DRAFT DECISION
Australian Gas Networks Access Arrangement 2016 to 2021

Attachment 11 - Reference tariff variation mechanism

November 2015

AUSTRALIAN ENERGY REGULATOR

Inquiries about this publication should be addressed to:

Australian Energy Regulator
GPO Box 520
Melbourne Vic 3001

Tel: (03) 9290 1444
Fax: (03) 9290 1457

Email: AERInquiry@aer.gov.au

Note

This attachment forms part of the AER's draft decision on Australian Gas Networks' 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

Attachment 9 - Efficiency carryover mechanism

Attachment 10 - Reference tariff setting

Attachment 11 - Reference tariff variation mechanism

Attachment 12 - Non-tariff components

Attachment 13 - Demand

Attachment 14 - Other incentive schemes

Contents

Shortened forms

Shortened form	Extended form
AA	Access Arrangement
AAI	Access Arrangement Information
AER	Australian Energy Regulator
ATO	Australian Tax Office
capex	capital expenditure
CAPM	capital asset pricing model
CCP	Consumer Challenge Panel
CESS	Capital Expenditure Sharing Scheme
CPI	consumer price index
CSIS	Customer Service Incentive Scheme
DRP	debt risk premium
EBSS	Efficiency Benefit Sharing Scheme
ERP	equity risk premium
Expenditure Guideline	Expenditure Forecast Assessment Guideline
gamma	Value of Imputation Credits
GSL	Guaranteed Service Level
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
NIS	Network Incentive Scheme
NPV	net present value
opex	operating expenditure
PFP	partial factor productivity
PPI	partial performance indicators
PTRM	post-tax revenue model
RBA	Reserve Bank of Australia

Shortened form	Extended form
RFM	roll forward model
RIN	regulatory information notice
RoLR	retailer of last resort
RPP	revenue and pricing principles
SLCAPM	Sharpe-Lintner capital asset pricing model
STPIS	Service Target Performance Incentive Scheme
TAB	Tax asset base
UAFG	Unaccounted for gas
WACC	weighted average cost of capital
WPI	Wage Price Index

11 Reference tariff variation mechanism

This attachment sets out the AER's consideration of the reference tariff variation mechanism proposed by Australian Gas Networks (AGN). 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 AGN's proposed reference tariff variation mechanism for the 2016–21 access arrangement period. We consider that some elements of AGN'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 identified in the overview attachment of this draft decision
- we do not accept definitions for certain parameters within the control and rebalancing mechanisms
- we do not accept AGN's reference tariff variation process
- we do not accept all of AGN's proposed pass through events.

We have also included in AGN's reference tariff variation mechanism adjustment factors to accommodate additional variations to reference tariffs with respect to:

- an approved cost pass through event
- price variations for gas required to meet unaccounted for gas obligations (UAFG price variations).

Our reasons for this decision are discussed below.

11.2 AGN's proposal

AGN proposed to retain a weighted average price cap for its haulage reference service for the 2016–21 access arrangement period.[1] But it proposed to:

- include annual X factor updates in the weighted average price cap to reflect the updated trailing return on debt approach adopted by us as part of the rate of return guideline
- change the timing by which it must submit its annual tariff variation mechanism proposal to the AER from 50 business days to at least 40 business days before those proposed tariffs are to come into effect.[2]

AGN sought to retain the existing approach of annually adjusting ancillary reference services charges by inflation only.[3]

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 distributor to recover (that is, pass through) the costs of defined unpredictable, high cost events.

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

Table 11.1 AGN'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: a) falls within no other category of Cost-Pass-Through Event; and b) occurs during the course of an access arrangement period; and c) affects the manner in which AGN provides reference services (as the case requires); and that d) materially increases or materially decreases the costs of providing those services.
Service Standard Event	'Service Standard Event' means: A legislative or administrative act or decision that a) has the effect of: i. varying, during the course of an access arrangement period,

1 AGN, *Access Arrangement Information*, July 2015, pp. 260–263.
2 AGN, *Access arrangement information*, July 2015, pp. 262–263.
3 AGN, *Access arrangement information*, July 2015, p. 263.

Proposed event	Proposed definition
	the manner in which AGN is required to provide a reference service; or ii. imposing, removing or varying, during the course of an access arrangement period, minimum service standards applicable to prescribed reference services; or iii. altering, during the course of an access arrangement period, the nature or scope of the prescribed reference services provided by AGN; b) materially increases or materially decreases the costs to AGN of providing prescribed reference services.
Tax Change Event	'Tax Change Event' means: A Tax Change Event occurs if any of the following occurs during the course of an access arrangement period for AGN: a) a change in a relevant tax, in the application or official interpretation of a relevant tax, in the rate of a relevant tax, or in the way a relevant tax is calculated; or b) the removal of a relevant tax; or c) the imposition of a relevant tax; and in consequence, the costs to AGN of providing prescribed reference services are materially increased or decreased.
Terrorism Event	A '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 materially increases the costs to AGN of providing a reference service.
Network User Failure Event	A 'Network User Failure Event' means: A network user failure event means the occurrence of an event whereby an existing network user becomes insolvent or is unable to continue to supply gas to its customers, and those customers are transferred to another network user, and which increases the costs of AGN providing reference services. No materiality threshold applies for this event.
Insurer Credit Risk Event	An 'Insurer Credit Risk Event' means: An event where the insolvency of the nominated insurers of AGN occurs, as a result of which AGN: a) incurs materially higher or lower costs for insurance premiums than those allowed for in the access arrangement; or b) in respect of a claim for a risk that would have been insured by AGN's insurers, is subject to a materially higher or lower claim limit or a materially higher or lower deductible than would have applied under that policy; or c) incurs additional costs associated with self-funding an insurance claim,

