



FINAL DECISION
ActewAGL Distribution
Access Arrangement
2016 to 2021

**Attachment 11 – Reference
tariff variation mechanism**

May 2016

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Note

This attachment forms part of the AER's final decision on the access arrangement for ActewAGL Distribution for 2016–21. It should be read with all other parts of the final decision.

The final 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

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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
CMF	construction management fee
CPI	consumer price index
DAMS	Distribution Asset Management Services
DRP	debt risk premium
EBSS	Efficiency Benefit Sharing Scheme
ECM	Efficiency Carryover Mechanism
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 our final decision on the reference tariff variation mechanism in ActewAGL's amended access arrangement proposal for its ACT gas distribution network for the 2016 to 2021 access arrangement period.

The proposed reference tariff variation mechanism includes:

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

11.1 Final decision

We accept some, but not all, elements of the reference tariff variation mechanism in ActewAGL's revised access arrangement proposal.

We have revised the access arrangement having regard to our reasons for refusing to approve ActewAGL's proposal and the further matters identified in the NGR section 64(2).

Our revisions are reflected in 7.4, 7.5, 7.6, 7.18(d), 7.19, 7.26, 7.27, 7.28, Schedule 1 clause 1.1 and Schedule 4 of the Approved ActewAGL Distribution Access arrangement for the ACT, Queanbeyan and Palerang gas distribution network 1 July 2016-30 June 2021, which gives effect to this decision.¹

11.1.1 Annual reference tariff variation mechanism

We do not accept ActewAGL's proposed annual reference tariff mechanism.

Our final decision is that amendments to the following elements of the reference tariff variation mechanism are preferable to ActewAGL's proposal and comply with the National Gas Law (NGL) and National Gas Rules (NGR):

- Amend clause 7.4, 7.18(d) and Schedule 4 in the ActewAGL access arrangement to be consistent with figure 11.1, 11.2, 11.3 and 11.4 in Attachment 11 of our Final Decision
- Delete clauses 7.5, 7.19, 7.26, 7.27 and 7.28 in the ActewAGL access arrangement.

Our reasons for this decision are set out in section 11.4.1.

¹ AER, *Approved ActewAGL Distribution Access arrangement for the ACT, Queanbeyan and Palerang gas distribution network 1 July 2016-30 June 2021*, May 2016.

11.1.2 Cost pass through events

We approve seven of the nine pass through events in ActewAGL's revised proposal, with the definitions set out in Table 11.1 below. In most cases we have amended the definition proposed by ActewAGL for the reasons set out in this attachment.

Table 11.1 Approved pass through events

Cost pass through event	Definition
Regulatory change event	<p>A change in a regulatory obligation or requirement that:</p> <ul style="list-style-type: none"> (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 ActewAGL provides the Reference Service; and (d) materially increases or materially decreases the costs of providing those services.
Service standard event	<p>A legislative or administrative act or decision that:</p> <ul style="list-style-type: none"> (a) has the effect of: <ul style="list-style-type: none"> (i) substantially varying, during the course of an access arrangement period, the manner in which ActewAGL is required to provide the Reference Service; or (ii) imposing, removing or varying, during the course of an access arrangement period, the 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 ActewAGL; and (b) materially increases or materially decreases the costs to ActewAGL of providing the Reference Service.
Insurance cap event	<p>Insurance Cap Event means an event where:</p> <ul style="list-style-type: none"> (a) ActewAGL makes a claim or claims and receives the benefit of a payment or payments under a relevant insurance policy; (b) ActewAGL incurs costs beyond the policy limit; and (c) the costs beyond the policy limit increase the costs to ActewAGL of providing the Reference Service. <p>For this Insurance Cap Event:</p> <ul style="list-style-type: none"> (d) 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 (e) ActewAGL will be deemed to have made a claim on a relevant

Cost pass through event	Definition
	<p>insurance policy if the claim is made by a related party of ActewAGL in relation to any aspect of the Network or ActewAGL's business</p> <p>Note in making a determination on an Insurance Cap Event, [the AER]* will have regard to, amongst other things:</p> <ul style="list-style-type: none"> (i) the insurance policy for the event (ii) the level of insurance that an efficient and prudent Service Provider would obtain in respect of the event, and (iii) any assessment by [the AER]* of ActewAGL insurance in approving the access arrangement for the relevant period.
Insurer credit risk event	<p>Insurer Credit Risk Event means an event where an insurer of ActewAGL becomes insolvent, and as a result, in respect of an existing, or potential, claim for a risk that was insured by the insolvent insurer, ActewAGL:</p> <ul style="list-style-type: none"> (a) 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 (b) incurs additional costs associated with self-funding an insurance claim, which would otherwise have been covered by the insolvent insurer. <p>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:</p> <ul style="list-style-type: none"> (i) ActewAGL'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 ActewAGL had reasonable opportunity to insure the risk with a different provider.
Terrorism event	<p>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:</p> <ul style="list-style-type: none"> (a) 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 (b) increases the cost to ActewAGL in providing the Reference Service.

Cost pass through event	Definition
	<p>Note for the avoidance of doubt, in making a determination on a Terrorism Event pursuant to clause 7.11 of this Access Arrangement, the AER will have regard to, amongst other things:</p> <ul style="list-style-type: none"> (i) whether ActewAGL 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 an act of terrorism has occurred.
Natural disaster event	<p>Natural Disaster Event means any natural disaster including but not limited to fire, flood or earthquake that occurs during the 2016–21 Access Arrangement Period that increases the costs to ActewAGL in providing the Reference Service, provided the fire, flood or other event was not a consequence of the acts or omissions of ActewAGL.</p> <p>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:</p> <ul style="list-style-type: none"> (i) whether ActewAGL has insurance against the event; and (ii) the level of insurance that an efficient and prudent service provider would obtain in respect of the event.
Network user failure event	<p>Network User Failure Event means the occurrence of an event where:</p> <ul style="list-style-type: none"> (a) a Retailer of Last Resort (RoLR) Event as defined in section 122 of the National Energy Retail Law has occurred, and (b) ActewAGL 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 ActewAGL 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. <p>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 ActewAGL 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.</p>

* In defining pass through events, ActewAGL's access arrangement uses the terms 'Relevant Regulator' and 'AER' interchangeably. For the purposes of our final decision on the pass through events that will apply under ActewAGL's 2016–21 access arrangement, we consider these terms have the same meaning.

We do not approve ActewAGL's proposed 'general pass through event' or 'supply curtailment event'.

We approve ActewAGL's proposed process for cross-period pass through events for the 2016–21 access arrangement period and the associated fixed principle.

11.2 ActewAGL's revised proposal

Our draft decision indicated the nature of the amendments we required to ActewAGL's access arrangement proposal.² In response ActewAGL submitted a revised access arrangement proposal incorporating some, but not all, of the required amendments.³

11.2.1 Annual reference tariff variation mechanism

Our draft decision required ActewAGL to revise its proposed access arrangement to:

- amend clause 7.4 and schedule 4 in the ActewAGL access arrangement to be consistent with figure 11.1, 11.2, 11.3 and 11.4 in Attachment 11 of the Draft Decision⁴
- 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.⁵

In its revised proposal, ActewAGL:

- did not make all revisions contained within figure 11.1 of the draft decision, but did incorporate amendments relating to the ABS and the CPI index
- did not make the revisions contained in figure 11.2
- did not make all revisions contained within figures 11.3 and 11.4, but did incorporate parts relating to the commencement years for calculations
- did not remove clause 7.5 of its proposed access arrangement.⁶

ActewAGL's arguments in support of its revised proposal are summarised in section 11.4 below.

² NGR, r. 59(2).

³ NGR, rr. 59(3), 60(1).

⁴ AER, *Draft decision: ActewAGL Access Arrangement 2016 to 2021, Attachment 11 – Reference tariff variation mechanism*, November 2015, p. 11-39 (Revision 11.1).

⁵ AER, *Draft decision: ActewAGL Access Arrangement 2016 to 2021, Attachment 11 – Reference tariff variation mechanism*, November 2015, p. 11-39 (Revision 11.2).

⁶ ActewAGL Distribution, *Response to the AER's draft decision: 2016–21 ACT, Queanbeyan and Palerang gas network access arrangement*, January 2016, p. 108.

11.2.2 Cost pass through events

Our draft decision required ActewAGL to revise seven of its proposed pass through event definitions and delete three of its proposed pass through events. In response, ActewAGL:

- made some changes to the seven pass through event definitions, but did not incorporate all of the required revisions, and
- deleted one of the three events required to be deleted, but retained the other two.

