# FINAL DECISION
# Jemena Gas Networks (NSW) Ltd
# Access Arrangement 2015-20

## Attachment 11 − Reference tariff variation mechanism

June 2015

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# Note

This attachment forms part of the AER's final decision on Jemena Gas Networks' 2015–20 access arrangement. It should be read with 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

# Contents

# Shortened forms

| Shortened form | Extended form |
|---|---|
| AER | Australian Energy Regulator |
| capex | capital expenditure |
| CAPM | capital asset pricing model |
| CCP | Consumer Challenge Panel |
| Code | National Third Party Access Code for Natural Gas Pipeline Systems |
| CPI | consumer price index |
| DRP | debt risk premium |
| ERP | equity risk premium |
| JGN | Jemena Gas Networks (NSW) Ltd (ACN 003 004 322) |
| MRP | market risk premium |
| NGL | national gas law |
| NGO | national gas objective |
| NGR | national gas rules |
| opex | operating expenditure |
| PPI | partial performance indicators |
| PTRM | post-tax revenue model |
| RAB | regulatory asset base |
| RBA | Reserve Bank of Australia |
| RFM | roll forward model |
| RIN | regulatory information notice |
| RoLR | retailer of last resort |
| RPP | revenue and pricing principles |
| SLCAPM | Sharpe-Lintner capital asset pricing model |
| WACC | weighted average cost of capital |

# 11 Reference tariff variation mechanism

This attachment sets out our decision on the reference tariff variation mechanism (including cost pass through events) proposed by JGN in its revised proposal. The reference tariff variation mechanism:

- permits building block revenues to be recovered smoothly over the access arrangement period, subject to any differences between forecast and actual demand
- accounts for actual inflation
- accommodates other reference tariff variation adjustments that may be required, such as approved cost pass through events, and
- sets administrative procedures for the approval of any proposed changes to reference tariffs.

## 11.1 Final decision

We have made all revisions necessary to give effect to this final decision to JGN's revised proposed access arrangement. These revisions can be found in section 3, and schedules 1 and 2 of the *Approved Access Arrangement, JGN's NSW gas distribution networks 1 July 2015 – 30 June 2020* (June 2015).[1]

### Reference tariff variation mechanism

We do not accept JGN's revised reference tariff variation mechanism for the 2015-20 access arrangement period. JGN's proposed initial reference tariffs and X factors must be revised to reflect the changes to the forecast total revenue requirement and approved demand forecast in this final decision.

### Pass through events

Our final decision is that the following pass through events will apply to JGN for the 2015–20 access arrangement period:

- Service Standard Event
- Regulatory Change Event
- Terrorism Event
- Natural Disaster Event
- Insurance Cap Event
- Insurer's Credit Risk Event

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1 NGR, r. 64(1) & (4).

- Network User Failure Event.

We have not accepted JGN's proposed gas supply shortfall event.

The approved pass through events are defined in Table 11.1. These include revised definitions for each of these events.

Our final decision is that a materiality threshold will apply to pass through events for the 2015–20 access arrangement. A pass through event will result in JGN incurring materially higher (or lower) costs if the change in costs (as opposed to the revenue impact) that JGN has incurred and is likely to incur in any year of the access arrangement period exceeds one per cent of the smoothed revenue requirement for that year under this final decision.

We have approved JGN's proposed fixed principle relating to the process for cross-period pass through events for the 2015-20 regulatory control period.

### Table 11.1 Approved cost pass through event definitions

| Event | Definition |
|---|---|
| Service Standard Event | Service Standard Event means a legislative or administrative act or decision that has the effect of:<br>(a) Varying, during the course of an Access Arrangement Period, the manner in which the Service Provider is required to provide the Reference Service; or<br>(b) Imposing, removing or varying, during the course of an Access Arrangement Period, minimum service standards applicable to the Reference Service; or<br>(c) Altering, during the course of an Access Arrangement Period, the nature or scope of the Reference Service provided by the Service Provider. |
| Regulatory Change Event | Regulatory Change Event means a change in regulatory obligation or requirement that falls within no other category of Cost Pass Through Event and substantially affects the manner in which the Service Provider provides the Reference Service. |
| Terrorism Event | Terrorism Event means an act (including, but not limited to, the use of force or violence or the threat of force or violence) of any person or group of persons (whether acting alone or on behalf of or in connection with any organisation or government), which from its nature or context is done for, or in connection with, political, religious, ideological, ethnic or similar purposes or reasons (including the intention to influence or intimidate any government and/or put the public, or any section of the public, in fear) and which increases the cost to the Service Provider in providing the Reference Service.<br>Note for the avoidance of doubt, in making a determination on a Terrorism Event pursuant to clause 3.4(i) [of JGN's Access Arrangement] , the AER will have regard to, amongst other things:<br>i. whether the Service Provider has insurance against the event,<br>ii. the level of insurance that an efficient and prudent service provider would obtain in respect of the event, and<br>iii. whether a declaration has been made by a relevant government authority that a terrorism event has occurred. |
| Natural Disaster Event | Natural Disaster Event means any major fire, flood, earthquake or other natural disaster that occurs during the 2015-20 Access Arrangement Period and increases the costs to the Service Provider in providing the Reference Service, provided the fire, flood or other event was not a consequence of the acts or omissions of the |

