Attachment 13: Reference tariff variation mechanism

Access Arrangement Information for the 2016-21 ACT, Queanbeyan and Palerang Access Arrangement

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Key points

ActewAGL Distribution proposes the following revisions to the reference tariff variation mechanism:

- Replace the fixed schedule of tariffs with a weighted-average price cap (WAPC). This will provide ActewAGL Distribution with incentives aligned with the long term interests of customers and flexibility to respond to changes in the gas market, including changing consumption patterns, during the access arrangement period. A WAPC has been adopted by the Australian Energy Regulator (AER) in all the current gas distribution access arrangements.
- Refresh the cost pass through events, largely to reflect regulatory developments since the approval of the 2010-15 access arrangement. This includes removing unnecessary events, updating definitions to improve clarity and certainty and adding new events.
- Streamline the process for adjusting tariffs due to changes in specified uncontrollable costs. Instead of the cost pass through mechanism, ActewAGL Distribution proposes to use a symmetrical automatic adjustment factor in the reference tariff variation formula for specified costs.
- Align the tariff variation process with other access arrangements and the National Electricity Rules (NER). Enhanced consistency reduces the administrative burden on both ActewAGL Distribution and the AER.

Consumer benefits

- The WAPC aligns ActewAGL Distribution and consumer interests as it provides incentives to increase volumes and improve utilisation, which reduces ActewAGL Distribution's cost per customer and ultimately the prices consumers face.
- A well-functioning cost pass through mechanism should ensure that ActewAGL Distribution is able to fully recover its efficient costs (including those that are unexpected and uncontrollable), consistent with the promotion of the National Gas Objective (NGO) and the revenue and pricing principles in the National Gas Law (NGL). Reducing the administrative burden will benefit consumers and contribute to the achievement of the NGO as lower costs will be passed on to consumers in lower prices.

13.1 Introduction

As required by Rule 92(1) of the National Gas Rules (Rules), the access arrangement sets out a reference tariff variation mechanism, which comprises the mechanisms and processes for varying reference tariffs during the access arrangement period. In accordance with Rule 72(1)(k), in this attachment ActewAGL Distribution explains its proposed revisions to:

- the formula for annual variation of reference tariffs;
- the cost pass through arrangements; and
- the process for the annual reference tariff variation.

13.2 Requirements of the National Gas Rules and the National Gas Law

Under Rule 92(1) a full access arrangement must include a mechanism for variation of reference tariffs over the course of an access arrangement period. Rule 92(2) states that:

> *(2) The reference tariff variation mechanism must be designed to equalise (in terms of present values):*
>
> *(a) forecast revenue from reference services over the access arrangement period; and*
>
> *(b) the portion of total revenue allocated to reference services for the access arrangement period.*

Rule 97 provides guidance on the form of the reference tariff variation mechanism and sets out the factors that AER must have regard to when making its decision on the mechanism as follows:

1) A reference tariff variation mechanism may provide for variation of a reference tariff:

a. in accordance with a schedule of fixed tariffs; or

b. in accordance with a formula set out in the access arrangement; or

c. as a result of a cost pass through for a defined event (such as a cost pass through for a particular tax); or

d. by the combined operation of 2 or more or the above.

2) A formula for variation of a reference tariff may (for example) provide for:

a. variable caps on the revenue to be derived from a particular combination of reference services; or

b. tariff basket price control; or

c. revenue yield control; or

d. a combination of all or any of the above.

3) In deciding whether a particular reference tariff variation mechanism is appropriate to a particular access arrangement, the AER must have regard to:

a. the need for efficient tariff structures; and *b. the possible effects of the reference tariff variation mechanism on administrative costs of the AER, the service provider, and users or potential users; and*

c. the regulatory arrangements (if any) applicable to the relevant reference services before the commencement of the proposed reference tariff variation mechanism; and

d. the desirability of consistency between regulatory arrangements for similar services (both within and beyond the relevant jurisdiction); and

e. any other relevant factor.

4) A reference tariff variation mechanism must give the AER adequate oversight or powers of approval over variation of the reference tariff.

5) Except as provided by a reference tariff variation mechanism, a reference tariff is not to vary during the course of an access arrangement period.

Under Rule 72(1)(k) the access arrangement information must include ActewAGL Distribution's rationale for any proposed reference tariff variation mechanism.