Table 11.2 gives a high level overview of our draft decision and ActewAGL's response on each of its proposed pass through events.

Table 11.2 ActewAGL revised position at a glance

Pass through event	AER draft decision	ActewAGL revised proposal
Regulatory change	Revise	Revised but not as specified
Service standard	Revise	Revised but not as specified
Insurance cap	Revise	Revised but not as specified
Insurer credit risk	Revise	Revised but not as specified
Terrorism	Revise	Revised but not as specified
Natural disaster	Revise	Revised but not as specified
Network user failure	Revise	Revised but not as specified
Short term trading market	Remove	Removed
Supply curtailment	Remove	Retained ¹
General	Remove	Retained

1 ActewAGL submitted that the supply curtailment event would not be required if we approved its proposed general pass through event. If we did not approve the general pass through event, it submitted the supply curtailment event should be included - ActewAGL Distribution, *Response to the AER's draft decision: 2016–21 ACT, Queanbeyan and Palerang gas network access arrangement, January 2016*, p. 133.

Our draft decision also required an amendment to provide that the principle in clause 7.16 of ActewAGL's proposed access arrangement is a fixed principle for the 2016–21 access arrangement period only.⁷ ActewAGL proposed alternative drafting of the fixed principle to clarify its intent.

⁷ AER, *Draft decision: ActewAGL Access Arrangement 2016 to 2021, Attachment 11 – Reference tariff variation mechanism*, November 2015, p. 11-39 (Revision 11.5).

11.3 AER's assessment approach

The reference tariff variation mechanism must be designed to equalise (in terms of present values):⁸

- 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.

It may provide for variation of a reference tariff:⁹

- in accordance with a schedule of fixed tariffs,
- in accordance with a formula set out in the access arrangement,
- as a result of a cost pass through for a defined event, or
- by the combined operation of two or more of these.

A formula for variation of a reference tariff may (for example) provide for variable caps on the revenue to be derived from a particular combination of reference services, a tariff basket price control, a revenue yield control or a combination of all or any of these.¹⁰

In deciding whether a particular reference tariff variation mechanism is appropriate to a particular access arrangement, the NGR require us to have regard to:¹¹

- the need for efficient tariff structures; and
- the possible effects of the reference tariff variation mechanism on administrative costs of the AER, the service provider, and users or potential users; and
- the regulatory arrangements (if any) applicable to the relevant reference services before the commencement of the proposed reference tariff variation mechanism; and
- the desirability of consistency between regulatory arrangements for similar services (both within and beyond the relevant jurisdiction); and
- any other relevant factor.

A reference tariff variation mechanism must give us adequate oversight or powers of approval over variation of the reference tariff.¹²

In deciding whether a particular reference tariff variation mechanism is appropriate to a particular access arrangement, other factors we have regard to include:¹³

⁸ NGR, r. 92(2).

⁹ NGR, r. 97(1).

¹⁰ NGR, r. 97(2).

¹¹ NGR, r. 97(3).

¹² NGR, r. 97(4).

- the nature and scope of the reference services to which the reference tariffs are applicable
- how the proposed mechanism compares to that which applied under the current access arrangement, and to those that apply to other network service providers under our recent decisions
- the potential impact of the proposed mechanism on the service provider's incentives under the access arrangement to operate its network—and manage its risks—in a manner consistent with the National Gas Objective (NGO) and Revenue and Pricing Principles (RPPs)
- in the case of cost pass through events, the considerations discussed in section 11.3.1 below.

The reference tariff variation mechanism is an area of our decision over which we have full discretion. This means that we may withhold our approval of a proposed reference tariff variation mechanism if we consider a preferable alternative exists that complies with the applicable requirements of the NGL and is consistent with any applicable criteria prescribed by the NGL.¹⁴

11.3.1 Cost pass through events

Our forecast revenue requirement includes forecasts of the capital and operating expenditure (capex and opex) a service provider will require over the access arrangement period to operate and maintain its network and meet its regulatory obligations (see attachments 6 and 7 to this decision). During the access arrangement period, a service provider can apply to us to pass material changes in its costs arising from pre-defined exogenous events through to customers, in the form of higher or lower reference tariffs. These events are called cost pass through events.

Our decision on the reference tariff variation mechanism for an access arrangement includes decisions on the cost pass through events that will apply during the access arrangement period, how an application to pass through costs will be assessed and how approved amounts will be passed through under the reference tariff variation mechanism.

11.3.2 Assessment of proposed events

Our decision on the reference tariff variation mechanism includes a decision on the pass through events that are to apply for the access arrangement period.¹⁵

Our assessment approach is guided by the NGO and the RPPs. These provide that the service provider should be provided with a reasonable opportunity to recover at least

¹³ NGR, r. 97(3)(e).

¹⁴ NGR, rr. 40(3), 92, 97.

¹⁵ NGR, r. 97(1)(c).

the efficient costs incurred in providing services and complying with a regulatory obligation or requirement.¹⁶ They also provide incentives to promote economic efficiency.¹⁷ Together, they promote a balance between the economic costs and risks of the potential for under and over investment by a service provider, to promote efficient investment.¹⁸ In the context of pass through events, we have particular regard to the impact on price, quality, safety, reliability and security of supply that may arise as a result of any change in the efficient operation of, and ability and incentive of, a service provider to invest in its network.¹⁹

In determining whether we accept a proposed pass through event as part of the reference tariff variation mechanism, we also take into account the following considerations:

- (a) whether the event proposed is an event covered by another pass through event under the access arrangement or the NGR²⁰;
- (b) whether the nature or type of event can be clearly identified at the time the access arrangement is approved 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.

These considerations serve the same purpose under the National Electricity Rules (NER), and are referred to in the NER as the nominated pass through event considerations.²¹ We consider these considerations are relevant to help determine whether a proposed cost pass through event under an access arrangement is

¹⁶ NGL, s. 24(2).

¹⁷ NGL, s. 24(3).

¹⁸ NGL, s. 24(6).

¹⁹ NGL, s. 23; See also AEMC 2012, *Cost pass through arrangements for Network Service Providers, Rule Determination*, 2 August 2012, Sydney, p. 6.

²⁰ For example, rule 531 of the NGR provides for pass through of unpaid distribution service charges if a retailer insolvency event occurs.

²¹ NER, cl. 6.5.10(b), 6A.6.9(b); NER Chapter 10: Glossary, definition of 'nominated pass through event considerations'.

consistent with the NGO.²² In adding the nominated pass through event considerations to the NER, the Australian Energy Market Commission (AEMC) described their purpose as:

- to incorporate and reflect the essential components of a cost pass through regime. It was intended that in order for appropriate incentives to be maintained, any nominated pass through event should only be accepted when event avoidance, mitigation, commercial insurance and self-insurance are unavailable. That is, a cost pass through event is the least efficient option for managing the risk of unforeseen events.²³
- that a pass through event should only be accepted when it is the least inefficient option and event avoidance, mitigation, commercial insurance and self-insurance are found to be inappropriate. That is, it is included after ascertaining the most efficient allocation of risks between a service provider and end customers.²⁴

In turn, this limits the erosion of incentives on service providers to use market based mechanisms to mitigate the cost impacts that would arise.²⁵ This promotes the efficient investment in, and efficient operation and use of, network services for the long term interests of consumers with respect to price.²⁶

As a matter of good regulatory practice, one additional matter²⁷ we take into account is consistency in our approach to assessing pass through events across our electricity determinations and gas access arrangements.²⁸

Another additional matter we take into account²⁹ is how an application to pass through costs after an event occurs will be assessed, and the workability of the nominated pass through event in the context of the reference tariff variation mechanism. This is discussed below.

11.3.3 Assessment of pass through applications

Our decision on the reference tariff variation mechanism also includes a decision on the provisions of the access arrangement that set out how an application to pass through costs after a pass through event occurs will be made.

²² NGR, r. 100(1).

²³ AEMC 2012, *Cost pass through arrangements for Network Service Providers, Rule Determination*, 2 August 2012, Sydney, p. 19.

²⁴ AEMC 2012, *Cost pass through arrangements for Network Service Providers, Rule Determination*, 2 August 2012, Sydney, p. 20.

²⁵ NGL, s. 24(3); AEMC 2012, *Cost pass through arrangements for Network Service Providers, Rule Determination*, 2 August 2012, Sydney, p. 8.

²⁶ NGL, s. 23; AEMC 2012, *Cost pass through arrangements for Network Service Providers, Rule Determination*, 2 August 2012, Sydney, p. 8.

²⁷ NGR, r. 97(3)(e).