<table>
<tr><th>Event</th><th>Definition</th></tr>
<tr><td></td><td>Service Provider.<br><br>The term ‘major’ in the above paragraph means an event that is serious and significant.<br><br>Note for the avoidance of doubt, in making a determination on a Natural Disaster Event pursuant to clause 3.4(i) [of JGN’s Access Arrangement], the AER will have regard to, amongst other things:<br><br>i. whether the Service Provider has insurance against the event<br>ii. the level of insurance that an efficient and prudent service provider would obtain in respect of the event, and<br>iii. whether a relevant government authority has made a declaration that a natural disaster has occurred.</td></tr>
<tr><td>Insurance Cap Event</td><td>Insurance Cap Event means an event where:<br><br>(a) the Service Provider makes a claim or claims and receives the benefit of a payment or payments under a relevant insurance policy;<br>(b) the Service Provider incurs costs beyond the relevant policy limit; and<br>(c) the costs beyond the relevant policy limit increase the costs to the Service Provider of providing the Reference Service.<br><br>For this Insurance Cap Event:<br><br>(a) the relevant policy limit is the greater of:<br>i. the Service Provider’s actual policy limit at the time of the event that gives, or would have given rise to the claim; and<br>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;<br>(b) a relevant insurance policy is an insurance policy held during the Access Arrangement Period or a previous period in which access to the pipeline services was regulated; and<br>(c) the Service Provider will be deemed to have made a claim on a relevant insurance policy if the claim is made by a related party of the Service Provider in relation to any aspect of the Network or the Service Provider’s business<br><br>Note for the avoidance of doubt, in making a determination on an Insurance Cap Event pursuant to clause 3.4(i) [of JGN’s Access Arrangement] , the AER will have regard to, amongst other things:<br><br>i. the insurance policy for the event, and<br>ii. the level of insurance that an efficient and prudent Service Provider would obtain in respect of the event.</td></tr>
</table>

| Event | Definition |
| --- | --- |
| Insurer Credit Risk Event | Insurer Credit Risk Event means an event where:<br>(a) A nominated insurer of the Service Provider becomes insolvent, and as a result, in respect of an existing, or potential, claim for a risk that was insured by the insolvent insurer, the Service Provider:<br>i. is subject to a higher or lower claim limit or a higher or lower deductible than would have otherwise applied under the insolvent insurer's policy; or<br>ii. incurs additional costs associated with self-funding an insurance claim, which would otherwise have been covered by the insolvent insurer.<br>Note for the avoidance of doubt, in making a determination on an Insurer Credit Risk Event pursuant to clause 3.4(i) [of JGN's Access Arrangement] , the AER will have regard to, amongst other things:<br>i. the Service Provider's attempts to mitigate and prevent the event from occurring by reviewing and considering the insurer's track record, size, credit rating and reputation, and<br>ii. in the event that a claim would have been made after the insurance provider became insolvent, whether the Service Provider had reasonable opportunity to insure the risk with a different provider. |
| Network User Failure Event | Network User Failure Event means an event where:<br>(a) a Retailer of Last Resort (RoLR) Event as defined in section 122 of the National Energy Retail Law has occurred, and<br>(b) the Service Provider incurs costs in responding to the RoLR event in accordance with its obligations under the NERL, NERR, NGL or NGR (including Guidelines and procedures that are binding under those instruments), and<br>(c) the costs are not recoverable by the Service Provider under other provisions of the NERL, NERR, NGL or NGR as in force at the time of the event, including but not limited to rule 531 of the NGR and other pass through events in this Access Arrangement.<br>Note for the avoidance of doubt, in making a determination on a Network User Failure Event pursuant to clause 3.4(i) [of JGN's Access Arrangement] , the AER will have regard to, amongst other things, the extent to which the Service Provider has taken steps to minimise the costs associated with its responsibilities in a RoLR Event, both prior to, and after, the RoLR Event was triggered. |

## 11.2 JGN's revised proposal

### 11.2.1 Reference tariff variation mechanism

JGN's revised proposal accepted our draft decision on the reference tariff variation mechanism but suggested drafting changes for better clarity.[2]

[2] Jemena Gas Networks, *Access Arrangement 2015–20, Response to the AER's draft decision & revised proposal*, February 2015, p. 119.

### 11.2.2 Cost pass through events

In its revised proposal JGN:

- accepted the revisions to the service standard event and regulatory change event in the draft decision, subject to drafting amendments
- accepted our draft decision to reject JGN's proposed Business Continuity Event. In its place JGN proposed five more specifically defined events:
    - Insurance Cap Event
    - Natural Disaster Event
    - Terrorism Event
    - Gas Supply Shortfall Event, and
    - Insurer Credit Risk Event.
- did not accept our draft decision to reject its proposed Network User Failure Event
- did not accept our draft decision to apply a materiality threshold of one per cent revenue to all approved pass through events, and
- did not accept our rejection of JGN's proposed fixed principle in relation to cross period pass through events.

## 11.3 AER’s assessment approach

Our approach to assessing the reference tariff variation mechanism and JGN's proposed pass through events was described in detail in our draft decision for JGN.[3] We maintained this approach for the final decision.

## 11.4 Reasons for final decision

### 11.4.1 Reference tariff variation mechanism

We accept most of JGN's proposed drafting changes and the details are provided below. However, the initial reference tariffs in JGN's revised proposal must be amended to reflect our final decision on total revenue and forecast demand.

[3] AER, *Draft decision Jemena Gas Networks Access Arrangement 2015-2020, Attachment 11 - Reference tariff variation mechanism*, November 2014, section 11.3.1.