Proposed event	Proposed definition
	which would have otherwise been covered by the insolvent insurer.
Insurance Cap Event	An 'Insurance Cap Event' means: An event that would be covered by an insurance policy but for the amount that materially exceeds the policy limit, and as a result AGN must bear the amount of that excess loss. For the purposes of this Cost-Pass-Through Event, the relevant policy limit is the greater of the actual limit from time to time and the limit under AGN's insurance cover at the time of making this access arrangement. This event excludes all costs incurred beyond an insurance cap that are due to AGN's negligence, fault, or lack of care. This also excludes all liability arising from AGN's unlawful conduct, and excludes all liability and damages arising from actions or conduct expected or intended by AGN.
Significant Safety Event	'Significant Safety Event' means: Any flood, earthquake (or other natural disaster) or event, or series of events, that result in any part of the Network being damaged or posing an unacceptable risk to persons (but excluding those events for which external insurance or self-insurance has been included within AGN's forecast operating expenditure) that occurs during the forthcoming access arrangement period and materially increases the costs to AGN of providing reference services.
Security of Supply Event	'Security of Supply Event' means: Approval by AGN's Board to proceed with a proposal to undertake expenditure that would enhance the security of gas supply to consumers and which materially increases the costs to AGN of providing reference services.
Significant Extensions Event	'Significant Extension Event' means: Approval by AGN's Board to proceed with a proposal to reticulate a new town or area at a material cost to AGN.

Source: Australian Gas Networks SA,*Access Arrangement July 2015*, pp. 10–12.

11.3 AER's assessment approach

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

- must be designed to equalise (in present value terms):
  - forecast revenue from reference services over the access arrangement period, and
  - the portion of total revenue allocated to reference services for the access arrangement period.
- may provide for variation of a reference tariff:
  - in accordance with a schedule of fixed tariffs, or
  - in accordance with a formula set out in the access arrangement, or
  - as a result of a cost pass through for a defined event, or

- by the combination of two or more of these operations.[4]

A formula for varying reference tariffs may (for example) provide for variable caps on the revenue to be derived from a particular combination of reference services; or tariff basket price control; or revenue yield control; or a combination of all or any of these factors.[5] However, the reference tariff variation mechanism must give us adequate oversight and powers to approve reference tariff variations.[6]

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

- the need for efficient reference tariff structures
- the possible effects of the reference tariff variation mechanism on administrative costs
- the regulatory arrangements (if any) applicable to the relevant reference services before the commencement of the proposed reference tariff variation mechanism
- the desirability of consistency between regulatory arrangements for similar services
- any other relevant factor.[7]

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 AGN. 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 AGN's current access arrangement
- other recent gas distribution access arrangement decisions (and electricity determinations under the NER)
- consistency in approach across the provision of similar services.

We assessed the potential impact of AGN's proposal on incentives for pipeline operation in a manner consistent with the national gas objectives and with the revenue and pricing principles.[8] We also judged the implications of AGN's proposed reference tariff variation mechanism for effective risk management that would be in the long term interests of consumers of natural gas.

---

4 NGR, rr. 92(2), r. 97(1).
5 NGR, r. 97(2).
6 NGR, r. 97(4).
7 NGR, r. 97(3).
8 Including NGR, r. 97(3)(e).

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 agree 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 rule 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 that a preferable alternative exists.[9]

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,[10] while also providing effective incentives to promote economic efficiency.[11] It promotes a balance between the economic costs and risks for promoting efficient investment.[12]

We had regard to the criteria used by us in previous decisions[13] to assess pass throughs against both the NGO and the National Electricity Objective (NEO).[14] In 2012 these criteria were incorporated into the National Electricity Rules (NER) as nominated pass through event considerations. We consider that 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. [15]

The criteria to which we have had regard (as adopted by the AEMC as nominated pass through event considerations in the NER) are:[16]

> 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;

---

9 NGR, r. 40(3).

10 NGL, s. 24(2).

11 NGL, s. 24(3).

12 NGL, s. 24(6).

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

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

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

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

(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.

In assessing proposed pass through events we also consider whether it is good regulatory practice, in the context of a national regulatory framework, to achieve consistency across and between gas and electricity.[17] We will also consider whether the risk transferred to consumers via the pass through mechanism is appropriate.[18]

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 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.

---

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

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

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.[19] 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 AGN's proposed pass through events with the aim of achieving the right balance, in the long term interests of consumers.

11.3.2 Interrelationships

As mentioned above, pass through events are not the only mechanism in this decision by which AGN 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 AGN'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 AGN's proposed annual reference tariff variation formula complies in principle with r. 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.[20]

---

19 AMEC, *Cost pass through determination,* 2 August 2012, p. 18.

20 NGR, r. 92(2).

Reference tariff variation mechanism process

We accept AGN's proposal to apply a weighted average price cap as the tariff variation mechanism for haulage reference services to overall revenue from all reference tariffs, rather than applying to each tariff class individually. This application of the weighted average price cap tariff variation mechanism is consistent with its application by other gas distribution networks.