²⁸ AEMC 2012, *Cost pass through arrangements for Network Service Providers, Rule Determination*, 2 August 2012, Sydney, p. 18.

²⁹ NGR, r. 97(3)(e).

Typically, a pass through event is triggered when a defined event occurs, and entails the service provider incurring materially higher (or lower) costs than it would have occurred but for that event. When the change in costs is positive (that is, costs increase), the service provider may seek our approval to pass through an increase in the costs that it has incurred and is likely to incur over the access arrangement period to its users. When the change in costs is negative (and costs decrease), the service provider must provide us with a statement of the amount to be passed through back to customers, which leads to lower charges.

The pass through mechanism should not allow a service provider to pass through any change in its actual costs resulting from an event. As the AEMC has noted in the context of the NER pass through provisions:³⁰

The natural incentive properties of cost pass throughs are very weak. There is no direct financial benefit to the [service provider] from out performing in relation to those events that are covered by cost pass throughs, unlike the incentive arrangements for operating expenditure captured in the building blocks.

...the NER allow the AER to take into account the efficiency of the provider's decisions and actions in relation to the risk, as an attempt to impose some incentives to not overspend in relation to cost pass throughs. However, the incentives to find cost efficiencies on matters that can be claimed as cost pass through events are very poor.

We manage these incentives in our decisions in a number of ways.

First, a materiality threshold is typically applied so that an application to pass through costs (whether positive or negative) can only be made where the total change in costs resulting from the event is material. We consider the threshold prescribed in the NER is a suitable benchmark for a materiality threshold for cost pass through events under the NGR. This threshold requires the change in costs to be more than one per cent of the forecast revenue requirement for the service provider for the relevant regulatory year.³¹

Second, where a pass through event has occurred the access arrangement should set out factors relevant to our determination on the amount to be passed through. Again, we consider the relevant factors in the NER are also useful for the pass through mechanism under the NGR. These include:³²

- the information provided to us by the service provider
- the increase in the costs of providing reference services that the service provider has incurred and is likely to incur (or the costs in the provision of reference services the service provider has saved and is likely to save) until:

³⁰ AEMC 2012, *Cost pass through arrangements for Network Service Providers, Rule Determination*, 2 August 2012, Sydney, p. 3.

³¹ NER, Chapter 10: Glossary, definition of 'materially'.

³² NER, cll. 6A.7.3(j) / 6.6.1(j).

- the end of the access arrangement period in which the event occurred; or
- if the access arrangement for the access arrangement period following that in which the event occurred does not make any allowance for the recovery of that increase in costs (or the pass through of those cost savings) – the end of the access arrangement period following that in which the event occurred;
- for an increase in costs, the efficiency of the service provider's decisions and actions in relation to the risk of the event, including whether the service provider has failed to take any action that could reasonably be taken to reduce the magnitude of the pass through amount in respect of that event and whether the service provider has taken or omitted to take any action where such action or omission has increased the magnitude of the amount in respect of that event;
- the time cost of money based on the allowed rate of return for the service provider for the regulatory control period in which the pass through event occurred;
- the need to ensure that the service provider only recovers any actual or likely increment in costs to the extent that such increment is solely as a consequence of a pass through event;
- whether the costs of the pass through event have already been factored into the calculation of the service forecast revenue requirement for the access arrangement period in which the pass through event occurred or will be factored into the calculation of the provider's forecast revenue requirement for a subsequent access arrangement period;
- the extent to which the costs that the service provider has incurred and is likely to incur are the subject of a previous determination we have made on a cost pass through application; and
- any other factors we consider relevant.

What other factors may be relevant to a particular pass through event must—to some extent—be determined on a case by case basis. However, for some events there may be additional factors that can be identified in advance. We include these factors in the approved definitions of those events as part of the access arrangement. This is good regulatory practice for two reasons:

- It provides transparency and predictability to service providers and users, and allows service providers to address these factors directly in cost pass through applications.
- It allows us, service providers and users to consider and engage on how a pass through event will operate during the regulatory control period, and therefore to better take into account the considerations discussed above when defining an approved event.

11.3.4 Interrelationships

Tariffs are derived from the total revenue requirement after consideration of demand for each tariff category. ActewAGL operates under a weighted average tariff cap. This

means the tariffs we determine (including the means of varying the tariffs from year to year) are the binding constraint across the 2016–21 access arrangement period, rather than the total revenue requirement set in our decision.³³ Except as provided by a reference tariff variation mechanism, a reference tariff is not to vary during the course of an access arrangement period.³⁴

In assessing and approving a reference tariff variation mechanism, we consider the potential impact of the proposed mechanism on the service provider's incentives under the access arrangement to operate its network—and manage its risks—in a manner consistent with the NGO and RPPs.³⁵

The pass through component of the reference tariff variation mechanism is also interrelated with other parts of this decision, in particular with the forecast opex³⁶ and capex³⁷ and rate of return³⁸ included in our forecast revenue requirement. These interrelationships require us to balance the incentives in the various parts of our decision.

Pass through events are one way, but not the only way, in which service providers can manage their risks under an access arrangement. For systemic risks, service providers are compensated through the allowed rate of return. Service providers also face business-specific, or residual, risks. Service providers are compensated for the prudent and efficient management of these risks through the forecast opex and capex we include in our forecast revenue requirement for strategies such as:

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

An efficient business will manage its risk by employing the most cost effective combination of these strategies. In order to maintain appropriate incentives under an access arrangement, we only accept a service provider's nominated pass through events where we are satisfied that event avoidance, mitigation, commercial insurance and self-insurance under approved forecasts of prudent and efficient opex and capex

³³ Where actual demand across the 2016–21 access arrangement period varies from the demand forecast in the access arrangement, ActewAGL's actual revenue will vary from the revenue allowance determined in our decision. In general, if actual demand is above forecast demand, ActewAGL's actual revenue will be above forecast revenue, and vice versa.

³⁴ NGR, r. 97(5).

³⁵ NGL, ss. 23, 24.

³⁶ See Attachment 7 (Operating expenditure) to this final decision.

³⁷ See Attachment 6 (Capital expenditure) to this final decision.

³⁸ See Attachment 3 (Rate of return) to this final decision.

are either unavailable or inappropriate.³⁹ For smaller projects a service provider should generally utilise its existing expenditure allowance or reprioritise its work program rather than seeking approval of a pass through.⁴⁰ This is reflected in the materiality threshold that applies to applications for cost pass through under the approved access arrangement.⁴¹

Cost pass through amounts approved in an access arrangement period are added to forecast opex for the purpose of calculating efficiency carryover amounts under the efficiency carryover mechanism in the approved access arrangement.⁴²

11.4 Reasons for final decision

In this section we set out the reasons for our final decision on ActewAGL's annual reference tariff variation mechanism.

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.

While we generally consider ActewAGL's proposed annual reference tariff variation formula complies with rule 92(2) there are aspects of it we do not accept. Where we do not accept the ActewAGL's proposed annual reference tariff variation formula, we consider our final decision provides for greater consistency of these aspects with other gas and electricity distributors across jurisdictions.⁴³ For these aspects, we have amended ActewAGL's revised access arrangement to reflect our final decision. These revisions and our reasons why are set out below.

Further, the quantum of ActewAGL's revised proposal reference tariffs has been revised to reflect our final decision total revenue requirement and forecast demand. The total revenue requirement and forecast demand are outlined in their respective sections of this final decision.

³⁹ The AEMC expressed a similar view in AEMC 2012, *Cost pass through arrangements for Network Service Providers, Rule Determination*, 2 August 2012, Sydney, pp. 19–20.

⁴⁰ The AEMC made similar observations in AEMC 2012, *Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services, Rule Determination*, 29 November 2012, Sydney, p. 186,

⁴¹ AER, *Approved ActewAGL Distribution Access arrangement for the ACT, Queanbeyan and Palerang gas distribution network 1 July 2016–30 June 2021*, May 2016, Schedule 1: Definitions, 'Administrative cost impact'.

⁴² AER, *Approved ActewAGL Distribution Access arrangement for the ACT, Queanbeyan and Palerang gas distribution network 1 July 2016–30 June 2021*, May 2016, cl. 3.7(c); See Attachment 9 (Efficiency carryover mechanism) to this final decision.

⁴³ NGR, r. 97(3)(d).

Reference tariff variation mechanism

For the reasons set out in our draft decision, we accept ActewAGL's proposal to replace the current fixed schedule of tariffs with a weighted average price cap reference tariff variation mechanism.⁴⁴ A weighted average price cap is a form of tariff basket price control which is compliant with the NGR.⁴⁵ The weighted average price cap will include:

- an automatic adjustment factor to account for the differences between forecast and actual costs for specified uncontrollable events
- a pass through adjustment factor.