## Table 11.2: AER consideration on JGN's revised proposal reference tariff variation mechanism

| Clause of AA | AER's intention for draft decision | JGN's revised proposal | AER consideration |
|---|---|---|---|
| 3.1(b) | The intention for this amendment was to give us greater oversight over the tariff variation process. | AER amendment partly accepted.<br>JGN has used the simpler wording from its initial proposal, but included additional wording to make it clearer that variations may only be made with AER approval.[4] | We accept JGN's revisions because it allows us greater oversight on the tariff variation process. |
| Schedule 2 item 4 | The intention of this amendment was to update the initial reference tariff for the revenue requirement and X factors. | JGN has identified minor drafting issues with the draft decision (decimal places in tariff prices and tariff names). | We note JGN's suggested drafting changes. Initial reference tariffs will again be updated for the revenue requirement and X factors approved in this final decision. |
| 3.6(a)(iii) | The intention for this amendment was to give us greater oversight over the tariff variation process. | JGN did not agree with our drafting changes but proposed drafting that is intended to have the same meaning as our draft decision amendment. | We accept JGN's revisions because it is consistent with our intention to collect sufficient information from JGN prior to approving its haulage reference tariffs. |
| 3.6(a)(iv) and 3.7(a)(iv) | The intention for this amendment was to give us greater oversight over the tariff variation process by requesting auditor sign off historical gas quantity inputs. | JGN largely accepted the AER's amendments subject to minor drafting amendments. | We accept JGN's revisions because it is consistent with our intention to allow us greater oversight and certainty over the tariff variation process. |
| 3.2(b) | This revision was intended to update the reference tariff variation mechanism formula. | JGN partially accepted our draft decision:<br>• Amendment 11.4.1: ability to vary, add or remove tariffs. JGN considers that it should be allowed to vary tariffs under the access arrangement with the AER's approval rather than through NER clause 65.<br>• Accepted the AER's draft decision on the rebalancing side constraint formula.<br>• Rejected the AER's definition for CPI<br>• Proposed changes to the | We accept JGN's proposal to vary tariffs under the access arrangement with our approval rather than through NER clause 65. We consider that JGN's access arrangement allow us sufficient oversight on the tariff variation process should JGN decide to vary, withdraw or vary, add or remove reference tariffs.<br>We accept JGN's definition of CPI because the December quarter will be the most up to date data available.<br>We accept JGN's proposed definition changes to the X factor noting that it will be based on our final decision and JGN's revenue model. |

4 Jemena Gas Networks, *Access Arrangement 2015–20, Appendix 10.4 - Response to draft decision on JGN's revised AA*, February 2015, p. 4.

| Clause of AA | AER's intention for draft decision | JGN's revised proposal | AER consideration |
|---|---|---|---|
| | | AER's definition of the X factor. | |
| Schedule 3 | This revision was intended to allow only carbon costs that were approved by the AER to be recovered.<br>Also included were amendments to the APt definition and revisions to 11.4 as stated above. | JGN largely accepted the AER's amendments for carbon but suggested minor changes.<br>AER amendment to the APt definition was not accepted. | We accept JGN's proposed changes to carbon costs because it is consistent with our draft decision.<br>We accept JGN's definition of APt because it is more appropriate to use the word "network" rather than "JGN" in this clause. |

Source: AER analysis and JGN's revised *Response to the AER's draft decision and revised proposal: Appendix 1.04: Response to draft decision on JGN's revised AA*, February 2015, pp. 4–10.

### Vanilla weighted average cost of capital

As part of its revised proposal, JGN sought minor adjustments to the definition of the real weighted average cost of capital (WACC) to apply to the automatic adjustment factor and the licence fee. This included ensuring that the definition made it clear that the WACC was a variable number, not a fixed value, on account of annual updates to the cost of capital as per the methodology set out in the AER's rate of return guideline.

For the most part we have taken up JGN's suggestions. However, for consistency with the rest of our final decision on the WACC definition, the relevant rate of return is the real vanilla weighted average cost of capital (*real vanilla WACCt*) as set out in this final decision and updated annually within the revenue model used by the AER to set JGN revenues for each year of the access arrangement.

## 11.4.2 Cost pass through reference tariff variation mechanism

We have used the same approach that we described in the draft decision for JGN to assess the pass through events in JGN's revised proposal. In particular, we have taken account of each consideration discussed in attachment 11, section 11.3.1 of the draft decision.

Using that approach, we have considered the arguments in JGN's revised proposal. We did not receive any submissions from stakeholders in relation to cost pass through events.

In this section we discuss the reasons for our final decision on:

- each of JGN's proposed pass through events
- the application of a materiality threshold to the approved cost pass through events, and

- the application of a fixed principle in relation to cross period pass through applications.

This is an area in which we have full discretion. This means that we have discretion to withhold our approval of any aspect of JGN's proposal if, in our opinion, a preferable alternative exists that complies with the requirements of the NGL and is consistent with the applicable criteria prescribed by the NGL.[5]

## Service Standard Event and Regulatory Change Event

In our draft decision we set out revisions to JGN's proposed definitions of the Service Standard Event and Regulatory Change Event. JGN has made some, but not all, of these revisions, and proposed additional drafting amendments. JGN's revised proposal:

1. kept Cost Pass Through Events as a defined term in the 2015–20 Access Arrangement[6]
2. used the words 'Service Provider' rather than JGN to maintain consistency with other areas in the 2015–20 Access Arrangement[7]
3. kept the word 'means' after the name of the event for consistency[8]
4. replaced 'the Reference Service' with 'a Reference Service', as JGN only has one reference service under the 2015–20 Access Arrangement[9]
5. removed the word 'substantial' in the regulatory change event definition to avoid duplication with the materiality threshold, which it considered essentially means the same thing.[10]

We accept JGN's proposed changes 1 – 4 above. These are minor drafting changes and will not affect the operation of the event definitions.

We do not accept JGN's removal of the word 'substantial' from the definition of regulatory change event.

Our draft decision accepted the following definition of the regulatory change event:

> Regulatory Change Event means a change in a regulatory obligation or requirement that falls within no other category of Cost Pass Through Event and

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5 NGR, r. 40(3).

6 Jemena Gas Networks, *Access Arrangement 2015–20, Response to the AER's draft decision & revised proposal*, February 2015, p. 127.

7 Jemena Gas Networks, *Access Arrangement 2015–20, Response to the AER's draft decision & revised proposal*, February 2015, p. 128.

8 Jemena Gas Networks, *Access Arrangement 2015–20, Response to the AER's draft decision & revised proposal*, February 2015, p. 128.

9 Jemena Gas Networks, *Access Arrangement 2015–20, Response to the AER's draft decision & revised proposal*, February 2015, p. 128.