In addition to the Rules requirements relating explicitly to the reference tariff variation mechanism, the overarching requirements in the NGL regarding the NGO and the revenue and pricing principles are relevant to the decision on the reference tariff variation mechanism. As discussed in the Overview to this access arrangement information, the NGL requires the AER to make the decision which will or is likely to promote the NGO to the greatest degree. [1] The NGO is: [2]

> *… to promote efficient investment in, and efficient operation and use of, natural gas services for the long term interests of consumers of natural gas with respect to price, quality, safety, reliability and security of supply of natural gas.*

The NGL also requires the AER, when making a decision relating to reference tariffs or charges, to take into account the revenue and pricing principles.[3]

In contrast to the NER, the Rules do not contain explicit requirements for cost pass throughs. However, the requirements for electricity, and the AER's application of them, provide some relevant guidance for gas. This is discussed in the cost pass through section below. In addition, the revenue and pricing principles must be considered, as the cost pass through provisions relate to reference tariffs. The NGO is also relevant as an inability by a service provider to recover its efficient costs will hinder the achievement of the NGO (as has been recognised by the Australian Energy Market Commission (AEMC) in the context of the NER).[4]

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[1] NGL section 28(1)(b)(ii) and (iii)

[2] NGL section 23

[3] NGL section 28(2)(a)

[4] AEMC 2012, *National Electricity Amendment (Cost pass through arrangements for Network Service Providers) Rule 2012 Rule Determination,* November, p.18, where the AEMC recognized that cost pass throughs enable the service provider to recover the efficient unforeseen costs of events outside the provider's control and that the

13.3 Reference tariff variation mechanism in the 2010-15 access arrangement

Part 6 of the 2010-15 access arrangement contains the reference tariff variation mechanism. The mechanism comprises two components:

- an annual scheduled reference tariff adjustment formula mechanism – under which each reference tariff is set by the AER at the start of the period and escalated annually by CPI; and
- a cost pass through reference tariff variation mechanism – under which ActewAGL Distribution or the AER may seek to vary one or more of the reference tariffs as a consequence of the occurrence of a defined event.

Part 6 of the 2010-15 access arrangement also sets out the process for the annual variation of reference tariffs.

Annual scheduled reference tariff adjustment formula mechanism

The AER approved the fixed tariff schedule for 2010-15 on the basis that a similar approach had been adopted in the previous access arrangement period and the mechanism involved relatively low administration costs. More recently, in the context of the ACT, NSW and Victorian electricity distribution determinations, the AER has been critical of fixed price schedule mechanisms, noting that they provide very little scope to introduce new tariffs or rebalance existing tariffs within the regulatory period. In the Final Framework and Approach paper for the Victorian electricity distribution businesses the AER said it did not consider fixed price schedules as a control mechanism option because;

> *these direct price control mechanisms do not provide the level of flexibility within the regulatory control period for distributors to manage distribution use of service charges shared across the broad customer base.* [5]

ActewAGL Distribution is currently the only gas distribution network regulated by the AER under a fixed tariff schedule. Weighted average price caps (WAPCs) currently apply to all other gas distribution networks regulated by the AER. Jemena Gas Networks (JGN) proposed to retain a WAPC for its 2015-20 access arrangement, and the AER accepted the proposal in its final decision.[6]

Cost pass through reference tariff variation mechanism

The cost pass through mechanism in ActewAGL Distribution's 2010-15 access arrangement allows recovery of costs not already incorporated into tariffs for defined events.[7] Reference

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inability to recover these efficient costs would, over the long term, adversely affect the efficient investment in, and operation of, the provider's network.

[5] AER 2014, *Final Framework and Approach for the Victorian Electricity Distributors, Regulatory control period commencing 1 July 2016*, October, p. 61.

[6] AER 2015, *Jemena Gas Networks Approved access arrangement 2015-20*, clause 3.2, June

[7] Specifically, the Carbon Pollution Reduction Scheme Event, Change in Tax Event, Regulatory Change Event, Service Standard Event, Short Term Trading Market Event, Specified Uncontrollable Cost Event, Supply Curtailment Event, and General Pass through Event.

tariffs can only be varied if there is, or is expected to be, an 'administrative cost impact' on providing reference services. The administrative cost impact is lower for specified uncontrollable costs[8] and change in tax events where ActewAGL Distribution can verify the incurred costs of the event by documentation.

In 2012 the AEMC introduced nominated pass through event considerations into the NER.[9] The AER has recently noted that the same criteria remain relevant as general principles to help determine whether a proposed cost pass through event for a gas network is consistent with the NGO.[10]

13.4 Proposed reference tariff variation mechanism

ActewAGL Distribution's proposed revisions to the reference tariff variation mechanism in the access arrangement relate to the following elements:

- the formula for variation of reference tariffs;
- the cost pass through events; and
- the process for reference tariff variations.