While we accept the application of a weighted average price cap, we accept some but not all of ActewAGL's proposed changes to the reference tariff variation mechanism formulas as set out in our draft decision. Our reasons for our final decision are set out in the discussion of each formula below.

Intra-year variations to reference tariffs

For the reasons set out in our draft decision, our final decision does 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 (intra-year tariff variations).⁴⁶ We consider intra-year tariff variations 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.

We consider tariff stability is particularly imperative for ActewAGL's customers over the 2016–21 access arrangement period given ActewAGL will introduce significant changes to its tariff structures. As noted by ActewAGL, tariffs will be set to enable customer response to the tariffs' price signals to encourage the efficient use and growth of the network.⁴⁷ We consider customers will need time to adjust to the new tariff structures so they can respond to the price signals. Any intra-year tariff variations will disrupt these signals. Therefore stability in the tariffs is desirable.

The importance of tariff stability is recognised by ActewAGL. We note that one of ActewAGL's pricing objectives is to provide stability in its network tariffs and to minimise any sudden changes in them.⁴⁸ Therefore, we consider the proposed intra-

⁴⁴ AER, *Draft decision: ActewAGL Access Arrangement 2016 to 2021, Attachment 11 – Reference tariff variation mechanism*, November 2015, pp. 14–15.

⁴⁵ NGR, r. 97(2).

⁴⁶ AER, *Draft decision: ActewAGL Distribution access arrangement 2016 to 2021, Attachment 11 – Reference tariff variation mechanism*, November 2015, p. 16.

⁴⁷ ActewAGL Distribution, *Tariff structure statement: Access arrangement information for the 2016–21 ACT, Queanbeyan and Palerang access arrangement—Submission to the Australian Energy Regulator—Attachment 4*, February 2016, p. 18. (ActewAGL Distribution, *Tariff structure statement*, February 2016)

⁴⁸ ActewAGL Distribution, *Tariff structure statement*, February 2016, p. 18.

year tariff variations—which create tariff instability and sudden changes in tariffs—should not be accepted as they are inconsistent with ActewAGL's pricing objectives.

Further, we do not consider that intra-year tariff variations are in the long term interest of ActewAGL's customers as they can lead to price shocks and—as noted by ActewAGL—potential customer losses.

ActewAGL noted that there are likely to be trade-offs between competing pricing objectives.⁴⁹ However, it stated that tariffs will be set to balance the competing objectives in a transparent way that promotes the long term interest of customers. In the trade-off between price stability and economic efficiency, it stated:

Updating our network tariffs to ensure they are purely cost reflective might incorporate a degree of volatility inconsistent with the value customers' place on price stability and certainty. Price shocks are likely to lead to us losing customers.⁵⁰

We consider customer loss through price shocks is not in the long term interest to ActewAGL's remaining customers as the network costs for these customers will increase. Therefore intra-year tariff variations should not be allowed as they could allow such price shocks.

We also note our final decision approach does not impact ActewAGL's ability to recover its efficient costs nor does it compromise the long term interests of customers. While our approach creates a delay in the recovery of costs (or the return of cost savings to customers) due to the two year lag in the adjustment, the method to calculate the adjustment accounts for the time value of money. Therefore, we do not consider it prudent or necessary to include provision for intra-year tariff variations as the time value of money adjustments mean that neither ActewAGL nor customers are impacted by the delay in recovering these costs.

Finally, we acknowledge ActewAGL's observations that in the past we have approved intra-year variations to its reference tariffs in exceptional circumstances—such as the removal of the carbon tax.⁵¹ We also acknowledge that intra-year tariff variations are available to distributors in other jurisdictions. However, we do not agree with ActewAGL that these are appropriate reasons for allowing intra-year tariff variations particularly when they can lead to price shocks and customer losses. Instead, we consider tariff stability is in the long term interest of ActewAGL's customers and should be the priority over the 2016–21 access arrangement period.

⁴⁹ ActewAGL Distribution, *Tariff structure statement*, February 2016, p. 22.

⁵⁰ ActewAGL Distribution, *Tariff structure statement*, February 2016, p. 10.

⁵¹ ActewAGL Distribution, *Response to the AER's draft decision: 2016–21 ACT, Queanbeyan and Palerang gas network access arrangement*, January 2016, p. 138.

Annual haulage reference tariff variation formula

We accept some, but not all, of ActewAGL's revised proposal changes to the annual haulage reference tariff variation formula as set out in our draft decision.⁵² Where we do not accept the revised proposal, we consider our final decision provides for greater consistency of these aspects with other gas and electricity distributors across jurisdictions.⁵³

ActewAGL's revised proposal did not accept the following aspects of the formula in our draft decision:

- removal of the reference to the access arrangement scaling clause from the definition of price for year $t-1$ ⁵⁴ (p_{t-1}^{ij})
- change in notation of indices in the formula
- change in the definition of quantities for year $t-2$ (q_{t-2}^{ij}) to include the term 'audited'.⁵⁵

Our final decision accepts ActewAGL's revised proposal to reinsert into the definition of price for year $t-1$ the reference to the tariff scaling clause in the access arrangement. We agree that the inclusion of this reference provides transparency on the tariff setting process in the instance that a tariff variation notice is not submitted or is rejected.⁵⁶

However, we do not accept the other aspects of ActewAGL's revised proposal on the annual haulage reference tariff variation formula.

Our final decision maintains the notation of indices as set out in our draft formulas.⁵⁷ Our final decision notation of indices is consistent with how these indices are applied in revenue control formulas for almost all regulated gas and electricity distributors across jurisdictions.⁵⁸ We consider consistent approaches across gas distributors and

⁵² AER, *Draft decision: ActewAGL Distribution access arrangement 2016 to 2021, Attachment 11 – Reference tariff variation mechanism*, November 2015, pp. 16–18.

⁵³ NGR, r. 97(3)(d).

⁵⁴ Year t represents the forthcoming regulatory year. Therefore, year $t-2$ and year $t-1$ are the two regulatory years prior to year t . By way of example, if year t is financial year 2017–18 then year $t-2$ is financial year 2015–16 and year $t-1$ is financial year 2016–17.

⁵⁵ ActewAGL Distribution, *Response to the AER's draft decision: 2016–21 ACT, Queanbeyan and Palerang gas network access arrangement*, January 2016, p. 108.

⁵⁶ ActewAGL Distribution, *Response to the AER's draft decision: 2016–21 ACT, Queanbeyan and Palerang gas network access arrangement*, January 2016, p. 108.

⁵⁷ AER, *Draft decision: ActewAGL Distribution access arrangement 2016 to 2021, Attachment 11 – Reference tariff variation mechanism*, November 2015, pp. 17–18.

⁵⁸ For example, see: ActewAGL, *Access arrangement for ActewAGL's South Australian gas distribution network 1 July 2016–30 June 2021*, January 2016, Annexure E; SP AusNet, *Gas access arrangement revision 2013–2017: Part B of the access arrangement for the distribution system—reference tariffs and reference tariff policy*, pp. 10–13; Envestra, *Access arrangement for Envestra's Queensland gas distribution system 1 July 2011–30 June 2016*, June 2011, Annexure E; AER, *Final Decision, ActewAGL distribution determination 2015–16 to 2018–19: Attachment 14—Control mechanism*, April 2015, p. 13.

jurisdictions are desirable as it enables regulators, retailers, policy makers and end users greater transparency in understanding tariff variation mechanisms.⁵⁹ Therefore, we do not accept this aspect of ActewAGL's revised proposal.

We also do not accept ActewAGL's proposal to remove the term 'audited' from the definition of quantities for year t–2. We acknowledge that the requirement to audit these quantities is set out elsewhere in ActewAGL's access arrangement. However, by maintaining the term 'audit' in the definition of quantities for year t–2 provides for consistent definitions of this factor across gas distribution networks. This consistency allows greater transparency in how this aspect of ActewAGL's access arrangement is applied. For the reasons stated above, we consider consistency is desirable.⁶⁰

We have also removed the statement in ActewAGL's access arrangement that quantities could be independently verified rather than audited to reflect that ActewAGL will be undertaking annual audits. We note our final decision has accepted ActewAGL's proposed operating expenditure step increase to undertake these quantity audits—see attachment 7.

We have also changed ActewAGL's revised proposal definition of the consumer price index (CPI) factor in this formula to be consistent with that applied in the revenue control formulas for gas and electricity distributors across jurisdictions. As noted, we consider consistency is desirable.⁶¹

Our final decision for ActewAGL's annual haulage reference tariff variation formula is set out in Figure 11.1.

