allow the financial impact of an approved cost pass through event that occurs late in the 2016–21 access arrangement period to be addressed in the reference tariffs that apply in the next access arrangement period. It submitted that this mechanism (clause 7.16 of its proposed access arrangement) should be a fixed principle for both the 2016–21 access arrangement period and the next access arrangement period.[46]

Our recent decision for JGN rejected the application of a similar, fixed principle to future access arrangement periods. We considered that fixed principles for the next access arrangement period were appropriately considered together with other revisions that would apply in that period.[47]

ActewAGL submitted that its proposal:[48]

> …fixes the principle concerning the inter-period treatment of cost pass throughs so that a pass through event occurring within the 2016–21 access arrangement period can be recovered over both the 2016–21 access arrangement period and the subsequent 2021–26 access arrangement period.

ActewAGL argued that this addressed our concern. It does not. By making this treatment of inter-period pass throughs a fixed principle for 2021–26 as well as for 2016–21, ActewAGL has proposed that the same arrangement would also apply between 2021–26 and the subsequent period. We do not consider this appropriate.

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46 ActewAGL, *Access arrangement for the ACT, Queanbeyan and Palerang gas distribution network, 1 July 2016 - 30 June 2021*, June 2015, cll. 5.1(c), 7.16; *ActewAGL Distribution, 2016–21 Access arrangement information – Attachment 13: reference tariff variation mechanism*, June 2015, p. 30.

47 AER, *Final decision: Jemena Gas Networks 2015–20, Attachment 11 – Reference tariff variation mechanism*, p. 11-27.

48 ActewAGL *Distribution, 2016–21 Access arrangement information – Attachment 13: reference tariff variation mechanism*, June 2015, p. 31.

The application of this fixed principle in subsequent access arrangement periods is more appropriately considered as part of our consultation on ActewAGL’s proposals for those periods. This will allow consideration of this fixed principle to be revisited with the benefit of lessons learnt in the 2016–21 Access Arrangement period.

We approve ActewAGL's proposal that the principle in clause 7.16 be a fixed principle in respect of the 2016–21 access arrangement period. We do not approve its proposal that this also be a fixed principle in respect of the period that follows.

We therefore require ActewAGL to amend its access arrangement to provide that the principle in clause 7.16 is a fixed principle for the 2016–21 access arrangement period only.

11.4.4 Cost pass through application and approval process

ActewAGL has proposed that the application and decision process for pass through events under its access arrangement be aligned with that approved for JGN in June, to lower the administrative burden and regulatory complexity for ActewAGL and for us.

We support this alignment and are satisfied that the process thus proposed remains appropriate. We therefore approve this element of ActewAGL's proposal.

11.5 Revisions

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

Revision 11.1: Amend clause 7.4 and schedule 4 in the ActewAGL access arrangement to be consistent with Figure 11.1, Figure 11.2, Figure 11.3 and Figure 11.4.

Revision 11.2: Remove clause 7.5 in ActewAGL's access arrangement to reflect our draft decision that reference tariffs cannot be varied during a financial year to apply at a date prior to the start of the next financial year.

Revision 11.3: Replace the definitions of the following cost pass through events with those set out in section 11.4.2 of this attachment: regulatory change event, service standard event, insurance cap event, insurer credit risk event, terrorism event, natural disaster event, network user failure event.

Revision 11.4: Remove the following cost pass through events: short term trading market event, supply curtailment event, general pass through event.

Revision 11.5: Amend the access arrangement to provide that the principle in clause 7.16 is a fixed principle for the 2016–21 access arrangement period only.