Nevertheless we do not accept AGN's proposal to change the timing by which it must submit its annual tariff variation mechanism proposal.

The Energy Consumers Coalition of South Australia submitted that a revenue cap may be a better tariff variation mechanism for the 2016–21 access arrangement period to 'insulate' AGN from changes in consumption levels from those forecast.[21] While we agree, a revenue cap approach transfers that consumption risk from AGN to its customers. This can have an effect on actual revenues earned and tariffs.

This occurs because under a revenue cap a decline in consumption will require an increase in tariffs, as allowed revenues are a function of tariffs multiplied by consumption. Therefore, we consider for the 2016–21 access arrangement period this consumption risk should be managed by AGN under a weighted average price cap and not its customers under a revenue cap.

The Consumers Coalition further was concerned that AGN has the potential to increase its allowed revenue through 'bias' tariff development under the weighted average price cap compared to a revenue cap.[22] However, we consider the potential for this 'bias' is significantly reduced through our thorough analysis of AGN's proposal—particularly its proposed opex, capex, rate of return and tariff structure.

Furthermore, we note there is limited evidence from the current access arrangement period to suggest AGN's tariff structures or the application of a weighted average price cap has allowed concerning levels of revenues. This is acknowledged by the Consumers Coalition noting that AGN's actual revenues has in most years of the current access arrangement period been below the allowed revenues established by the AER.[23]

All gas distributors in the national gas market are on weighted average price caps. We wish to ensure consistency in regulatory approach.

With respect to AGN's proposal to submit its tariffs to us at least 40 business days before their commencement, rather than 50 business days, we reject the proposition.

---

[21] Energy Consumers Coalition of South Australia, *Australian Energy Regulator: SA gas distribution reset - AGN application: A response by the Energy Consumers Coalition of South Australia*, August 2015, p. 73. (ECCSA, *SA gas distribution reset - AGN application*, August 2015.)

[22] ECCSA, *SA gas distribution reset - AGN application*, August 2015, p. 73.

[23] ECCSA, *SA gas distribution reset - AGN application*, August 2015, p. 73.

AGN's reasoning for the 40 business days is that it better accords with the timing of the release of the March quarter consumer price index (CPI) by the Australian Bureau of Statistics (ABS).[24] AGN notes the current 50 day time limit requires it to submit its tariff variation proposal prior to the release of the March quarter CPI. Therefore it must submit a revised proposal two weeks later to incorporate the then known March quarter CPI.

We concur this is administratively inefficient. But we are now adopting a December quarter CPI in place of March quarter, meaning that a 50 business day's submission now works without administrative headaches.[25] Only one tariff variation will now be required. We note this approach is consistent with the timing of CPI escalation for other gas distribution networks such as ActewAGL and Jemena Gas Networks (New South Wales).

Moreover, Origin Energy stated it takes retailers approximately six weeks to incorporate changes to network tariffs into their systems and give adequate notice to stakeholders.[26] Our change ensures this can happen.

Annual haulage reference tariff variation formula

AGN's proposed annual haulage weighted average price cap formula is consistent with that applied in the current access arrangement. Nevertheless, we have made amendments to the formula to include adjustment factors for:

- an approved cost pass through event
- unaccounted for gas price variations.

Including an adjustment factor to accommodate reference tariff adjustments for approved cost pass through events is a simple and transparent method for cost recovery and pass through to customers. This approach mimics the application for other gas distribution networks.

The reasons for including the reference tariff adjustment for unaccounted for gas price variations is discussed in detail in our draft decision attachment 7—operating expenditure.

As noted above, we have also changed the definition of the CPI escalation factor to accommodate the change in timing.

We have also made amendments to some of the adjustment factor definitions for consistency with other gas distribution networks and transparency. These modifications are purely presentational and have not altered the application of the adjustment factor.

---

[24] AGN, *Access arrangement information*, July 2015, p. 262.

[26] Origin Energy, *Submission on Australian Gas Networks (South Australia) access arrangement proposal 2016–21*, 10 August 2015, p. 7.

Figure 11.1 Annual haulage reference tariff variation formula

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

where:

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.

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

U_t is the adjustment factor to accommodate unaccounted for gas price variations as outlined below

PT_t is the cost pass through factor 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)).

AGN's annual haulage reference tariff variation formula is subject to the rebalancing formula set out in Figure 11.2. The rebalancing control formula is consistent with that proposed by AGN but amended to include the adjustment factors for cost pass throughs and price variations for unaccounted for gas.

Figure 11.2 Rebalancing control formula

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

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.

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

U_t is the adjustment factor to accommodate unaccounted for gas price variations as outlined below

PT_t is the cost pass through factor 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)).

Adjustment factor to accommodate unaccounted for gas price variations

We have included in the haulage reference tariff variation mechanism formula an adjustment factor to accommodate price variations in unaccounted for gas. The formula for this adjustment factor is set out in Figure 11.3.