Figure 11.1 Annual haulage reference tariff variation formula

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

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

⁵⁹ NGR, r. 97(3)(d).

⁶⁰ NGR, r. 97(3)(d).

⁶¹ NGR, r. 97(3)(d).

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 tariff for component j of reference tariff i in year t

p_{t-1}^{ij} is the prevailing tariff for 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)).

Rebalancing constraint

Our draft decision accepted ActewAGL's proposal to include a side constraint (or rebalancing constraint) in its access arrangement.⁶² For annual tariff variations, rebalancing constraints apply to the weighted average revenue to be raised from each tariff class to limit annual tariff price movements.

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

⁶² AER, *Draft decision: ActewAGL Distribution access arrangement 2016 to 2021, Attachment 11 – Reference tariff variation mechanism*, November 2015, p. 15.

average price cap.⁶³ We agree with ActewAGL that the application of a rebalancing constraint reduces price volatility and provides additional certainty to customers on annual price movements.

In response to our draft decision, ActewAGL's revised proposal did not accept the following aspects in the rebalancing constraint formula:

- repetition of definitions of parameters/factors already defined in the annual haulage reference tariff variation formula
- change in notation of indices in the rebalancing constraint formula
- reducing the rebalancing constraint adjustment from 10 to two per cent.⁶⁴

We accept ActewAGL's revised access arrangement presentation of the rebalancing constraint formula which removes the need to repeat definitions of parameters/factors already defined in the annual haulage reference tariff variation formula. The revised access arrangement presents the rebalancing constraint formula as part of the annual haulage reference tariff variation formula.⁶⁵ Therefore, the same definitions can be applied for both formulas.

However, for the reasons set out above, we do not accept ActewAGL's proposed notation of indices in the rebalancing constraint formula. Our final decision maintains the notation of indices as set out in our draft decision rebalancing constraint formula.

We also do not accept ActewAGL's revised proposal to include an annual 10 per cent adjustment in the rebalancing constraint. As set out in our draft decision we consider that 10 per cent is a significant adjustment that could allow price volatility and reduce certainty in customers' prices. Instead, our final decision applies a 2 per cent adjustment in the balancing constraint which is consistent with the rebalancing constraints applied by other gas and electricity distribution networks.⁶⁶

However, we acknowledge ActewAGL's consideration that our draft decision application of the rebalancing constraint in the first year of the 2016–21 access arrangement period would be overly restrictive.⁶⁷ We agree that flexibility is needed so that ActewAGL's initial tariffs can reflect our final decision revenue requirement and

⁶³ ActewAGL Distribution, *Access arrangement information, Attachment 13: Reference tariff variation mechanism*, June 2015, p. 13.

⁶⁴ ActewAGL Distribution, *Response to the AER's draft decision: 2016–21 ACT, Queanbeyan and Palerang gas network access arrangement*, January 2016, p. 108.

⁶⁵ ActewAGL Distribution, *Access arrangement for the ACT, Queanbeyan and Palerang gas distribution network 1 July 2016–30 June 2021: Incorporating revisions that address matters raised in the AER draft decision*, 6 January 2016, p. 20, clause 7.4.

⁶⁶ 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); ActewAGL, (proposed) *Access arrangement for ActewAGL's South Australian gas distribution network 1 July 2016 – 30 June 2021*, July 2015, clause 4.4 and Annexure E; NER, cl. 6.18.6.

⁶⁷ ActewAGL Distribution, *Response to the AER's draft decision: 2016–21 ACT, Queanbeyan and Palerang gas network access arrangement*, January 2016, p. 110.

allow transition to its new tariff structure. Therefore, our final decision is to begin application of the rebalancing constraint in the second year and for each remaining year of the 2016–21 access arrangement period. We consider this alleviates ActewAGL's concerns that our draft decision rebalancing constraint would not allow it flexibility to implement these significant changes.⁶⁸

Our final for ActewAGL's rebalancing constraint formula is set out in Figure 11.2.

Figure 11.2 Rebalancing control formula

$$(1 + CPI_t)(1 - X_t)(1 + A_t)(1 + PT_t)(1 + 0.02) \geq \frac{\sum_{i=1}^n \sum_{j=1}^m P_t^{ij} Q_{t-2}^{ij}}{\sum_{i=1}^n \sum_{j=1}^m P_{t-1}^{ij} Q_{t-2}^{ij}}$$

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 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

⁶⁸ ActewAGL Distribution, *Response to the AER's draft decision: 2016–21 ACT, Queanbeyan and Palerang gas network access arrangement*, January 2016, p. 110.

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 tariff for component j of reference tariff i in year t

p_{t-1}^{ij} is the prevailing tariff for 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)).

Where we do not accept the revised proposal, we consider our final decision provides for greater consistency of these aspects with other gas and electricity distributors across jurisdictions.

Automatic adjustment factor

We accept some, but not all, of ActewAGL's revised proposal changes to the automatic adjustment factor as set out in our draft decision.⁶⁹ We accept ActewAGL's revised proposal changes to:

- remove repetition of parameter/factor definitions which are already defined in the annual haulage reference tariff variation formula
- remove the requirement for the automatic adjustment factor to be zero when year $t-1$ is 2017–18 otherwise it may generate an over or under recovery of revenue in 2018–19
- use of the terms:
 - 'Relevant Regulator' instead of 'AER'
 - 'Relevant Tax factor' instead of 'Tax factor'

to be consistent with other references to these terms in the access arrangement,

- remove from the definition of the carbon cost factor amount the requirement that a carbon scheme be approved by the AER as the access arrangement already explicitly defines what constitutes a carbon scheme
- reinstate its proposed definition of the real weighted average cost of capital as it includes cross references to other clauses of its access arrangement for transparency.⁷⁰

⁶⁹ AER, *Draft decision: ActewAGL Distribution access arrangement 2016 to 2021, Attachment 11 – Reference tariff variation mechanism*, November 2015, pp. 16–18.

⁷⁰ ActewAGL Distribution, *Response to the AER's draft decision: 2016–21 ACT, Queanbeyan and Palerang gas network access arrangement*, January 2016, pp. 108, 111–112.

However, we do not accept ActewAGL's proposed changes to the notation of indices in the automatic adjustment factor formula.⁷¹ For the reasons set out above, our final decision maintains the same notation of indices as set out in our draft decision.⁷²

We have also updated the automatic adjustment factor formula to apply the correct real weighted average cost of capital assumptions in the net present value calculations for this adjustment. We note both our draft decision and ActewAGL's proposal failed to take into account that the real weighted average cost of capital is updated annually.

As the true-up of the adjustment factors are calculated in year t-2, two years of escalation needs to be applied to bring these values to net present terms for year t in order to appropriately adjust ActewAGL's forthcoming revenues. Each year of escalation should apply the relevant real weighted average cost of capital. That is, the relevant weighted average cost of capital to escalate from year t-2 to year t-1 (realWACC_{t-1}) and another to escalate from year t-1 to year t (realWACC_t). However, our draft decision and ActewAGL's proposal incorrectly applied the real weighted average cost of capital for year t (realWACC_t) twice for these two years of escalation. Our final decision corrects for this error.

Our final decision for ActewAGL's automatic adjustment factor 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 financial year t-1 refers to financial years 2016-17; and
- (b) the value of A'_t determined in the financial year t-1 for all other years

and:

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

where:

⁷¹ ActewAGL Distribution, *Response to the AER's draft decision: 2016-21 ACT, Queanbeyan and Palerang gas network access arrangement*, January 2016, p. 108.

⁷² AER, *Draft decision: ActewAGL Distribution access arrangement 2016 to 2021, Attachment 11 – Reference tariff variation mechanism*, November 2015, pp. 19-22.

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 the pre-tax real weighted average cost of capital for financial year t determined in accordance with the PTRM using the updated return on debt for financial year t determined in accordance with clauses 6.1 to 6.24 of the access arrangement

$realWACC_{t-1}$ is the pre-tax real weighted average cost of capital determined for Financial Year $t-1$

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

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

T_{t-2} is the change in relevant 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 tariff for 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, 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 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 2016–21 access arrangement period.

The forecast UAG costs are as follows:

Table 11.3 AER final decision forecast of the total UAG costs

	2016–17	2017–18	2018–19	2019–20	2020–21
Forecast UAG cost (\$million, 2014–15)	1.51	1.49	1.48	1.46	1.45

Source: AER analysis.

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 ActewAGL as a result of the operation of a Carbon Scheme for 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 included in the Relevant Regulator's relevant final decision for financial year $t-2$.