13.4.1 The formula for variation of reference tariffs

Under Rule 97(2) *'[a] formula for variation of a reference tariff may (for example) provide for:*

(a) variable caps on the revenue to be derived from a particular combination of reference services; or
(b) tariff basket price control; or
(c) revenue yield control; or
(d) *a combination of all or any of the above.'*

The WAPC is a form of tariff basket price control.

ActewAGL Distribution proposes to amend the access arrangement by replacing the fixed schedule of tariffs with a WAPC. The rationale for the WAPC and the proposed formulae are set out below.

[8] The specified costs related to the AEMO Fee, the Utilities Network Facilities Tax (UNFT), the Energy Industry Levy and cost differences in the unaccounted for gas (UAG) forecast due to price changes.

[9] AEMC 2012, *National Electricity Amendment (Cost pass through arrangements for Network Service Providers) Rule 2012 Rule Determination,* November.

[10] AER 2014, *Draft Decision Jemena Gas Networks Access arrangement 2015-2020, Attachment 11 – Reference tariff variation mechanism*, November, p.11-11. The AER maintained this approach in its final decision: AER 2015, *Final decision, Jemena Gas Networks Access Arrangement, Reference tariff setting*, *Attachment 11*, June, p. 11-9.

13.4.2 Rationale for the weighted-average price cap

A WAPC sets a limit on the weighted-average increase in prices from one year to the next, with the weights based on the quantities sold at each charging parameter. The network service provider complies with this constraint by setting prices annually so the change in the weighted-average price is less than or equal to a CPI-X cap. A small increase in the price of a high volume service would need to be offset by a large decrease in the price of an infrequently provided service in order to remain within the cap. The most common formulation of the WAPC mechanism uses weights based on quantities sold two years previously, as this is the most recent audited data available at the time of the annual pricing approval process.

ActewAGL Distribution has evaluated the WAPC and the other options permitted under Rule 97(1) and (2) (as listed above) against the criteria that the AER must consider, under Rule 97(3), when making a decision on the reference tariff variation mechanism. Two additional factors of relevance are considered—revenue recovery and price stability. The AER has included these additional factors in recent assessments of control mechanisms for electricity distribution networks. [11]

Revenue recovery is relevant in terms of the promotion of the NGO and the revenue and pricing principles in the NGL, and particularly principle 2:

> *A service provider should be provided with a reasonable opportunity to recover at least the efficient costs the service provider incurs in—*
>
> *a) providing reference services; and*
>
> *b) complying with a regulatory obligation or requirement or making a regulatory payment.*

Price stability is also an important consideration for consumers. This has been confirmed in feedback provided by the Energy Consumer Reference Council (ECRC) to ActewAGL Distribution.

ActewAGL Distribution's comparison of the WAPC and the schedule of fixed tariffs is summarised in Table 13.1 below.

Table 13.1 Assessment of current and proposed reference tariff variation mechanisms

	WAPC	Fixed tariff schedule
Incentives to set efficient tariff structures	Provides strong incentives for efficient pricing. The AER has commented that "WAPCs provide a strong theoretical incentive for DNSPs to price efficiently"[12]. This aligns consumers' and ActewAGL Distribution's interests.	Does not provide incentives for efficient pricing or align network and consumer interests.

[11] For example AER 2012, *ActewAGL Framework and Approach, Preliminary Positions, Regulatory control period commencing 1 July 2014*, June, p. 36; and AER 2014, *Final Framework and Approach for the Victorian Electricity Distributors, Regulatory control period commencing 1 July 2016*, October, p. 76.

[12] AER 2012, *ActewAGL Framework and Approach, Preliminary Positions*, *Regulatory control period commencing 1 July 2014*, June, p. 45

	WAPC	Fixed tariff schedule
Administrative costs	Higher than fixed tariff schedule. However consistency with the mechanism for all other gas distribution businesses should help to reduce the AER's administration costs.	Relatively low, although the need for annual cost pass through approvals creates an administrative burden. Also, the fact that ActewAGL Distribution is the only gas network provider with this mechanism could increase costs for users.
Consistency with current arrangements	Requires a change from the current arrangements.	Yes, consistent with current arrangements for ActewAGL Distribution.
Consistency with similar services	Consistent with mechanism in access arrangements for all other gas distribution networks.	Not consistent as ActewAGL Distribution is the only gas network service provider with this mechanism.
Revenue recovery	Service provider bears revenue risk. The AER has previously commented that it is appropriate for the service provider to bear volume and revenue risk.[13]	Service provider bears the revenue risk. No scope to rebalance tariff levels to manage revenue risk.
Price stability	Tariffs expected to vary over time and between tariff classes. ActewAGL Distribution's proposed side constraint in the tariff variation mechanism formulae will assist in delivering price stability.	Relatively stable price path.

