

Attachment 16.1

Response to Draft Decision:
Tariff Variation Mechanisms

**2016/17 to 2020/21 Access
Arrangement Information
Response to Draft Decision**

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1 Response to Draft Decision on Tariff Variation Mechanisms

1.1 Introduction

This attachment sets out Australian Gas Networks Limited's (AGN's) response to the Australian Energy Regulator's (AER's) Draft Decision on the Tariff Variation Mechanisms to apply over the next (2016/17 to 2020/21) Access Arrangement (AA) period.

AGN proposed a number of Tariff Variation Mechanisms which allow for the adjustment of tariffs where certain defined events occur. Rule 97(1) of the National Gas Rules (NGR) requires AGN to 'provide an explanation of the proposed reference tariff variation mechanism and the basis for any parameters used in the mechanism¹. AGN proposed:

- to maintain the current annual tariff variation mechanism in the form of a weighted average price cap (WAPC) formula for the next AA period;
- to change the date by which AGN must submit its annual tariff variation mechanism proposal to the AER; and
- certain cost-pass-through events for the next AA period.

The AER has accepted elements of AGN's proposal such as the use of the WAPC and modified or rejected other elements, namely AGN's proposed cost-pass-through events.

1.2 AER Draft Decision

The AER reviewed AGN's proposed Tariff Variation Mechanisms against Rule 97 of the National Gas Rules (NGR).² The AER made some modifications in its Draft Decision but have largely accepted most of AGN's proposals. Table 1.1 below summarises the AER's Draft Decision for each element of AGN's Tariff Variation Mechanisms proposal.

TABLE 1.1: SUMMARY OF AER'S DRAFT DECISION ON TARIFF VARIATION MECHANISMS

	AER Draft Decision	AER Comment
Reference Tariff Variation Mechanism Process	Modify AGN proposal	Accept the application of the WAPC as the tariff variation mechanism for haulage reference services to overall revenue from all reference tariffs, rather than applying to each tariff class individually. Reject the proposal to change the timing by which AGN must submit its annual tariff variation mechanism proposal. Rather, adopt a December quarter Consumer Price Index (CPI) in place of March quarter CPI.
Annual Haulage Reference Tariff Variation formula	Modify AGN proposal	Accept that AGN's proposed annual haulage WAPC formula is consistent with that applied in the current (2011/12 to 2015/16) AA period, but amend the formula to include adjustment factors for an approved cost pass through event and to accommodate price variations in unaccounted for gas.
Annual ancillary reference tariff variation formula	Modify AGN proposal	Accept the proposed formula but modify the definition of the CPI escalation to be consistent with that applied in the WAPC.

¹ National Gas Rules, Rule 97.

² National Gas Rules, Rule 97.

Regulatory Change Event and Service Standard Event	Modify AGN proposal	The proposed definitions of Regulatory Change Event and Service Standard Event are consistent with the current AA period however should be modified for consistency with the definitions approved by the AER in more recent decisions.
Tax Change Event	Modify AGN proposal	The definition of Tax Change Event is accepted. However the supporting definition of 'Relevant Tax' is to be amended to be consistent with the definition approved by the AER in more recent decisions.
Terrorism Event	Modify AGN proposal	The inclusion of a Terrorism Event supports the National Gas Objective (NGO) and Revenue and Pricing Principles (RPP) but there is overlap between the definition of a terrorism event and an insurance cap event and therefore needs to be amended.
Network User Failure Event	Reject AGN proposal	AGN should amend its AA to remove this event. However if AGN pursues this issue in its revised proposal, the AER directs AGN to the definition approved in the recent decision for Jemena Gas Networks and the draft decision in relation to ActewAGL's network user failure event.
Insurer Credit Risk Event	Modify AGN proposal	The AER accepts the need for an Insurer Credit Risk Event cost pass through mechanism.
Insurance Cap Event	Modify AGN proposal	The proposed definition of Insurance Cap Event is consistent with the NGO and RPP but should be modified for consistency with the definitions approved by the AER in more recent decisions.
Significant Safety Event	Reject AGN proposal	AGN is appropriately placed to mitigate the likelihood or impacts of the additional events it seeks to incorporate through its proposed Significant Safety Event. The AER requires AGN to amend its AA to remove this event, however, should AGN pursue this issue in its revised proposal the AER directs AGN to the definition of Significant Safety Event approved in ActewAGL's Draft Decision.
Security of Supply Event	Reject AGN proposal	The AER considers that security of supply is a business risk that AGN can manage and should not be transferred to customers through a pass through mechanism. AGN is required to amend its AA to remove this event.
Significant Extension Event	Reject AGN proposal	The AER does not consider costs relating to significant extensions of AGN's network should be treated as a cost pass through event but as part of AGN's expenditure proposals.