Figure 11.3 Adjustment factor to accommodate price variations in unaccounted for gas

$$U_t = \frac{(1+U'_t)}{(1+U'_{t-1})} - 1$$

where:

U_{t-1} is:

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

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

$$U'_t = \frac{DP_{t-2}(1+realWACC_t)^2(1+CPI_{t-1})}{(1-X_t)\sum_{i=1}^{n}\sum_{j=1}^{m} p_{t-1}^{ij} q_{t-2}^{ij}}$$

where:

DP_{t-2} is the difference between the actual unaccounted for gas price and the forecast unaccounted for gas price calculated as:

$$DP_{t-2} = \frac{UP_{t-2}FQ_{t-2}}{FP_{t-2}FQ_{t-2}}$$

where:

UP_{t-2} is the actual price for unaccounted for gas as calculated as the sum of retail gas prices for wholesale, maximum daily quantity (MDQ) and transmission gas in financial year t-2[27]

FP_{t-2} is the price used to forecast the unaccounted for gas allowance in financial year t-2 and is as set out in Table 11.2

FQ_{t-2} is the quantity used to forecast the unaccounted for gas allowance in financial year t-2 and is as set out in Table 11.2

Table 11.2 Forecast price and quantities used to determine the unaccounted for gas allowance in AGN's allowed revenues

	2016–17	2017–18	2018–19	2019–20	2020–21
Forecast price for unaccounted for gas (FP) $/GJ	8.69	9.82	10.44	10.44	10.44
Forecast quantity of unaccounted for gas (FQ)	1205	1153	1110	1070	1035

CPI_{t-1} is the annual percentage change in the ABS CPI All Groups, Weighted Average of Eight Capital Cities from the December quarter in year t-3 to the December quarter in year t-2, calculated using the following method:

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

divided by

The ABS CPI All Groups, Weighted Average of Eight Capital Cities for the December quarter in financial year t-3

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.

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

[27] The wholesale gas price is the market price of gas realised by the supplier to produce and deliver gas into the transmission pipeline. This is the price for flat load gas production. The MDQ price is the cost of production to deliver maximum daily supply capacity to meet peak customer demand during the winter heating season. The transmission price is the cost of transporting gas along the transmission pipeline from the supply source to the distribution network. This includes base load and an additional load factor for maximum daily quantity MDQ capacity allowance.

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

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.

Pass through factor formula

We have included in the haulage reference tariff variation mechanism formula a pass through factor, consistent with that we have applied to other gas distribution networks' access arrangements. Inclusions of an adjustment factor to accommodate reference tariff adjustments on account of approved cost pass through events enables a simple and transparent method for cost recovery and pass through to customers. The pass through adjustment factor formula is set out in Figure 11.4.

Figure 11.4 Pass through adjustment 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

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

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 term is defined in the access arrangement applying to AGN in the immediately prior access arrangement period) occurring in the 2011–16 access arrangement period that AGN 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 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 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

U_t is the adjustment factor to accommodate price variations in unaccounted for gas 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.

Annual ancillary reference tariff variation formula

We accept the proposed annual ancillary reference tariff variation formula which is consistent with that of the current access arrangement. However, we have changed

the definition of the CPI escalation to be consistent with that applied in the WAPC. Our draft decision ancillary reference tariff variation formula is set out in Figure 11.5.

Figure 11.5 Ancillary reference tariff variation formula

$$ART_t = ART_{t-1} \times (1 + CPI_t)$$

where:

ART_t is the reference tariff that will apply to an ancillary reference service in year t

ART_{t-1} is the reference tariff applicable to an ancillary reference service in year t-1

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.

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 AGN's proposed regulatory change event as currently defined, and requiring amendments to the definition
- not approving AGN's proposed service standard event as currently defined, and requiring amendments to the definition
- not approving AGN's tax change event as currently defined, and requiring amendments to the definition of 'relevant tax' for the purposes of this event
- not approving AGN's proposed terrorism event as currently defined, and requiring amendments to the definition
- not approving AGN's proposed network user failure event as currently defined, and requiring amendments to the definition
- not approving AGN's proposed insurer credit risk event as currently defined, and requiring amendments to the definition

- not approving AGN's proposed insurance cap event as currently defined, and requiring amendments to the definition
- not approving the significant safety event
- not approving the security of supply event
- not approving the significant extension event

As set out below we have taken into account the considerations discussed in section 11.3.1 in assessing the pass through events proposed by AGN.

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 AGN proposed. For the reasons below, we require amendments to the definitions of these events to better reflect the NGO.

These events allow AGN 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 of pass through, the nature or type of event can be clearly identified and AGN 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 form 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]

AGN's proposed definition of these events is consistent with that in its current access arrangement. However, we consider it preferable that these events be defined consistently with those approved by us in more recent decisions, and with the equivalent event that applies to electricity network businesses under the NER. The latter were developed by the AEMC to achieve consistency with the NEO. The NEO and NGO are sufficiently similar that a regulatory change or service standard event that is consistent with the NEO will also be 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.[30]

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

---

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

[29] NER, cl. 6.5.10.

[30] NGR, r. 97(3)(d).

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 AGN 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 AGN 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 AGN; and

(b) materially increases or materially decreases the costs to AGN of providing the Reference Service.

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*. '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 for both 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 clause 4.5 of the AA.

We consider this amendment preferable to those proposed by AGN, and consistent with the NGO and NGR. It provides consistency with equivalent event that applies to electricity network businesses under the NER, developed by the AEMC to achieve consistency with the NEO. The NEO and NGO are sufficiently similar that they will serve the same purpose here.

11.4.2.2 Tax Change Event

A tax change event would allow AGN to pass through costs resulting from the change, removal or imposition of a relevant tax. We propose to accept this event, as defined by AGN.

Changes to the regulatory framework are outside the control of service providers. A service provider's ability to mitigate the cost impacts of such an event is also limited. AGN's proposed definition is consistent with the definitions approved in recent decisions by the AER.