10 Jemena Gas Networks, *Access Arrangement 2015–20, Response to the AER's draft decision & revised proposal*, February 2015, p. 127.

> substantially affects the manner in which the Service Provider provides the Reference Service.

'Substantially' in this definition refers to the effect the change in regulatory obligation has on the manner in which the Service Provider provides the reference service. That is, the event occurs when a change in regulatory obligation or requirement *substantially affects the manner in which the Service Provider provides the reference service*. Where that requirement is satisfied, the materiality threshold that applies to pass through events is used to determine whether the resultant change in costs is material.

The language used in our draft decision is taken from the prescribed regulatory change event in the National Electricity Rules (NER), which applies to all electricity network service providers:[11]

> ***regulatory change event***
>
> A change in a regulatory obligation or requirement that:
>
> a) falls within no other category of pass through event; and
>
> b) occurs during the course of a regulatory control period; and
>
> c) **substantially** affects the manner in which the Transmission Network Service Provider provides prescribed transmission services or the Distribution Network Service Provider provides direct control services (as the case requires); and
>
> d) materially increases or materially decreases the costs of providing those services.

The NER definition serves to address the same risks to electricity network service providers that JGN seeks to manage by including a regulatory change event in its Access Arrangement.

The definition in our draft decision incorporated clauses (b) and (c) of the NER definition. It did not include clause (a) or (d), which we considered were addressed in other clauses of the proposed access arrangement. However, when the definition and the materiality threshold are read together (as they appear in clauses (c) and (d) of the NER definition), it is clear that there is a cumulative requirement for a substantial effect on the manner in which a service is provided *and* a material cost impact.

JGN argues that this cumulative requirement creates uncertainty and ambiguity as to whether an application under this pass through event would be approved.[12] It suggests that, if retained, JGN would be left without certainty as to whether it would be permitted to pass through a material change in costs even where it could demonstrate that:

11 NER, Chapter 10 – Glossary.

12 Jemena Gas Networks, *Access Arrangement 2015–20, Response to the AER's draft decision & revised proposal*, February 2015, p. 127 (para. 610).

- the change was beyond its control
- there were no other available means of mitigation
- there was a financial impact on JGN's business that well exceeded the financial threshold
- there was a clear and demonstrable impact on the provision of the reference service.[13]

We consider that in such circumstances a change would be considered to have a substantial effect on the manner in which the reference service is provided. We do not, therefore, see a basis for distinction between JGN and the electricity businesses that are subject to the NER definition.

JGN also noted that previous Access Arrangement decisions by the AER (made in 2011 and 2013) did not include a requirement that the impact of a regulatory change event be substantial. It argued that it should receive equivalent treatment.[14] This decision reflects our most recent consideration of the appropriate definition of the regulatory change event. As explained above, the definition in our draft decision will also provide JGN with equivalent treatment to electricity network businesses under the prescribed regulatory change event in the NER.

In this final decision, we have therefore maintained our draft decision definition of the regulatory change event.

Our approved definitions for the service standard and regulatory change events are in Table 11.1.

## Insurance Cap Event

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

JGN proposed this event for the first time in its revised proposal, in response to our draft decision to reject its proposed business continuity event.[15]

In its revised proposal JGN stated that:

- it holds efficient levels of insurance cover commensurate with its assessment of business risk and undertakes periodic reviews of its insurances, and
- an insurance cap event is necessary to properly manage its exposure to the risk of liabilities crystallising over and above its insurance levels.[16]

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[13] Jemena Gas Networks, *Access Arrangement 2015–20, Response to the AER's draft decision & revised proposal*, February 2015, p. 127 (para. 611).

[14] Jemena Gas Networks, *Access Arrangement 2015–20, Response to the AER's draft decision & revised proposal*, February 2015, p. 127 (para. 612).

[15] Jemena Gas Networks, *Access Arrangement 2015–20, Response to the AER's draft decision & revised proposal*, February 2015, p. 129.

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

We accept that an insurance cap event would protect JGN from high cost impact events which would be uneconomical to insure against. We consider consumers benefit because they are not required to fund excessive premiums where insurance, if available, would be uneconomic. Consumers then only bear the risk should an insurance cap event occur.

We therefore consider the inclusion of an insurance cap event in JGN's 2015–20 Access Arrangement supports the NGO and RPP. However, we have substituted our preferred definition for that proposed by JGN. In particular, we have included in our definition the factors that we will consider when assessing an application for a pass through under this event. JGN's proposed definition did not include these factors.

We note that if a pass through event of this kind were to occur, in assessing JGN's application to pass through costs, we would consider the efficiency of JGN's decisions and actions in relation to the risk of the event.[17] We would consider, amongst other things, the level of insurance for the event and consider that in the context of the level an efficient and prudent service provider could obtain. This gives JGN an incentive to mitigate the risks associated with the event including through acquiring an appropriate level of insurance and implementing other practical risk minimisation strategies in its operations.

We consider including such factors in the definition is important as they provide transparency and increase regulatory certainty around how we will assess an application for this event.

Our revised definition for the insurance cap event is in Table 11.1.

## Terrorism Event

A terrorism pass through event would allow JGN to apply to pass through costs associated with acts of terrorism to customers.

JGN proposed this event for the first time in its revised proposal, in response to our draft decision to reject its proposed business continuity event.[18]

In its revised proposal JGN states:

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16 Jemena Gas Networks, *Access Arrangement 2015–20, Response to the AER's draft decision & revised proposal*, February 2015, p. 130.

17 Jemena Gas Networks, *Access Arrangement: JGN's NSW Gas distribution networks, 1 July 2015 - 30 June 2020*, cl. 3.4(j)(iii).

18 Jemena Gas Networks, *Access Arrangement 2015–20, Response to the AER's draft decision & revised proposal*, February 2015, p. 129.