1.3 AGN Response to the Draft Decision

AGN has accepted the modifications to its proposal in respect of the Reference Tariff Variation Mechanism, Annual Haulage Reference Tariff Variation formula, Annual Ancillary Reference Tariff Variation formula and Regulatory Change Event and Service Standard Event cost pass throughs.

A number of the Cost Pass Through events that AGN has proposed have been generally accepted by the AER, albeit with amendments (i.e. the Terrorism Event, the Insurer Credit Risk Event and the Insurance Cap Event). AGN has generally accepted the amendments proposed by the AER to those cost pass through events. In other cases, AGN has maintained certain pass through events, adjusted for the AER Draft Decision where appropriate.

Our response to the AER's Draft Decision is summarised in Table 1.2.

TABLE 1.2: SUMMARY OF AGN'S RESPONSE TO THE AER DRAFT DECISION ON TARIFF VARIATION MECHANISMS

	AER Draft Decision	AGN Response	AGN Comment
Reference Tariff Variation Mechanism Process	Modify AGN proposal	Accept Draft Decision	No comment.
Annual Haulage Reference Tariff Variation formula	Modify AGN proposal	Modify Draft Decision	AGN has amended the equation with respect to the adjustment factor to accommodate unaccounted for gas price variations. This adjustment can be made in the year after the event given the UAFG price period in that year is known.
Annual ancillary reference tariff variation formula	Modify AGN proposal	Accept Draft Decision	No comment.
Regulatory Change Event and Service Standard Event	Modify AGN proposal	Accept Draft Decision	No comment.
Tax Change Event	Modify AGN proposal	Accept Draft Decision	No comment.
Terrorism Event	Modify AGN proposal	Modify Draft Decision	AGN has amended the definition of "Terrorism Event" in the manner required by the AER, with some minor variations to adopt the format used in AGN's proposed AA.
Network User Failure Event	Reject AGN proposal	Respond to Draft Decision	AGN has replaced its proposed definition of "Network User Failure Event" with a definition which is substantially the same as the approved definition included in the Jemena Gas Networks' AA.
Insurer Credit Risk Event	Modify AGN proposal	Modify Draft Decision	AGN has amended the definition of "Insurer Credit Risk Event" in the manner required by the AER, with some minor variations to adopt the format and defined terms used in AGN's proposed AA.
Insurance Cap Event	Modify AGN proposal	Modify Draft Decision	AGN has amended the definition of "Insurance Cap Event" in the manner required by the AER, with some minor variations to adopt the format and defined terms used in AGN's proposed AA.
Significant Safety Event	Reject AGN proposal	Accept Draft Decision	AGN has deleted the definition of "Significant Safety Event" as required by the AER. AGN has also incorporated a definition of "Natural Disaster Event" which is in substantially the same terms as the event approved by the AER in the context of ActewAGL's proposed AA.
Security of Supply Event	Reject AGN proposal	Accept Draft Decision	No comment.
Significant Extension Event	Reject AGN proposal	Respond to Draft Decision	AGN considers this pass through event should only be maintained in the event the Mount Barker Business Case is not factored into the capital expenditure benchmarks.
Factors relevant to decisions on cost pass through event variations	Modify AGN proposal	Accept Draft Decision	No comment.

AGN's response to the AER's Draft Decision is discussed in the remainder of this attachment.

1.3.1 Reference Tariff Variation Mechanism Process

The AER has accepted the application of the WAPC to overall revenue derived from haulage reference services rather than applying to each individual tariff class. AGN proposed to submit its annual tariff variation

notice to the AER at least 40 business days before their commencement, rather than the current 50 business days. This was to avoid the issue of needing to submit the annual tariff variation notices twice as the March quarter CPI is not known at the time of the first submission. This reflected actual practice over the current (2011/12 to 2015/16) AA period.