The purpose of the cost pass through mechanism is to offer protection to service providers, from uncontrollable events that impact on the costs to the business. It is not intended to recover all costs a business would otherwise be expected to absorb. The AER considers, in general, cost pass through events should only apply where the event has a material impact on costs. Events that have a small or non-material impact on costs should be considered to be part of the general costs and risks of doing business and service providers should not be able to pass them on.

We accept the definition of 'Tax Change Event' proposed by AGN:

> **Tax Change Event**
>
> A Tax Change Event occurs if any of the following occurs during the course of an access arrangement period for AGN:
>
> (a) a change in a Relevant Tax, in the application or official interpretation of a Relevant Tax, in the rate of a Relevant Tax, or in the way a Relevant Tax is calculated; or
>
> (b) the removal of a Relevant Tax; or
>
> (c) the imposition of a Relevant Tax; and
>
> in consequence, the costs to AGN of providing prescribed reference services are materially increased or decreased.

However, we require AGN to amend the proposed supporting definition of 'Relevant Tax' as it applies to this event, to incorporate exclusions equivalent to those that apply to this event under the NER. Specifically, we require AGN to amend its access arrangement to explicitly exclude from the Tax Change Event:

(a) income tax and capital gains tax;

(b) stamp duty, financial institutions duty and bank accounts debits tax;

(c) penalties, charges, fees and interest on late payments, or deficiencies in payments, relating to any tax; or

(d) any tax that replaces or is the equivalent of or similar to any of the taxes referred to in paragraphs (a) to (b) (including any State equivalent tax).

11.4.2.3 Terrorism Event

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

We note if a pass through event of this kind were to occur, in assessing AGN's application to pass through costs, we will consider the efficiency of AGN's decisions and actions in relation to the risk of the event. We would consider, amongst other things, whether AGN has insurance for the event, the level of insurance 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. This gives AGN an incentive to mitigate the risks associated with the event including through acquiring an appropriate level of insurance and implementing other practical risk minimisation strategies in its operations. We consider inclusion of these factors in the definition of the Terrorism event is important as they provide transparency and increase regulatory certainty around how we will assess an application for this event.

We note there may be some overlap between a terrorism event and an insurance cap event. However, we accept the case for having both because AGN may incur costs in a terrorism event that an insurance policy would not ordinarily cover.

We therefore require AGN to amend its 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 AGN of providing the Reference Service.
>
> Note for the avoidance of doubt, in making a determination on a Terrorism Event pursuant, the AER will have regard to, amongst other things:
>
> i. whether AGN 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.

11.4.2.4 Network User Failure Event

The network user failure event covers costs incurred by AGN when a user becomes insolvent or is unable to supply gas to its customers. This pass through event was approved in AGN's current access arrangement, prior to the commencement of the National Energy Customer Framework in South Australia. AGN has not considered the implications of this in its proposal, and has not made arguments to support the continued availability of its network user failure event beyond noting that it has applied in previous periods.

We consider including a network user failure event in AGN's 2016–21 Access Arrangement would, if appropriately defined, support the NGO and the RPP. However, for the reasons set out below, we do not accept AGN's definition of this event and require amendments to reflect changes in the NGR and the introduction of the NERL.

The primary costs incurred by AGN as a result of a retailer becoming insolvent are now covered by retailer of last resort (RoLR) provisions, including section 167 of the National Energy Retail Law (NERL) and rule 531 of the NGR. This places AGN in a stronger position to manage the risks and mitigate the costs of network user failure within its business than it was in the current period. We have accepted in recent decisions that these provisions may only provide partial relief to AGN in certain circumstances of retailer failure.

First and foremost, AGN's proposed definition duplicates the protections provided by the NERL and NGR. This is no longer appropriate.

AGN's proposed definition applies to any network user, but the risk that it will be required to transfer customers from one user to another is specific to the failure of an authorised retailer. The definition should be narrowed accordingly.

AGN's proposal does not clearly identify the nature of the costs it seeks to recover. In recent decisions,[31] for example, we have approved pass through events that allow the service provider to pass through the costs of administering a retailer of last resort (RoLR) event where upfront investment in systems to support automated transfers is not prudent or efficient given the low likelihood of the event. We have not approved the recovery of foregone revenue, which we consider is a risk that AGN is best placed to manage. For example:

- AGN 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, AGN can and should pursue recovery of debts through the insolvency process under the Corporations Act 2001 (Cth)
- Where a RoLR event occurs and the failed retailer is not insolvent, AGN can and should pursue recovery of debts directly from that retailer

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

- AGN has not demonstrated any residual risk is uninsurable, such that it would be appropriate for consumers to insure AGN against this risk rather than AGN.

AGN's proposed definition removes the application of the materiality threshold that applies to other pass through events under its access arrangement. This is consistent with its current access arrangement, but inconsistent with our more recent decisions on this issue. The cost pass through mechanism is intended to enable costs that have a material impact on the business to be passed through to consumers. A materiality threshold provides a benchmark against which the cost impact is measured, relative to the revenue allowed AGN under this draft decision. Over a five year access arrangement period it is likely that many events will occur which add to or subtract from AGN's costs. We consider costs less than the materiality threshold reflect the risks associated with normal business operations, and should not be the subject of a pass through application.

For the reasons above we do not accept AGN's proposed network user failure event.

We require AGN to amend its access arrangement to remove this event.