- it has a risk assessment framework to proactively mitigate the security risk to its network and non-network assets,[19] and
- that full insurance coverage via external insurance is prohibitive.[20]

We consider the inclusion of a Terrorism Event in JGN's 2015–20 Access Arrangement supports the NGO and RPP. However, we have substituted our preferred definition of this event for that proposed by JGN. In particular, we have included in our definition the factors that we will consider when assessing an application for a pass through under this event. JGN's proposed definition did not include these factors.

We note that if a pass through event of this kind were to occur, in assessing JGN's application to pass through costs, we will consider the efficiency of JGN's decisions and actions in relation to the risk of the event.[21] We would consider, amongst other things, whether JGN has insurance for the event, the level of insurance an efficient and prudent service provider would obtain in respect of the event and whether a declaration has been made by a relevant government authority that a terrorism event has occurred. This gives JGN an incentive to mitigate the risks associated with the event including through acquiring an appropriate level of insurance and implementing other practical risk minimisation strategies in its operations.

We consider these factors are important as they provide transparency and increase regulatory certainty around how we will assess an application for this event.

We note that there may be some overlap between a Terrorism Event and an Insurance Cap Event. However, we accept the case for having both because JGN may incur costs in a Terrorism Event that an insurance policy would not ordinarily cover.

Our revised definition for the terrorism event is in Table 11.1.

## Natural Disaster Event

This pass through event would allow JGN to apply to pass through to consumers costs associated with JGN's actions in response to natural disasters.

JGN proposed this event for the first time in its revised proposal, in response to our draft decision to reject its proposed business continuity event.[22]

In its revised proposal JGN stated that:

[19] Jemena Gas Networks, *Access Arrangement 2015–20, Response to the AER's draft decision & revised proposal*, February 2015, p. 134.

[20] Jemena Gas Networks, *Access Arrangement 2015–20, Response to the AER's draft decision & revised proposal*, February 2015, p. 133.

[21] JGN, Access Arrangement: JGN's NSW Gas distribution networks, 1 July 2015 - 30 June 2020, cl. 3.4(j)(iii).

[22] Jemena Gas Networks, *Access Arrangement 2015–20, Response to the AER's draft decision & revised proposal*, February 2015, p. 129.

- this event captures a key category of uncertain, potentially high cost-impact events that are outside of JGN's control
- natural disaster events typically result in JGN incurring substantial costs in undertaking emergency response, repair and rectification works
- its proposed opex allowance for emergency response provides cover only to the level of emergency response expenditure incurred in the base year
- it takes steps to mitigate the cost impacts of natural disasters through its organisation resilience framework and associated plans and available insurance, and
- full insurance coverage is cost prohibitive.[23]

We consider that inclusion of a natural disaster event is consistent with the NGO and RPP. However, we consider JGN's definition of a natural disaster event is not sufficiently clear.[24] We consider that a natural disaster event should be more clearly defined so that the event can be identified and assessed. We have therefore substituted our preferred definition of this event for that proposed by JGN.

In particular, we have included in our definition:

- the requirement that the fire, flood or other event was not a consequence of the acts or omissions of the Service Provider. JGN states that this is unnecessary,[25] however we consider it provides upfront transparency and reiterates its importance, and
- we have included in our definition the factors that we will consider when assessing an application for a pass through under this event. We consider these factors are important as they provide transparency and increase regulatory certainty around how we will assess an application for this event.

Our revised definition for the natural disaster event is in Table 11.1.

## Insurer Credit Risk Event

This event is intended to provide for circumstances in which an insurance claim is, or is likely to be, successful but JGN is unable to recover outstanding insurance claims as a result of the insolvency of an insurance provider.

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[23] Jemena Gas Networks, *Access Arrangement 2015–20, Response to the AER's draft decision & revised proposal*, February 2015, p. 132.

[24] Jemena Gas Networks, *Access Arrangement 2015–20, Response to the AER's draft decision & revised proposal*, February 2015, p. 129.

[25] Jemena Gas Networks, *Access Arrangement 2015–20, Response to the AER's draft decision & revised proposal*, February 2015, p. 132.

JGN proposed this event for the first time in its revised proposal, in response to our draft decision to reject its proposed business continuity event.[26]

In its revised proposal JGN stated that:

- It takes a number of precautions to mitigate exposure to an insurer's credit risk event, including;
  - the appointment of a global insurance broker, ensuring all insurers are rated Standard and Poor's (or equivalent) A- or better,
  - the receipt of quarterly insurer security rating reports, and
  - diversifying the insurance portfolio.[27]
- Despite these efforts, an insurer may fail and leave JGN considerably exposed in circumstance beyond its ability to control.[28]
- A prudent service provider cannot always anticipate the failure of an insurance provider. JGN cited the HIH Insurance collapse and AIG Insurance's difficulties during the global financial crisis as examples.[29]

We have considered JGN's arguments and how the unanticipated collapse of an insurance provider would impact service providers. If a similar event to the HIH Insurance collapse was to occur during the 2015–20 Access Arrangement period a service provider that had acted prudently and efficiently could still incur material costs. The service provider may therefore still potentially suffer a significant loss as a consequence of an insurer becoming insolvent and thereby unable to satisfy all insurance claims. Service providers are also limited in the extent to which they can avoid such losses, short of taking out multiple insurance policies to cover the same risks.

We accept that the options available to service providers to manage these risks are limited, and given the rarity of such events, may in fact result in greater expenditure on insurance than is prudent or efficient.

We therefore accept that an Insurer's Credit Risk Event can be consistent with the NGO and the RPP, if appropriately defined. We consider a targeted definition of this event—which makes clear that in assessing a pass through application we will have regard to the importance of JGN reviewing and considering the viability of its selected

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26 Jemena Gas Networks, *Access Arrangement 2015–20, Response to the AER's draft decision & revised proposal*, February 2015, p. 129.