The AER however rejected this proposal but has resolved the issue by adopting a December quarter CPI in place of the March quarter CPI to inflate tariffs. This means that at the time the annual tariff variation notice is required to be submitted 50 business days before the tariffs take effect, all relevant information will be known, thereby avoiding the need to provide another tariff variation notice. The AER notes this approach is consistent with the timing of CPI escalation for other gas distribution networks such as ActewAGL and Jemena Gas Networks (New South Wales). AGN accepts the AER's approach.

1.3.2 Annual Haulage Reference Tariff Variation formula

The AER accepts that AGN's proposed annual haulage WAPC formula is consistent with that applied in the current AA period. Nevertheless, it has made amendments to the formula to include adjustment factors for:

- any approved cost pass through events; and
- unaccounted for gas (UAFG) price variations.

The AER have included in the haulage reference tariff variation mechanism formula a pass through factor, consistent with that applied to other gas distributors. The AER considers that the inclusion of an adjustment factor to accommodate reference tariff adjustments on account of approved cost pass through events enables a simple and transparent method for cost recovery and the pass through of costs to customers. AGN accepts this modification.

In the AER's Draft Decision, the AER also proposed an adjustment factor in respect of UAFG. The intent of the adjustment factor is to correct for any unaccounted for gas price variations between what is forecast by the AER now and the price AGN will actually achieve through the tender process. The AER's proposed mechanism is as follows:

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

where:

U'_{t-1} is:

- zero when financial year t-1 refers to financial year 2016–17; and
- the value of U'_t determined in the financial year t-1 for all other financial years in the AA period.

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

where:

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

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

where:

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

FP_{t-2} is the price used to forecast the UAFG allowance in financial year t-2

FQ_{t-2} is the quantity used to forecast the unaccounted for gas allowance in financial year t-2

AGN accepts the AER's application of the UAFG price variation factor. AGN does however propose some minor variations to the formula reflecting the fact the actual unaccounted for gas price for year $t-1$ is known in year $t-1$. This enables the true up between forecast and actual UAFG price to occur for year $t-1$, instead of having to wait for year $t-2$. This has the effect of removing the need for one year of time value money adjustment. The AGN's proposed formulae are shown below:

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

where:

U_t is:

- zero when financial year t-1 refers to financial year 2016–17; and
- the value of U'_t determined in the financial year t-1 for all other financial years in the AA period.

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

Additionally, to simplify the calculation of the difference between the forecast and actual unaccounted for gas price, AGN has proposed removing the forecast quantity factor (FQ) as it serves no purpose.

$$DP_{t-1} = \frac{UP_{t-1}}{FP_{t-1}}$$

1.3.3 Annual Ancillary Reference Tariff Variation Formula

The AER accepts the proposed annual ancillary reference tariff variation formula which is consistent with that of the current access arrangement. However, AGN has changed the definition of the CPI escalation to be consistent with that applied in the WAPC.

1.3.4 Regulatory Change Event and Service Standard Event

The AER considers that the proposed definitions of Regulatory Change Event and Service Standard Event are consistent with the current AA, but should be modified for consistency with the definitions approved by the AER in more recent decisions. AGN has amended both definitions in the manner required by the AER.

1.3.5 Tax Change Event

The definition of 'Tax Change Event' is accepted. However the supporting definition of 'Relevant Tax' is to be amended. AGN has amended the definition of "Relevant Tax" in the manner required by the AER.

1.3.6 Terrorism Event

AGN has amended the definition of “Terrorism Event” in the manner required by the AER, with some minor variations to adopt the format used in AGN’s Initial AA Proposal. AGN’s definition of “Terrorism Event” is as follows:

“Terrorism Event

An act (including, but not limited to, the use of force or violence or the threat of force or violence) of any person or group of persons (whether acting alone or on behalf of or in connection with any organisation or government), which from its nature or context is done for, or in connection with, political, religious, ideological, ethnic or similar purposes or reasons (including the intention to influence or intimidate any government and/or put the public, or any section of the public, in fear) and which materially increases the costs to AGN of providing a the reference service.