Should AGN pursue this issue in its revised proposal, we direct its attention to the definition of the Network User Failure Event approved in our recent decision on the access arrangement for Jemena Gas Networks (NSW) Ltd, and in our draft decision on ActewAGL's proposed network user failure event, released concurrently with this decision (below). Origin Energy also submitted that the network user failure event we approved in June for Jemena Gas Networks (NSW) Ltd (JGN) could replace AGN's proposed definition, as its specific reference to RoLR and the NERL improve the clarity of the definition and allows greater consistency across networks.[32]

> **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

[32] Origin Energy, *Submission on AGN 2016–21 Access Arrangement Proposal for its SA Gas Distribution Network*, 10 August 2015, p. 7.

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.

11.4.2.5 Insurer Credit Risk Event

This event was included in AGN's current access arrangement, and is intended to provide for circumstances in which an insurance provider becomes insolvent and, as a result, AGN:

- incurs materially 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.

AGN can, and should, take precautions to mitigate to an insurer credit risk event, for example by investigating market development, insurer reputation and credit rating and financial stabilities of potential insuring entities.

Despite these efforts, however, an insurer may fail and leave AGN 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.

AGN's proposed insurer credit risk event is broader in two respects than that we have approved in recent decisions.

First, in its proposed definition for this event, AGN sought to include provision for it to pass through costs associated with changes to insurance premiums as a result of an insurer becoming insolvent. 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.[33]

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, AGN's proposed 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 AGN's proposed definition of this event, and require it to amend the definition of its insurer credit risk event as follows:

---

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

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, 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.

11.4.2.6 Insurance Cap Event

The insurance cap event allows AGN to make a pass through application if it makes a claim under an insurance policy, and the actual costs to AGN exceed its policy limit.

Insurance is funded through AGN's approved forecast operating expenditure (opex), which allows AGN to acquire and maintain an appropriate level of insurance coverage. We expect AGN to acquire prudent and efficient levels of insurance coverage commensurate with its business risk, as reflected in its approved forecast opex.

We accept an insurance cap event would protect AGN 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 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 AGN's 2016–21 Access Arrangement is consistent with the NGO and RPP. However, the definition of the insurance cap event in AGN's current access arrangement, which it proposed be retained, differs to the definition of this event we have approved in more recent decisions.

There are two key differences between our preferred definition and that proposed by AGN.

First, our preferred definition measures the amount that can be passed through against the greater of the level of insurance AGN 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 AGN'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 AGN's approved opex, which allows AGN 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 AGN to acquire prudent and efficient levels of insurance coverage commensurate with its business risk, as reflected in its approved forecast opex.

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 AGN'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 decisions, we therefore consider this definition preferable to that proposed by AGN, and consistent with the NGO and NGR.

We therefore require AGN to amend the definition of the insurance cap event as follows:

> **Insurance Cap Event**
>
> Insurance Cap Event means an event where:
>
> i. the Service Provider makes a claim or claims and receives the benefit of a payment or payments under a relevant insurance policy;
>
> ii. the Service Provider incurs costs beyond the relevant policy limit; and

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.

11.4.2.7 Significant Safety Event

In its current access arrangement, AGN has a natural disaster event:

> Any major fire, flood, earthquake, or other natural disaster beyond the control of AGN (but excluding those events for which external insurance or self-insurance has been included within AGN's forecast operating expenditure) that occurs during the forthcoming access arrangement period and materially increases the costs to AGN of providing reference services.

AGN has proposed an expansion of this event, to cover other situations that may not be covered as a natural disaster, but are outside its control and may require significant action by AGN to remedy. AGN's proposed significant safety event would allow AGN to recover costs arising from a natural disaster event, but also from any other event (or series of events) that result in any part of the network being damaged or posing an unacceptable risk to persons. The pass through event excludes incidences where external insurance or self-insurance has been included within AGN's forecast operating expenditure (opex).

The Acting Minister for Mineral Resources and Energy submitted that the amended definition should maintain current text which makes it clear that any event is beyond AGN's control.[34] Similarly, Origin Energy suggested that, should we approve the amended event, the definition should also be limited to events that are outside the direct control of AGN and cannot be attributed any party.[35]

However, it remains extremely broad. It appears to encompass a wide variety of events, including events caused by the negligence on the part of AGN and its associated entities. It could also be read to encompass events and risks more appropriately considered under the banner of asset management, and managed by AGN through its approved opex and capital expenditure (capex). For example, in its proposal for this period AGN has included forecast expenditure for a significant program of asset inspection, and asset replacement to address safety issues.

The Energy Consumers Coalition of SA (ECCSA) did not support this change, and considers it 'removes from AGN any responsibility for damage limitation and ensuring its insurance is adequate'.[36] The ECCSA also observed that its members are not indemnified from such events, and questioned why gas consumers should be asked to indemnify AGN from this risk.[37]

We consider AGN is appropriately placed to mitigate the likelihood or impacts of the additional events it seeks to incorporate through its proposed significant safety event. A prudent and efficient service provider can and should take reasonable steps to reduce the risk of such events and mitigate their impact.

For the reasons above we do not approve AGN's proposed significant safety event. We require it to amend its access arrangement to remove this event.

Should AGN choose to pursue this matter in its revised proposal, we direct its attention to the definition of the natural disaster event approved in our draft decision on ActewAGL's proposed network user failure event, released concurrently with this decision:

> **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.