Overall ActewAGL Distribution considers that the WAPC best meets consumers' long term interests. It is superior in terms of the factors that the AER must consider under the Rules, and in terms of the NGO and the revenue and pricing principles in the NGL. In terms of promoting the NGO, the WAPC is superior to the current fixed price schedule as it aligns ActewAGL Distribution's incentives with the long term interests of consumers. The incentives for ActewAGL Distribution are to:

- Increase throughput and network utilisation, given revenues are not constrained. This supports productive and allocative efficiency.
- Price at cost reflective levels to help ensure customers that are susceptible to bypassing the network are retained, again supporting allocative efficiency.

13.4.3 Proposed formula for the WAPC

Under clause 7.4 of the 2016-21 access arrangement, ActewAGL Distribution may vary reference tariffs subject to compliance with:

[13] For example AER 2013, *Stage 1 Framework and Approach, ActewAGL*, *Regulatory control period commencing 1 July 2014*,March, p. 36

(a) the following tariff basket price control formula:

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

where ActewAGL has *n* Reference Tariffs and each Reference Tariff has up to *m* tariff components; and

(a) the following side constraint formula applying to each Tariff Class:

$$(1+CPI_t)(1-X_t)(1+A_t)(1+PT_t)(1+0.1) \geq \frac{\sum_{x=1}^{b}\sum_{y=1}^{a} p_t^{xy} q_{t-2}^{xy}}{\sum_{x=1}^{b}\sum_{y=1}^{a} p_{t-1}^{xy} q_{t-2}^{xy}}$$

where ActewAGL has *b* Reference Tariffs within each Tariff Class and each of those Reference Tariffs has up to *a* tariff components,

and where for the purposes of each of the formulae above:

t	is the Financial Year for which the Tariffs are being set;
p_t^{xy}	is the proposed Tariff for component y of Reference Tariff *x* in Financial Year *t*, i.e. the new Tariff to apply from the commencement of Financial Year *t*;
p_{t-1}^{xy}	is the Tariff for component *y* of Reference Tariff *x* that is being charged in Financial Year *t-1* at the time the Variation Notice is submitted to the Relevant Regulator for assessment or, for the purposes of scaling by the Relevant Regulator in accordance with clause 7.24 of the access arrangement, at the time that scaling process commences;
q_{t-2}^{xy}	is the quantity of component y of Reference Tariff *x* that was sold in Financial Year *t-2*;
CPI_t	is, for Financial Year *t*:

(i) the CPI for the December quarter immediately preceding the start of Financial Year *t*; divided by

(ii) the CPI for the December quarter immediately preceding the December quarter referred to in paragraph (i);

(iii) minus one,

provided that if the Australian Bureau of Statistics does not, or ceases to, calculate and publish the CPI, then in this Access Arrangement CPI will mean an inflation index or measure agreed between the AER and ActewAGL Distribution;

X_t	means the *X* factor for Financial Year *t*, determined in accordance with the PTRM, updated for the return on debt in accordance with clauses 6.25 to 6.28 of the access arrangement;
A_t	is the automatic adjustment factor for Financial Year *t* calculated in accordance with Part 1 of Schedule 4 of the access arrangement; and
PT_t	is the cost pass through factor for Financial Year *t* calculated in accordance with Part 2.5 of Schedule 4 of the access arrangement.

The AER has approved the same WAPC formula in its final decision for JGN and a similar side constraint formula.[14] The elements of the formula are explained below.

13.4.4 Side constraint

The Rules do not include requirements for side constraints. However, ActewAGL Distribution proposes to apply a side constraint at the tariff class level, recognising that:

- the AER has adopted side constraints in previous gas access arrangement determinations, where a WAPC has applied;
- a side constraint reduces price volatility and provides additional certainty to customers on annual price movements; and
- the ECRC has told ActewAGL Distribution that price shocks should be avoided.