27 Jemena Gas Networks, *Access Arrangement 2015–20, Response to the AER's draft decision & revised proposal*, February 2015, p. 138-139.

28 Jemena Gas Networks, *Access Arrangement 2015–20, Response to the AER's draft decision & revised proposal*, February 2015, p. 139.

29 Jemena Gas Networks, *Access Arrangement 2015–20, Response to the AER's draft decision & revised proposal*, February 2015, p. 139.

insurer—will maintain incentives on JGN to take prudent and reasonable actions in relation to insurance.

In its proposed definition for this event, JGN sought to include provision for it to pass through costs associated with changes to insurance premiums as a result of an insurer becoming insolvent.[30] However, we consider insurance premiums are a typical business expense, subject to ordinary market factors in the economy. This is a risk that businesses are best placed to manage, rather than customers.

We therefore do not accept JGN's proposed definition of this event, and have substituted our preferred definition. Our definition:

- limits the pass through event to costs incurred by JGN where an existing insurance claim cannot be recovered due to the insurer becoming insolvent.
- includes provision for JGN to apply to pass through unrecovered claim amounts if the insurer becomes insolvent and the need for a claim comes very shortly after the insurer becomes insolvent, such that JGN could not reasonably have found another insurer in time.
- includes factors that we will have regard to when assessing an application for an Insurer's Credit Risk Event to increase clarity and regulatory certainty.

JGN’s proposed definition included provisions outlining its proposed materiality threshold for this event. Our decision regarding the materiality threshold for cost pass through events in JGN's 2015–20 Access Arrangement is the discussed in section 11.4.3 below.

Our revised definition for the insurer credit risk event is in Table 11.1.

## Network User Failure Event

In its original proposal, JGN proposed a network user failure event. It submitted that the proposed event covers costs incurred by JGN in following required procedures in a Retailer of Last Resort (RoLR) event under the National Energy Retail Law (NERL), which JGN considers are not adequately addressed in the NERL and NGR.[31]

We rejected this cost pass through event in our draft decision as we considered that:[32]

- the primary costs incurred by JGN as a result of a retailer becoming insolvent or unable to supply gas are already covered by section 167 of the NERL and rule 531 of the NGR

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[30] Jemena Gas Networks, *Access Arrangement 2015–20, Response to the AER's draft decision & revised proposal*, February 2015, p. 138.

[31] NERL, Part 6, s. 122.

[32] AER, *Draft decision Jemena Gas Networks Access Arrangement 2015-2020, Attachment 11 - Reference tariff variation mechanism*, November 2014, pp. 11–21.

- JGN is best placed to manage and mitigate the costs associated with a retailer becoming insolvent, including undertaking steps to recover debts, and
- not approving this event will maintain JGN's incentives to take action to recover unpaid network charges and undertake appropriate debt recovery processes.

In its revised proposal JGN did not accept our position.[33] It stated that:

- Section 167 of the NERL and rule 531 of the NGR provide only partial relief to JGN in certain circumstances of retailer failure.[34]
- In any RoLR event which then leads to the Australian Energy Market Operator (AEMO) applying the RoLR procedures, JGN will be required to perform its obligations under the NERL and the RoLR procedures to facilitate the transfer of customers in retail market systems. These costs include:
    - providing AEMO with an estimate meter reading for every customer being transferred[35]
    - working with AEMO and the designated RoLR to settle an outcome for each outstanding service order transaction that is "open" (e.g. customer churns, new connection requests, disconnection requests)[36]
    - working with AEMO and the designated RoLR to complete a reconciliation, where deemed necessary by AEMO no later than 65 days after the transfer.[37]
- JGN has very limited system automation for this process, given the low probability of a RoLR event occurring,[38] and costs in a RoLR event would be dependent on the particular circumstances, including the number of customers to be transferred.[39] JGN considers it has acted efficiently to avoid the cost of a project to change its systems to automate RoLR customer transfer processes, because the low probability of occurrence does not justify the significant cost.[40]

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[33] Jemena Gas Networks, *Access Arrangement 2015–20, Response to the AER's draft decision & revised proposal*, February 2015, p. 140.

[34] Jemena Gas Networks, *Access Arrangement 2015–20, Response to the AER's draft decision & revised proposal*, February 2015, p. 140.

[35] Jemena Gas Networks, *Access Arrangement 2015–20, Response to the AER's draft decision & revised proposal*, February 2015, p. 141.

[36] Jemena Gas Networks, *Access Arrangement 2015–20, Response to the AER's draft decision & revised proposal*, February 2015, p. 142.

[37] Jemena Gas Networks, *Access Arrangement 2015–20, Response to the AER's draft decision & revised proposal*, February 2015, p. 142.

[38] Jemena Gas Networks, *Access Arrangement 2015–20, Response to the AER's draft decision & revised proposal*, February 2015, p. 142.

[39] Jemena Gas Networks, *Access Arrangement 2015–20, Response to the AER's draft decision & revised proposal*, February 2015, p. 142.

[40] Jemena Gas Networks, *Access Arrangement 2015–20, Response to the AER's draft decision & revised proposal*, February 2015, p. 143.

With the benefit of this additional information we consider that including a Network User Failure Event in JGN's 2015–20 Access Arrangement would, if appropriately defined, support the NGO and the RPP. However, for the reasons set out below, we do not accept JGN's definition of this event and have substituted our preferred definition.

We consider a Network User Failure Event could provide an efficient alternative to JGN investing an automated system solely for transferring customers in a RoLR event. Where such systems significantly exceed what JGN would otherwise require to process customer transfers in accordance with the NERL, NERR, NGR and retail market procedures, this expenditure may not be prudent or efficient, particularly given the low frequency of RoLR events. For avoidance of doubt, our preferred definition notes that when assessing an application under a Network User Failure Event we will have regard to, amongst other things the extent to which the service provider has taken steps to minimise the costs associated with its responsibilities in a RoLR event, both prior to, and after, the RoLR event was triggered.