---

34 A/Minister for Mineral Resources and Energy, *Submission on the Australian Gas Networks (AGN) (SA) Access Arrangement 2016–2021*, 21 August 2015, p. 8.

35 Origin, *Submission on AGN 2016–21 Access Arrangement Proposal for its SA Gas Distribution Network,* 10 August 2015, p. 7

36 ECCSA, *Australian Energy Regulator SA Gas Distribution Revenue Reset AGN Application response,* 16 August 2015, p. 72.

37 ECCSA, *Australian Energy Regulator SA Gas Distribution Revenue Reset AGN Application response,* 16 August 2015, p. 72.

> 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.

11.4.2.8 Security of Supply Event

A security of supply event would enable AGN to pass through costs of new proposals approved by AGN's Board that would enhance the security of gas supply to customers and which materially increases the costs to AGN of providing reference services. While not included in its proposed definition of this event, AGN has offered, if required, to submit a business case for such proposals for our approval.

In providing evidence to support its argument for a nominated security of supply event, AGN provided examples of:

- a 2015 gas outage, which was the result of a fault on the upstream gas transmission pipeline owned by Epic Energy. AGN utilised gas trucked in from Victoria in order to maintain a minimum safe level of gas supply
- a 2012 gas outage, which was the result of third party damage to a key supply main, and
- a 2008 gas outage, which was a result of an upstream failure of the AGN network.[38]

AGN advised that, *following the most recent outage* (in April 2015), it has initiated a program of work to identify where actions can be taken on the network to improve the security of supply. It has submitted that it "is not in a position to incorporate the security of supply initiatives in its Revised [Access Arrangement] Proposal given the time taken to properly scope out those projects that would satisfy the relevant requirements of the NGR".[39]

The Acting Minister for Mineral Resources and Energy noted that, in large part, the Government's concern with this proposed event is with the insufficient definition of the event. The Minister's submission noted the need for further clarity around the scope of

---

[38] Australian Gas Networks SA, *Access Arrangement Information July 2015*, p. 265.

[39] Australian Gas Networks SA, *Access Arrangement Information July 2015*, p. 265.

the proposal which, it was suggested, should be limited to recovery of funds for an identified project.[40]

The ECCSA submitted that this proposal was not acceptable, first because the discretion lies with AGN exclusively, and secondly that these are risks that AGN has taken through being a service provider with obligations to ensure there is security of supply.[41] Origin made a similar submission, and did not support this event as improving security of supply is standard business for AGN.[42] Where there is a strong case for a particular supply solution, Origin considered this should be progressed. However, it did not consider a pass through event for this purpose appropriate as improving security of supply is a standard function of the network and should form part of the access arrangement.[43]

We agree with AGN that it is in the long term interests of consumers to investigate and implement prudent and efficient security of supply solutions. We do not, however, consider that this is appropriately managed through the cost pass through mechanism. Security of supply is a business risk that AGN is best placed to manage, and is not one that should be transferred to customers through the pass through mechanism.

The first incident cited by AGN in support of its proposal occurred in May 2008, just over two years prior to the submission of the access arrangement for its current, 2011–16 access arrangement. The second occurred less than one year into the current period, and just over three years prior to submission of the proposal we are now considering. There was ample opportunity prior to the April 2015 incident for AGN to have investigated and implemented prudent and efficient supply solutions. Any expenditure to be incurred in the 2016–21 period could then have been considered—as it should—as part of our public consultation on, and assessment of, AGN's proposed capex and opex for that period.

The Minister's submission suggested we consider whether a cap on the proposed event was appropriate.[44]After submission of its proposal on 1 July 2015 AGN indicated that it would be willing to include a cap at a level of $10 million in total for this event, over five years.[45] We do not consider a cap on the amount recoverable addresses the concerns raised above. The limited assessment of an application under the cost pass through mechanism should not be considered an alternative avenue for approval of

---

40 A/Minister for Mineral Resources and Energy, *Submission on the Australian Gas Networks (AGN) (SA) Access Arrangement 2016-2021*, 21 August 2015, p. 7.

41 ECCSA, *Australian Energy Regulator SA Gas Distribution Revenue Reset AGN Application response,* 16 August 2015, p. 72.

42 Origin Energy, *Submission on AGN 2016–21 Access Arrangement Proposal for its SA Gas Distribution Network*, 10 August 2015, p. 7.

43 Origin Energy, *Submission on AGN 2016–21 Access Arrangement Proposal for its SA Gas Distribution Network*, 10 August 2015, p. 8.

44 A/Minister for Mineral Resources and Energy, *Submission on the Australian Gas Networks (AGN) (SA) Access Arrangement 2016–2021*, 21 August 2015, p. 8.

45 AGN, *Five year plan for the South Australian Natural Gas Distribution Network - presentation to AER Board*, 13 August 2015.

expenditure where a service provider is unable to submit a proposal that satisfies the requirements of the NGR by the review commencement date.

For the reasons above, we do not approve AGN's security of supply event. We require AGN to amend its access arrangement to remove this event.

11.4.2.9 Significant Extension Event

A significant extension event would allow AGN to pass through costs if there has been approval by AGN's Board to proceed with a proposal to reticulate a new town or area at a material cost to AGN.

AGN has noted its commitment to investigating and evaluating opportunities to supply gas to new areas.[46] It submitted that these extensions may arise during the access arrangement period, and as such, AGN cannot forecast with certainty a significant extension at the time its proposal is prepared. AGN believes this should not inhibit the development or implementation of projects and proposes a pass through event should be in place to facilitate significant extensions.