Relevant Tax factor amount

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

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

minus

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

Pass through factor formula

We accept some, but not all, of ActewAGL's revised proposal changes to the pass through factor formula as set out in our draft decision.⁷³ Where we do not accept the revised proposal, we consider our final decision provides for greater consistency of these aspects with other gas and electricity distributors across jurisdictions.

We accept the following aspects of ActewAGL's revised proposal changes to the pass through factor formula:

- remove repetition of parameter/factor definitions which are already defined in the annual haulage reference tariff variation formula
- clarification that the term PT'_{t-1} will be zero in the financial year 2016–17 and not the term PT_t as set out in our draft decision. We agree this was an error in our draft decision.⁷⁴

However, we do not accept the following aspects of ActewAGL's revised proposal changes to the automatic adjustment factor formula:

⁷³ AER, *Draft decision: ActewAGL Distribution access arrangement 2016 to 2021, Attachment 11 – Reference tariff variation mechanism*, November 2015, pp. 16–18.

⁷⁴ ActewAGL Distribution, *Response to the AER's draft decision: 2016–21 ACT, Queanbeyan and Palerang gas network access arrangement*, January 2016, p. 108.

- change in notation of indices in the rebalancing constraint formula
- remove reference to the AER in the definition of the approved pass through amounts factor AP_t .⁷⁵

For the reasons set out above, we do not accept ActewAGL's proposed notation of indices in the pass through factor formula. Our final decision maintains the same notation of indices as set out in our draft decision.

We also do not accept ActewAGL's consideration that the definition of the approved pass through amounts factor (AP_t) should remove reference to the AER. We agree with ActewAGL that by definition any pass through amount can only include amounts the AER has approved. However, we consider the inclusion of reference to the AER in the definition is required to be consistent with this definition in revenue control formulas for gas and electricity distributors across jurisdictions.⁷⁶ We consider consistent approaches across gas distribution networks and jurisdictions is desirable as it enables regulators, retailers, policy makers and end users greater transparency in understanding tariff variation mechanisms.⁷⁷

Our final decision for ActewAGL's 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-1} is:

- zero when financial year t-1 refers to financial year 2016-17
- the value of PT'_t determined in the financial year t-1 for all other financial years in the access arrangement period

and

⁷⁵ ActewAGL Distribution, *Response to the AER's draft decision: 2016-21 ACT, Queanbeyan and Palerang gas network access arrangement*, January 2016, p. 108.

⁷⁶ For example, see: ActewAGL, *Access arrangement for ActewAGL's South Australian gas distribution network 1 July 2016-30 June 2021*, January 2016, Annexure E; SP AusNet, *Gas access arrangement revision 2013-2017: Part B of the access arrangement for the distribution system—reference tariffs and reference tariff policy*, pp. 10-13; Envestra, *Access arrangement for Envestra's Queensland gas distribution system 1 July 2011-30 June 2016*, June 2011, Annexure E; AER, *Final Decision, ActewAGL distribution determination 2015-16 to 2018-19: Attachment 14—Control mechanism*, April 2015, p. 13.

⁷⁷ NGR, r. 97(3)(d).

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

where

AP_t is:

- (a) any determined pass through amount that the AER approves for 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.

t is the financial year for which tariffs are being set

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 tariff for 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)).

11.4.2 Cost pass through events

This section sets out the reasons for our final decisions on ActewAGL's proposed cost pass through events and its proposed treatment of cross-period pass through applications.

Regulatory change event and service standard event

Our draft decision approved the inclusion of a regulatory change event and service standard event in ActewAGL's access arrangement, but required ActewAGL to revise those definitions to align with the corresponding definitions in the NER.⁷⁸ The NER definitions of these events, which our draft decision adapted for ActewAGL's access arrangement, require the triggering occurrence to 'substantially affect' or 'substantially vary' how the reference service is to be provided. The NER definitions also require that the event 'materially increases or materially decreases' the cost of providing reference services.

Responding to our draft decision, ActewAGL maintained its opposition to these aspects to the NER definitions. It argued the word 'substantially' adds uncertainty and wrongly adds a second threshold beyond materiality, which it says was unintended by the AEMC.⁷⁹ However, we consider the AEMC's language in the corresponding NER definitions is clear, and unambiguously indicates a requirement for both a substantial effect on the manner of service provision, and a material cost impact.

ActewAGL argues the word 'materially' is unnecessary since clause 7.7 of the access arrangement allows it to seek recovery only if an event results in a change of cost of at least one percent of smoothed forecast revenue for the relevant year. We agree clause 7.7, by inclusion of the defined pre-requisite "Administrative Cost Impact", addresses the same issue as the materiality limb of these definitions, but we do not consider this leads to ambiguity. We retain the materiality limb in the definitions of regulatory change event and service standard event to maintain consistency with the NER (as applied to ActewAGL's electricity distribution network), and we see no difficulty in these requirements operating concurrently.

The NER definition of 'regulatory change event', which we have adapted for this access arrangement, also provides that the change in a regulatory obligation or requirement can be passed through under this event only if it does not fall within another other pass through category. ActewAGL submitted that the 'no other category'

⁷⁸ AER, *Draft decision: ActewAGL Access Arrangement 2016 to 2021, Attachment 11 – Reference tariff variation mechanism*, November 2015. pp 11-24–26.

⁷⁹ ActewAGL Distribution, *Response to the AER's draft decision: 2016–21 ACT, Queanbeyan and Palerang gas network access arrangement*, January 2016, p. 119.

proviso should not be in the regulatory change event definition because it is also included in the proposed 'general' pass through event. However, we have not approved the general pass through event, and we see no reason to depart from the NER approach of including the 'no other category' proviso in the definition of regulatory change event.

Insurance cap event

We accept the inclusion of an insurance cap event but not the corresponding definition in ActewAGL's revised access arrangement proposal.

Our draft decision adopted the following insurance cap event definition:

Insurance Cap Event means an event where:

- (a) ActewAGL makes a claim or claims and receives the benefit of a payment or payments under a relevant insurance policy;
- (b) ActewAGL incurs costs beyond the relevant policy limit; and
- (c) the costs beyond the relevant policy limit increase the costs to ActewAGL of providing the Reference Service.

For this Insurance Cap Event:

- (a) the relevant policy limit is the greater of:
 - (i) ActewAGL'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 the pipeline services was regulated; and
- (c) ActewAGL will be deemed to have made a claim on a relevant insurance policy if the claim is made by a related party of ActewAGL in relation to any aspect of the Network or ActewAGL'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.⁸⁰

⁸⁰ AER, *Draft decision: ActewAGL Access Arrangement 2016 to 2021, Attachment 11 – Reference tariff variation mechanism*, November 2015, p.11-27.

Our draft decision defined the relevant policy limit for this insurance cap event as the greater of (a) ActewAGL's actual policy level, and (b) 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. Our objective was to avoid a perverse incentive for a service provider to reduce its expenditure on insurance below prudent and efficient levels, thereby reducing its operating expenditure relative to the approved forecast by transferring insurable risks to its customers instead of through genuine efficiencies.

ActewAGL opposed this limb of our definition, arguing that:⁸¹

Under such a definition the AER's discretion would be limited as the definition may prevent the event from occurring. Specifically, the policy limit assumed or provided for in forecasting opex at the time the access arrangement is approved (putting aside the ambiguity in determining what is implicitly commensurate with the allowance) may be substantially different from a new actual policy limit. If the new limit is lower and ActewAGL Distribution incurs costs beyond that new limit, even if the decision to change the policy limit was made acting efficiently in accordance with good industry practice, no insurance cap event would occur and the AER would not be able to exercise its discretion to determine what the appropriate policy limit should be and the consequent pass through amount.

Concurrent revised proposals from other service providers raised objections to defining the relevant policy limit by reference to the policy limit commensurate with the allowance for insurance premiums in the regulated firm's approved operating expenditure. CitiPower argued that this limb is uncertain in meaning and effect.⁸²

Given the manner in which the AER determines our operating expenditure allowances, it is not possible to ascertain a specific policy limit for particular insurance policies that is explicitly or implicitly commensurate with the allowance for insurance premiums included in forecast operating ex. period in which the policy is issued. Indeed, it is not possible to ascertain the allowance for insurance premiums. The AER's approach to determining our forecast operating expenditure did not involve any conclusions as to the efficient and prudent amount for insurance. Further, it is impossible to determine the policy limit implicit in the operating expenditure allowance in the distribution determination for policies that were entered into after the distribution determination is made.