### *Application where failed retailer is not insolvent*

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

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

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

### *Recovery of foregone revenue*

JGN raised its concern that rule 531 of the NGR does not explicitly allow for recovery of foregone revenue, and by referring to costs could be read as limited to JGN’s costs in administering a RoLR event.

We are also aware that this issue is currently under consideration by the AEMC, which is consulting on changes to the equivalent provisions in the NER proposed by the COAG Energy Council.[41] The rule change, proposed by the COAG Energy Council,

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41 Jemena Gas Networks, *Access Arrangement 2015–20, Response to the AER's draft decision & revised proposal*, February 2015, p. 140. See also the rule change proposal, Retailer insolvency costs - pass through provisions, on the AEMC website http://www.aemc.gov.au/Rule-Changes/Retailer-insolvency-costs-pass-through-provisions.

relates to amendments the Energy Council intended to make to the NER prior to commencement of the National Energy Customer Framework.[42]

The AEMC's consideration of this rule change proposal is ongoing at the time of this decision, and no decision has been made as to whether the proposed changes to the NER will be made. It is not for us to pre-empt the outcomes of the AEMC's consideration of the changes proposed to the NER. In reaching its decision, the AEMC's consultation paper suggests that it will look at a number of considerations that are similar to those we have regard to in assessing proposed pass through events. However, we must make our decision on the pass through events to be included in JGN's 2015-20 Access Arrangement based on the information before us in this process.

Key to our consideration of this event are the appropriate allocation of risk between JGN and its customers, and the incentives that would flow from a pass through event that allowed JGN to recover amounts unpaid by a failed retailer directly from its customers.

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

- JGN can and should make use of credit support arrangements under Part 21 of the NGR to limit its exposure to credit risk.
- Should a retailer become insolvent, JGN can and should pursue recovery of debts through the insolvency process under the *Corporations Act 2001 (Cth)*.
- Where a RoLR event occurs and the failed retailer is not insolvent, JGN can and should pursue recovery of debts directly from that retailer.
- JGN has not demonstrated that any residual risk is uninsurable, such that it would be appropriate for consumers to insure JGN against this risk rather than JGN.

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

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

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[42] The National Energy Customer Framework (NECF) comprised the National Energy Retail Law, Regulations and Rules, and supporting amendments to the National Gas Law and Rules. These included the RoLR regime, the pass through event in rule 531 of the NGR and the retail support framework in Part X of the NGR.

### *Application to non-retailer users*

The arguments JGN included in its revised proposal in support of this event relate to RoLR processes triggered by the AER under the NERL. These are specific to energy retailers. However, JGN's proposed definition of the Network User Failure Event refers to any User, and does not reference the RoLR process.

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

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

### *Exemption from materiality threshold*

In its revised proposal JGN proposed that this event should not be subject to a materiality threshold.[43] In support of this proposal it cited the current drafting of rule 531 of the NGR, which it considered is not subject to a financial materiality threshold. It also referred again to the COAG Energy Council's proposed changes to the NER. As noted above, the AEMC's consideration of the proposed changes to the NER is ongoing, and does not currently extend to the NGR. Again, we must make our decision on the pass through events to be included in JGN's 2015-20 Access Arrangement based on the information before us in this process.

We do not consider either of these arguments demonstrates that the materiality threshold applied to other pass through events should not be applied to the Network User Failure Event. It is correct to say that rule 531 of the NGR is silent on the application of a materiality threshold. We do not consider that this prohibits us from applying one to other pass through events where we find it to be appropriate.

The cost pass through mechanism is intended to enable costs that have a material impact on the business to be passed through to consumers. A materiality threshold provides a benchmark against which the cost impact is measured, relative to the revenue allowed JGN under this final decision. As discussed in section 11.4.3, over a five year access arrangement period it is likely that many events will occur which add to or subtract from JGN's costs. We consider costs less than the materiality threshold reflect the risks associated with normal business operations, and should not be the subject of a pass through application.

Our revised definition for the network user failure event is in Table 11.1. Our definition includes the factors that we will consider when assessing an application for a Network User Failure Event, to increase clarity and regulatory certainty.

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[43] Jemena Gas Networks, *Access Arrangement 2015–20, Response to the AER's draft decision & revised proposal*, February 2015, p. 141.

## Gas Supply Shortfall Event

This pass through event would allow JGN to apply to pass through to consumers costs associated with JGN's actions in response to a situation in which there is materially insufficient gas available for injection into the network.

JGN proposed this event for the first time in its revised proposal, in response to our draft decision to reject its proposed business continuity event.[44]

In its revised proposal JGN stated that:

- There are a number of factors that contribute to gas supply uncertainty. In particular, supply in the NSW gas market in the future will largely depend on whether production will be able to meet domestic and international demands.[45]
- If there is a lack, or shortfall, of gas to inject into JGN's network, JGN will need to take actions to manage the shortfall, including:
    - consultation with market participants to understand the situation
    - promote network users to take all possible commercial actions to avoid a supply imbalance
    - if necessary, take steps to reduce demand
    - if supply is lost, take steps to introduce emergency operational procedures to actively manage and shut down parts of the network, and
    - re-introducing gas to the network. This is labour intensive and may take several days.[46]

JGN also stated that it has virtually no ability to prevent or mitigate the impacts of a gas supply shortfall, and the potential consequences of a shortage could be material.[47]

For the reasons below, we reject this proposed pass through event. We do not consider the costs associated with the occurrence of a gas supply shortfall should be passed through directly to consumers for the following reasons:

- Accepting a pass through event for gas shortfalls would weaken JGN's incentives to properly mitigate the risk, and minimise the costs, of a gas shortfall. JGN has stated in its revised proposal that there are several potential risk mitigation strategies that it can undertake to help prevent a gas supply shortfall and minimise

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44 Jemena Gas Networks, *Access Arrangement 2015–20, Response to the AER's draft decision & revised proposal*, February 2015, p. 129.