While not opposed to the intention of this cost pass through, the Minister's submission noted the Government's view that it is not clear what the scope of the proposed pass through is, and that more work is required on the definition of the event and its parameters.[47]

The ECCSA expressed concern that AGN was seeking for its Board to decide that existing customers should underwrite the extensions to the network that the AGN Board consider is needed. It argued that any expansion needs to be prudent and efficient, and that where it is so it will be rolled into the capital base. The ECCSA submitted it was inappropriate to seek a pass through that would override the need for assessment of prudency and efficiency.[48]

Origin did not support the proposed event, and also considered forecasting significant extensions a standard function of the network and an integral element of the access arrangement. It expressed concern that inclusion of this event would effectively allow AGN to bypass the access arrangement process. [49] Like the ECCSA, Origin noted the desirability of an ex ante review including a thorough examination of the prudency of the expansion and associated costs to confirm that a significant expansion was in the long term interest of consumers.[50] The Minister and Origin Energy suggested

---

46 Australian Gas Networks SA, *Access Arrangement Information July 2015*, p. 266.

47 A/Minister for Mineral Resources and Energy, *Submission on the Australian Gas Networks (AGN) (SA) Access Arrangement 2016–2021,* 21 August 2015, p. 7.

48 ECCSA, *Australian Energy Regulator SA Gas Distribution Revenue Reset AGN Application response*, 16 August 2015, p. 73.

49 Origin Energy, *Submission on AGN 2016–21 Access Arrangement Proposal for its SA Gas Distribution Network*, 10 August 2015, p. 8.

50 Origin Energy, *Submission on AGN 2016–21 Access Arrangement Proposal for its SA Gas Distribution Network*, 10 August 2015, pp. 8–9

respectively that, if this event were approved, we should consider a cap (for example on customer numbers)[51] or a demand-based threshold as a trigger.[52]

We do not consider costs relating to significant extensions of AGN's network should be treated as a pass through event. While infrequent, significant extensions to the network are not unpredictable or uncontrollable. AGN's proposal outlines a number of investigations AGN is currently conducting about developing its network. It has put, however, that the need for further expansions may arise during the access arrangement period. As we have noted above in our consideration of the proposed security of supply event, the limited assessment of an application under the cost pass through mechanism should not be considered an alternative avenue for approval of expenditure where a service provider is unable to submit a proposal that satisfies the requirements of the NGR by the review commencement date. Such expenditure should be considered as part of our public consultation on, and assessment of, AGN's proposed capex and opex for an access arrangement period.

11.4.3 Factors relevant to decisions on cost pass through event variations

Clause 4.5 of AGN's proposed access arrangement lists certain matters we must take into account in making our decision on whether to approve an application for a cost pass through event variation.

These include that:

- the costs to be passed through are for the delivery of network services;
- the costs are incremental to costs already allowed for in reference tariffs;
- the total costs to be passed through are building block components of total revenue;
- the costs to be passed through meet the relevant National Gas Rules criteria for determining the building block for total revenue in determining reference services;
- any other factors the AER considers relevant and consistent with the NGR and NGL.

While captured under the last of these (as another factor we consider relevant and consistent with the NGL and NGR), we consider it preferable that this list explicitly include the efficiency of AGN's actions in relation to the risk of the event occurring and the magnitude of costs incurred as a result of the event.

---

[51] A/Minister for Mineral Resources and Energy, *Submission on the Australian Gas Networks (AGN) (SA) Access Arrangement 2016–2021*, 21 August 2015, p. 8.

[52] Origin Energy, *Submission on AGN 2016–21 Access Arrangement Proposal for its SA Gas Distribution Network*, 10 August 2015, p. 8.

We therefore require AGN to amend its access arrangement to add the following factor to the list in clause 4.5:

- the efficiency of AGN's decisions and actions in relation to the risk of the Relevant Pass Through Event occurring, including whether AGN has failed to take any action that could reasonably be taken to reduce the magnitude of the costs incurred as a result of the Relevant Pass Through Event and whether AGN has taken or omitted to take any action where such action or omission has increased the magnitude of the costs.

This also provides consistency with the access arrangement approved for AGN's Victorian network, which includes this consideration.[53]

11.5 Revisions

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

Revision 11.1: Amend clause 4.4 and Annexure E in the AGN access arrangement to be consistent with Figure 11.1, Figure 11.2, Figure 11.3, Figure 11.4 and Figure 11.5.

Revision 11.2: Amend clause 4.6.1 in the AGN access arrangement to reflect our draft decision that the tariff variation notification will be submitted 50 business days before the date of implementation.

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, tax change event, terrorism event, network user failure event, insurer credit risk event, insurance cap event.

Revision 11.4: Remove the following cost pass through events: significant safety event, security of supply event, significant extension event.

Revision 11.5: Amend clause 4.5 of the AGN access arrangement to add the following factor:

the efficiency of AGN's decisions and actions in relation to the risk of the Relevant Pass Through Event occurring, including whether AGN has failed to take any action that could reasonably be taken to reduce the magnitude of the costs incurred as a result of the Relevant Pass Through Event and whether AGN has taken or omitted to take any action where such action or omission has increased the magnitude of the costs.

[53] *Access Arrangement for Envestra's Victorian Gas Distribution System 2013–2017*, April 2013, cl. 4.5(e)