We accept that a firm's approved operating expenditure allowance may not unambiguously imply a particular level of insurance cover and have removed this limb from the definition. However, it remains appropriate that we take into account where relevant, any assessments and analysis we have undertaken in relation to insurance

⁸¹ ActewAGL Distribution, *Response to AER's draft decision, 2016-21 ACT, Queanbeyan and Palerang Gas Network Access Arrangement*, January 2016, p. 125.

⁸² CitiPower, *Revised Regulatory Proposal 2016 - 2020*, January 2016, p. 420.

when approving the access arrangement. We have added a note to this effect stating that, when making a determination on a pass through application, we will have regard to:

(iii) any assessment by the AER of ActewAGL's insurance in approving the access arrangement for the relevant period.⁸³

ActewAGL objected to the requirement that the service provider actually makes an insurance claim and receives a benefit, on the basis that payment might be unforthcoming for various reasons such as the insolvency of the insurer.⁸⁴ ActewAGL argued the 'insurer credit risk event' considered below is inadequate in this respect because it allows recovery only to the insurance cap level and not to higher levels of loss. In a previous regulatory process ActewAGL gave the further scenario of:

the insurer raising an unmeritorious dispute to the claim or otherwise seeking to evade or failing to honour its contractual obligations.⁸⁵

We consider the suggested scenarios are not sufficiently related to the level of the insurance cover to be properly included within the definition of insurance cap event. Insurer insolvency is covered by its own pass through event, which is considered below. Further, the risk of an insurer raising an unmeritorious dispute or failing to honour its obligations—and the resolution of any such complaints—is best managed by the service provider.

Insurer credit risk event

We accept the inclusion of an insurer credit risk event but not the definition in ActewAGL's revised access arrangement proposal. We approve the definition of insurance credit risk event as used in our draft decision, with one modification to remove a redundant word.⁸⁶

The substantive differences between ActewAGL's proposed definition and that in our draft decision are as follows (ActewAGL's proposed amendments are underlined):

Insurer Credit Risk Event means the occurrence of an event whereby an insurer of the Service Provider becomes insolvent and, as a result, in respect of an existing, or potential, claim for a risk that was insured by the insolvent insurer, ActewAGL:

⁸³ ActewAGL has advised it has no objection to this modification: ActewAGL Distribution, *Response to AER Information Request 056*, 1 April 2016, p. 4.

⁸⁴ ActewAGL Distribution, *Response to AER's draft decision, 2016-21 ACT, Queanbeyan and Palerang Gas Network Access Arrangement*, January 2016, p. 124.

⁸⁵ ActewAGL, *Revised Regulatory Proposal, 2015-19 Regulatory control period, Distribution services provided by the ActewAGL Distribution electricity network in the ACT*, January 2015, p. 540.

⁸⁶ Paragraph (a) of our definition now commences 'an insurer of the service provider becomes insolvent' instead of 'a nominated insurer of the service provider becomes insolvent'. The word 'nominated' was redundant.

(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:

(i) ActewAGL'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 ActewAGL had reasonable opportunity to insure the risk with a different provider.⁸⁷

In addition to costs incurred as a result of a change in claim limits or deductibles, ActewAGL's proposal would allow it to pass through an increase in insurance premiums, and would allow it to do so regardless of whether ActewAGL itself insured with the failed insurer. ActewAGL argued:

- the failure of one insurer could result in other insurers increasing premiums or deductibles
- allowing pass through of insurance premiums or deductibles regardless of whether ActewAGL insured with the failed insurer will "ensure this definition does not create an incentive to inefficiently delay obtaining insurance"
- any increase in costs from this event is unlikely to exceed the materiality threshold, but if it does it should flow through to prices as in a workably competitive market.⁸⁸

We do not accept ActewAGL's reasoning. We maintain the position taken in our draft decision that insurance premiums are a typical business expense subject to ordinary market factors and which the regulated entity is best placed to manage. We accept that the failure of a large insurer such as what occurred with HIH can have significant implications for the availability and cost of insurance. However, we do not believe this provides a foundation to shift the risk from the regulated firm to its customers. The firm remains best placed to manage risks in the new environment, and therefore should bear the costs of an increase in premiums following the failure of an insurer.

We do not agree that not allowing pass through increases regardless of whether ActewAGL insured with the failed insurer would create an incentive to delay obtaining

⁸⁷ ActewAGL Distribution, *Access Arrangement for ACT, Queanbeyan and Palerang gas distribution network 1 July 2016 - 30 June 2021*, January 2016, Schedule 1: Definitions, definition of Insurer Credit Risk Event.

⁸⁸ ActewAGL Distribution, *Response to AER's draft decision, 2016-21 ACT, Queanbeyan and Palerang Gas Network Access Arrangement*, January 2016, p. 125.

insurance. Any such tendency would be countered by the provision in ActewAGL's access arrangement⁸⁹ for consideration of ActewAGL's acts or omissions part (for example, in obtaining new insurance) when assessing a pass through application. We consider our preferred definition provides incentives for ActewAGL to efficiently manage this risk.

We have modified ActewAGL's proposed definition to remove the ability to pass through the cost of premium increases resulting from any insurer becoming insolvent, and to restrict the pass through to the cost of specific claims against the failed insurer of the service provider.⁹⁰

Terrorism event

We agree to the inclusion of a terrorism pass through event, and we have largely adopted the definition in ActewAGL's revised access arrangement proposal.

Our draft decision required ActewAGL to amend its definition of the terrorism event to explicitly require that the event increase the cost of providing the reference service.⁹¹ ActewAGL's revised proposal addressed this requirement.

Our draft decision also required ActewAGL to remove cyber-terrorism from the examples of what might constitute an act of terrorism. We expressed concern that allowing cyber-terrorism costs to be passed through may act as a disincentive to prudent and efficient IT protection.⁹²

ActewAGL did not make this amendment, arguing that a cyber-related attack could occur despite it having taken prudent and efficient actions in accordance with good industry practice. ActewAGL drew support from Australian Government sources to argue the risk is substantially increasing and impossible to completely remove.⁹³

We accept ActewAGL's submission that a cyber-related attack could occur despite prudent protection measures. Accordingly, if a cyber-attack has the characteristics of an act of terrorism, then ActewAGL could apply to have those costs passed through. However, we consider it unnecessary to refer expressly to cyber-related attacks in the definition of terrorism event.

⁸⁹ ActewAGL Distribution, *Access Arrangement for ACT, Queanbeyan and Palerang gas distribution network 1 July 2016 - 30 June 2021*, January 2016, cl. 7.12(c).

⁹⁰ AER, *Draft decision: ActewAGL Access Arrangement 2016 to 2021, Attachment 11 – Reference tariff variation mechanism*, November 2015, p. 11-29.

⁹¹ AER, *Draft decision: ActewAGL Access Arrangement 2016 to 2021, Attachment 11 – Reference tariff variation mechanism*, November 2015, pp. 11-30, 31.

⁹² AER, *Draft decision: ActewAGL Access Arrangement 2016 to 2021, Attachment 11 – Reference tariff variation mechanism*, November 2015, p. 11-31

⁹³ ActewAGL Distribution, *Response to AER's draft decision, 2016-21 ACT, Queanbeyan and Palerang Gas Network Access Arrangement*, January 2016, pp. 125–128.

Natural disaster event

We agree to include a natural disaster event, but have modified the definition in ActewAGL's revised access arrangement proposal.

Our draft decision required ActewAGL to amend the definition of this event to cover only events occurring within the access arrangement period, and to exclude pass through of events caused by ActewAGL's acts or omissions.

In response, ActewAGL amended the definition to confine it to events occurring in the access arrangement period, but maintained that natural disasters arising from its own acts or omissions should be excluded only where negligent. ActewAGL argued that allowing a pass through will give operators confidence to respond efficiently if the low probability event occurs, whereas if there is uncertainty as to whether a pass through is triggered this could create a disincentive to respond appropriately.⁹⁴

For the reasons set out in our draft decision we do not approve this modification. The exclusion of disasters caused by the service provider ensures service providers are incentivised to take appropriate action to manage the risks. The question of negligence or otherwise will often be uncertain until resolved by a court or other inquiry.

While not an issue raised in ActewAGL's revised proposal, in our final decisions on concurrent proposals for other service providers, we have:

- removed the adjectives 'major' and 'materially' from the definition of the natural disaster event to avoid perceived confusion with the materiality threshold that applies to all pass through events under the access arrangement.
- deleted reference to whether a government authority has made a natural disaster declaration, following submissions that this may not be an appropriate matter for us to consider in the context of a claim under the natural disaster pass through event..