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

- (a) whether AGN has insurance against the event;*
- (b) the level of insurance that an efficient and prudent service provider would obtain in respect of the event; and*
- (c) whether a declaration has been made by a relevant government authority that a terrorism event has occurred.”*

1.3.7 Network User Failure Event

The AER’s Draft Decision requires AGN to remove the definition of “Network User Failure Event”. However, the AER stated that, should AGN wish to pursue this matter in its revised proposal, AGN should adopt the network user failure event approved in the AER’s draft decision on Jemena’s proposed AA. AGN has replaced its proposed definition of “Network User Failure Event” with a definition which is substantially the same as the definition included in Jemena’s AA, which is in the following terms:

“Network User Failure Event

The occurrence of an event where:

- (a) a Retailer of Last Resort (RoLR) Event as defined in section 122 of the National Energy Retail Law has occurred; and*
- (b) AGN 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 AGN under other provisions of the NERL, NERR, NGL or NGR as in force at the time of the event, including but not limited to rule 531 of the NGR and other pass through events in this Access Arrangement.*

Note for the avoidance of doubt, in making a determination on a Network User Failure Event, the AER will have regard to, amongst other things, the extent to which AGN 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.”

1.3.8 Insurer Credit Risk Event and Insurance Cap Event

The AER’s Draft Decision requires AGN to amend the definition of “Insurer Credit Risk Event” and “Insurance Cap Event”. AGN has amended the definition of “Insurer Credit Risk Event” and “Insurance Cap Event” in the manner required by the AER, with some minor variations to adopt the format and defined terms used in AGN’s Initial AA Proposal.

1.3.9 Significant Safety Event

The AER's Draft Decision requires AGN to remove the "Significant Safety Event". However, the AER stated that should AGN wish to pursue this matter in its revised proposal, AGN should adopt the natural disaster event approved in the AER's draft decision on ActewAGL's proposed AA. AGN accepts the AER Draft Decision and has replaced its proposed "Significant Safety Event" with a "Natural Disaster Event" as defined below:

"Natural Disaster Event"

Any major fire, flood, earthquake or other natural disaster that occurs during the Fourth Access Arrangement Period and increases the cost 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 AGN.

The term 'major' in the above paragraph means an event that is serious and significant.

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

- (a) whether AGN has insurance against the event;*
- (b) the level of insurance that an efficient and prudent service provider would obtain in respect of the event; and*
- (c) whether a relevant government authority has made a declaration that a natural disaster has occurred."*

1.3.10 Security of Supply Event

The AER's Draft Decision requires AGN to remove the "Security of Supply Event" from AGN's proposed AA. AGN has removed the "Security of Supply Event" as required by the AER.

1.3.11 Significant Extension Event

AGN is committed to extending its network where it is in the long-term interests of consumers. AGN has recently extended its network in Tanunda and is completing an extension to McLaren Vale. AGN had proposed that a cost-pass-through event should be in place to facilitate significant extensions of its network at any time during the next AA period, including where those events were not known at the time of preparing this AA Proposal.

In response to the AER's Draft Decision rejecting AGN's proposed Significant Extensions Event, AGN is re-proposing the Mount Barker extension as capex with a supporting Business Case (see Business Case SA25, Attachment 7.1A). AGN's preference is that the Mount Barker extension is approved as capex in order to facilitate the reticulation of areas within the council area of Mount Barker.

In the event that the Mount Barker Business Case is not approved as capex, AGN is re-proposing that the Significant Extension Event be approved by the AER in the following form:

'Significant Extension Event' means:

Approval by AGN's Board to proceed with a project to supply gas to the area of Mount Barker, where the capital expenditure for such a project over the regulatory period exceeds [\$20m] and such expenditure has not been considered and approved by the AER at the time of revision of AGN's access arrangement proposal in 2016.

1.3.12 Factors Relevant to Decisions on Cost Pass Through Event Variations

The AER's Draft Decision requires AGN to amend Clause 4.5 of its Initial AA Proposal to include the following:

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

AGN has amended Clause 4.5 of the AA in the manner required by the AER.

1.4 Summary

AGN has largely accepted the AER's Draft Decision in relation to Tariff Variation Mechanisms and Cost Pass Through events. Where the AER's suggested definitions of Tariff Variation Mechanisms have not been adopted in their original form, the amendments have been minor, usually made to accommodate formatting or defined terms used in AGN's AA.

AGN proposed a Significant Extensions Event to cover the reticulation of Mount Barker in its original proposal. AGN is now submitting a Business Case for the Mount Barker extension as part of its revised capex proposal. Should this extension not be accepted as capex, AGN is seeking approval of the Significant Extensions Event to facilitate the efficient extension of the network.