45 Jemena Gas Networks, *Access Arrangement 2015–20, Response to the AER's draft decision & revised proposal*, February 2015, pp. 134 & 135.

46 Jemena Gas Networks, *Access Arrangement 2015–20, Response to the AER's draft decision & revised proposal*, February 2015, pp. 136 & 137.

47 Jemena Gas Networks, *Access Arrangement 2015–20, Response to the AER's draft decision & revised proposal*, February 2015, p. 135.

its costs in the event of one.[48] JGN is best placed to manage this risk and should not be permitted to pass the risk directly onto consumers. As stated in its revised proposal, JGN also has contractual relationships with upstream parties. These contracts, if effectively drafted and enforced, should be useful to minimise JGN's costs in the event of a gas supply shortfall.[49]

- Adequate gas supply is fundamental to JGN's business. Properly managing the risk of low supply is vital for JGN to be an effective gas distributor. Therefore, we consider managing this risk is a typical business expense for JGN, and should not be passed through to consumers.

### 11.4.3 Materiality threshold for cost pass through events

Our draft decision was to apply a materiality threshold to the approved pass through events for the 2015–20 Access Arrangement. Under this threshold, costs claimed in relation to a pass through event in any given year must be at least one per cent of the smoothed annual revenue requirement for that year specified in the final decision.[50] This is consistent with the definition of “materially” that applies to pass through applications for electricity network service providers under the NER.[51] This materiality threshold is to apply to all the defined Cost Pass Through Events for JGN's 2015–20 Access Arrangement.

JGN did not accept this position in its revised proposal.

In its revised proposal JGN maintained its proposed, alternative materiality threshold whereby costs related to an approved event could be either:

- in total over the 2015–20 Access Arrangement period equal to or greater than 0.5 per cent of revenue specified in the Access Arrangement Information, or
- in at least one of the financial years of the Access Arrangement period equal to or greater than one per cent of the revenue specified in the Access Arrangement Information.

In our final decision we maintain the position expressed in our draft decision. JGN's proposal effectively sets a threshold of less than one per cent of revenue for each year. Over a five year access arrangement period it is likely that many events will occur which add to or subtract from JGN’s costs. We consider changes in costs of less than one per cent of revenue reflect the cost of normal business operations, and should not be the subject of a pass through application.

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48 Jemena Gas Networks, *Access Arrangement 2015–20, Response to the AER's draft decision & revised proposal*, February 2015, pp. 137 & 138.

49 Jemena Gas Networks, *Access Arrangement 2015–20, Response to the AER's draft decision & revised proposal*, February 2015, p. 138.

50 We are specifying a materiality threshold as provided for in r. 97(3)(e) of the NGR.

51 NER, Chapter 10 – Glossary.

### 11.4.4 Fixed principle in relation to cost pass through events from an immediately prior access arrangement period

We approve the inclusion of a fixed principle in relation to cross period cost pass throughs in JGN's 2015–20 Access Arrangement. The principle will be fixed for the 2015–20 access arrangement only.

In our draft decision we rejected JGN's proposed fixed principle in relation to cost pass throughs as we were not satisfied that JGN had made sufficient arguments for the necessity of a fixed principle.[52]

In its revised proposal JGN rejected our draft decision, and provided more information on its primary areas of concern.[53] JGN stated that a fixed principle is required to potentially allow the financial impact of an approved cost pass through event that occurs late in one access arrangement period to be addressed in the reference tariffs that apply in the next access arrangement period.[54]

During the last year of an access arrangement period there will be three months, between 31 March 2020 (when JGN submits its last tariff variation notice for the access arrangement period) and 30 June 2020 (the last day of that access arrangement period). Within that period, JGN may not be able to apply to pass through the costs of an approved pass through event to consumers, as there is not a tariff mechanism to enable such costs to be collected in a subsequent access arrangement period. In effect, therefore, because of the way the tariff mechanisms work, the cost pass through events we approve for an access arrangement period would not be in effect for the full five years, but only for four years and nine months.

In the NER, this gap was rectified in a rule change in August 2012.[55] The rule change gave electricity distributors the opportunity to recover the costs associated with approved pass through events in the subsequent regulatory control period. There was no equivalent change made to the NGR.

To rectify this issue for JGN's 2015-20 access arrangement we consider a fixed principle is necessary and appropriate as it:

- allows JGN the opportunity to recover its efficient costs should a pass through event occur late in the 2015–20 access arrangement period

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52 AER, *Draft decision Jemena Gas Networks Access Arrangement 2015-2020, Attachment 11 - Reference tariff variation mechanism*, November 2014, pp. 11–22.

53 Jemena Gas Networks, *Access Arrangement 2015–20, Response to the AER's draft decision & revised proposal*, February 2015, p. 117.

54 Jemena Gas Networks, *Access Arrangement 2015–20, Response to the AER's draft decision & revised proposal*, February 2015, p. 117.

55 Australian Energy Market Commission, *Rule Determination, National Electricity Amendment (Cost pass through amendments for Network Service Providers) Rule 2012*, 2 August 2012.

- provides for consistency between the electricity and gas regulatory regimes, where the same risks and regulatory functions to govern that risk (cost pass throughs) exist.

We approve this fixed principle for the 2015–20 Access Arrangement. JGN proposed that this fixed principle also apply for the 2020–25 Access Arrangement.[56] We have not accepted this proposal. The application of this fixed principle in subsequent access arrangement periods is more appropriately considered as part of our consultation on JGN's proposals for those periods. Given the recent changes to the NER, this will allow consideration of this fixed principle to be revisited with the benefit of lessons learnt in the 2015-20 Access Arrangement period and the experience of electricity distributors under the amendments to the NER.

[56] Rule 99 of the NGR provides that a principle may be fixed for a period extending over two or more access arrangement periods.