We consulted ActewAGL on the final form of this definition and it advised that it supports each of these changes.⁹⁵

Network user failure event

We agree to include a network user failure event, but do not accept the definition in ActewAGL's revised access arrangement proposal. We have adopted a definition which differs from ActewAGL's proposal in these ways:

- our definition allows recovery of costs resulting from any RoLR event under section 122 of the NERL where those costs are not recoverable under other provisions of the NERL, NERR, NGL or NGR, including rule 531 of the NGR

⁹⁴ ActewAGL Distribution, *Response to AER's draft decision, 2016-21 ACT, Queanbeyan and Palerang Gas Network Access Arrangement*, January 2016, p. 130.

⁹⁵ ActewAGL Distribution, *Response to AER Information Request 056*, 1 April 2016, p. 7.

- our definition does not allow recovery of foregone revenue
- our definition confines the scope of this event to failure of retailers (which is consistent with ActewAGL's arguments in support of this event and its nexus to the RoLR process), and not users more broadly and
- our definition confirms that, in assessing an application under the proposed event, we would consider the efficiency of ActewAGL's decisions and actions in relation to the risk.⁹⁶

Our reasons are set out in detail in our draft decision.⁹⁷ In response to our draft decision ActewAGL accepted the fourth point above (consideration of efficiency of decisions and action) but did not incorporate our other required changes. It argued its proposed clause achieves the NGO to a greater degree because it applies in a larger number of circumstances. ActewAGL submitted that in those additional circumstances it considered the most efficient risk mitigation mechanism to be the cost pass through mechanism, because they could not be prevented, or substantially mitigated or insured against. We considered the extended set of circumstances ActewAGL has proposed in our draft decision, and for the reasons set out in that draft decision we disagree.⁹⁸ In the absence of any further argument, we are not persuaded by ActewAGL's submission and we maintain our draft decision position.

General pass through event

We do not accept the general pass through event in ActewAGL's revised access arrangement proposal. This maintains the position we took in our draft decision, which was on the basis that:

- the lack of specificity as to what risks are within the scope of the event would make it difficult for us to assess how a prudent service provider would manage the risk, and
- this difficulty is not remedied by excluding from the scope of the event any occurrence that could not have been prevented, mitigated against or insured against, as proposed by ActewAGL.

We also observed that ActewAGL's proposal would require us to assess a largely unlimited range of situations after they had occurred, indicating an unacceptable degree of uncertainty as to the potential scope of the event.

In response ActewAGL argued that historically few occurrences have required assessment under general pass through provisions. It submitted that this showed the

⁹⁶ AER, *Draft decision: ActewAGL Access Arrangement 2016 to 2021, Attachment 11 – Reference tariff variation mechanism*, November 2015, pp. 11-33 to 11-36.

⁹⁷ AER, *Draft decision: ActewAGL Access Arrangement 2016 to 2021, Attachment 11 – Reference tariff variation mechanism*, November 2015, pp. 11-33 to 11-36.

⁹⁸ AER, *Draft decision: ActewAGL Access Arrangement 2016 to 2021, Attachment 11 – Reference tariff variation mechanism*, November 2015, section 11.4.2.6.

assessment is not difficult and does not require us to assess a potentially limitless range of situations.⁹⁹

ActewAGL's proposal does not sit well with the pass through framework or its underpinning balance of service provider and user interests. The framework assumes events are 'pre-defined and exogenous',¹⁰⁰ and that pass through of costs is a last resort.¹⁰¹ This maintains incentives now and in the future to seek alternative mechanisms to manage risks. The regulator should use its discretion and seek justification that cost pass through is the most efficient method to manage the risks of the event. This model appropriately balances the interest of service providers in recovering efficient costs and attracting sufficient investment and the interest of users in ensuring prices are more than necessary to ensure an appropriate level of services.

ActewAGL's proposal says pass through is potentially available for any risk, the only limitation being whether the regulator is satisfied—*after an event has occurred*—that pass through is the most efficient risk management method. We consider this weakens the incentives on service providers to effectively manage risks - no longer a last resort, pass through becomes part of the standard risk management armoury. It is important that service providers have incentives to evaluate other mechanisms to manage risks before utilising pass through measures. Placing a situation within the scope of a pass through event and allowing costs to be passed through erodes the incentives now and in the future on service providers to seek alternative mechanisms to mitigate the cost impacts that may arise.

Supply curtailment event

Our draft decision did not approve ActewAGL's proposed supply curtailment event. ActewAGL removed this event from its revised proposal, but on the basis that it considered it would be covered by its proposed general pass through event. In the event that we did not approve the general pass through event, ActewAGL submitted the supply curtailment event should be allowed.

For the reasons set out above, we have not accepted the general pass through event. However, we do not accept that it follows that the supply curtailment event should be allowed. As set out in our draft decision, we consider that:

⁹⁹ ActewAGL Distribution, *Response to AER's draft decision, 2016-21 ACT, Queanbeyan and Palerang Gas Network Access Arrangement*, January 2016, pp.136–137.

¹⁰⁰ NER, Chapter 10: Glossary, definition of 'nominated pass through event considerations', paragraph (b) - 'whether the nature or type of event can be clearly defined at the time the determination is made for the service provider.

¹⁰¹ AEMC, *Rule Determination, National Electricity Amendment (Cost pass through arrangements for NSPs) Rule 2012*, 2 August 2012, p. 20. Also, 'the AEMC has made it clear that the AER must have regard to the relative efficiency of a proposed pass through event as an option to manage risk, suggesting that we should only accept a general pass through event when we consider it is the least inefficient option to manage an identified risk, for which other mitigation strategies are demonstrably inappropriate.

- the risk is most efficiently managed by ActewAGL, and to allow pass through would weaken ActewAGL's incentives to properly mitigate and minimise costs of a gas shortfall, and
- managing this risk is fundamental to ActewAGL's business and should be regarded as a typical business expense and not passed through.

In response to our draft decision ActewAGL submitted that risk management options exist including dialogue with market actors, contractual arrangements and insurance, but these cannot manage the risk exposure for all shortfall scenarios.¹⁰² It argues that as a consequence, despite it acting efficiently and in accordance with good industry practice, a gas supply shortfall might still arise.

We acknowledge the possibility that ActewAGL might incur costs resulting from a shortfall situation despite having taken prudent steps to mitigate. However, we consider ActewAGL is best placed to manage this risk, and the proposed pass through event would weaken ActewAGL's incentives to properly mitigate the risk and minimise the costs of a gas shortfall.

Cross-period pass throughs

We accept the mechanism in ActewAGL's revised access arrangement proposal for passing through the financial impacts of a pass through event in subsequent periods.

The revised access arrangement proposal:

- allows the financial impacts of an event occurring in the 2016–21 access arrangement period, which are not passed through in the same period, to be passed through in the 2021–26 access arrangement period¹⁰³
- provides that this principle is fixed for the transition from the 2016–21 period to the 2021–26 period but, for avoidance of doubt, is not binding in respect of the 2026–31 access arrangement period¹⁰⁴
- allows the financial impacts of an event occurring before the 2016–21 access arrangement period, but for which assessment of a pass through application is incomplete, to be recovered in that period.

In our draft decision we rejected ActewAGL's proposed fixed principle, which we were concerned sought not only to capture the transition from 2016–21 to 2021–26 but also future periods. We believe this would be inappropriate, and that the issue of cross

¹⁰² ActewAGL Distribution, *Response to AER's draft decision, 2016-21 ACT, Queanbeyan and Palerang Gas Network Access Arrangement*, January 2016, p. 133.

¹⁰³ ActewAGL Distribution, *Access Arrangement for ACT, Queanbeyan and Palerang gas distribution network 1 July 2016 - 30 June 2021*, January 2016, cl. 7.17.

¹⁰⁴ ActewAGL Distribution, *Access Arrangement for ACT, Queanbeyan and Palerang gas distribution network 1 July 2016 - 30 June 2021*, January 2016, cl. 5.1(c).

period pass throughs should be dealt with as part of our consultation on ActewAGL's proposal for those periods.

In response, ActewAGL amended its proposal to clarify the specific periods to which the clauses apply, specifically to allow costs incurred in the 2016–21 period to be recovered in the 2021–26 period.¹⁰⁵ We take this to mean that, in the 2021–26 access arrangement period, the mechanism in clause 7.17 is to serve a 'backward-looking' function and ensure pass through of events which occurred in the previous period, but will not operate prospectively to embed the principle in later access arrangement periods. On that basis we are satisfied with ActewAGL's amendments.

¹⁰⁵ ActewAGL Distribution, *Response to AER's draft decision, 2016-21 ACT, Queanbeyan and Palerang Gas Network Access Arrangement*, January 2016, p. 139.