The proposed 10 per cent side constraint is the same as approved by the AER in its final decision for JGN. The AER concluded in its draft decision for JGN:[15]

> *"We approve JGN's proposal to retain a 10 per cent rebalancing control because it meets the relevant factors under r. 97(3) of the NGR. We consider that this would allow JGN to set its reference tariffs on a cost-reflective basis and ensure similar customers pay similar prices."*

ActewAGL Distribution's proposed side constraint will apply in every year of the 2016-21 period, including the first. Therefore, a lower side constraint value would not be appropriate.[16]

13.4.5 Automatic adjustment factor

The annual adjustment factor A_t, a component of the tariff variation mechanism, allows for differences between forecast and actual costs for specified events to be recovered or savings

[14] AER 2015, *Final decision, Jemena Gas Networks Access Arrangement, Reference tariff setting*, *Attachment 11*, June, p. 11-9; AER 2015, *Jemena Gas Networks Approved access arrangement 2015-20*, clause 3.2, June.

[15] AER 2014, Draft decision, *Jemena Gas Networks Access Arrangement 2015-20, Attachment 11 Reference tariff variation mechanism*, November, p. 11-14

[16] The NER (clause 6.18.6) apply a two per cent side constraint at the tariff class level. However this constraint does not apply to the first year of the regulatory period.

returned in tariffs. The proposed automatic adjustment factor, set out in Schedule 4 of the 2016-21 access arrangement, covers the following uncontrollable costs:

- licence fees, including the Australian Energy Market Operator (AEMO) Fee, the Energy Industry Levy and the Utilities (Networks Facilities) Tax (UNFT);
- benchmark unaccounted for gas (UAG) costs;
- carbon costs; and
- relevant taxes.

The automatic adjustment factor will reduce administrative cost for both the AER and ActewAGL Distribution by removing the need for annual cost pass through applications for specified uncontrollable costs.[17] This benefit was noted by the AER in approving JGN's proposed automatic adjustment factor:[18]

> *We approve JGN's proposed formula for a symmetrical automatic adjustment factor to allow it to pass through annual costs or savings across a number of uncontrollable cost categories. This adjustment will lower administrative cost because JGN will not have to lodge annual cost pass through applications for licencing fees, unaccounted for gas purchases and carbon tax payments.*

The automatic adjustment factor is consistent with the mechanism approved by the AER in other access arrangements, such as for JGN. It is also consistent with the approach adopted for electricity distribution networks, where costs associated with jurisdictional schemes (for example UNFT costs for ActewAGL Distribution's electricity network) are recovered via an adjustment in the annual pricing approval process rather than through the cost pass through mechanism.[19]

13.4.6 Update for the return on debt

The X_t factor in the WAPC formula in clause 7.4 (and section 13.4.2 above) is defined as follows:

> X_t means the *X* factor for Financial Year *t*, determined in accordance with the PTRM, updated for the return on debt in accordance with clauses 6.25 to 6.28.

Clauses 6.25 to 6.28 of the 2016-21 access arrangement explain the process for updating the X factor for the final three years of the access arrangement period. The basis for the proposed annual update is provided in attachment 8 and appendix 8.01 of this access arrangement information.

[17] Under the 2010-15 access arrangement, specified uncontrollable cost events - related to the AEMO Fee, the UNFT, the Energy Industry Levy and cost differences in the benchmark UAG forecast (set at the UAG target rate of 1.96 per cent) due to price changes - and change in tax events were addressed through the cost pass through mechanism.

[18] AER 2014, *Draft Decision, Jemena Gas Networks 2015-20 access arrangement, Attachment 11, Reference tariff variation mechanism*, November, p. 11-15

[19] AER 2015, *Final Decision, ActewAGL Distribution determination, 2015-19, Attachment 14, Control mechanisms*, April.

13.4.7 Adding or removing tariffs during the access arrangement period

Under clause 7.2 of the 2016-21 access arrangement ActewAGL Distribution may, with the approval of the AER:

- introduce a new tariff class and/or tariff category; and
- remove an existing tariff class and/or tariff category (with or without grandfathering for existing customers).

This clause will give ActewAGL Distribution flexibility to respond to changing consumer preferences or new market opportunities and to give better effect to the NGO. In the June 2015 final decision for JGN the AER noted that providing this flexibility is preferred to the alternative of re-opening and amending the access arrangement when tariff changes are proposed:[20]

> *"We agree with JGN's revised proposal that the introduction or withdrawal of reference tariffs be managed via the annual tariff variation mechanism, rather than reopening the access arrangement. This is administratively simpler, and more efficient and effective for network operators and customers, than reopening an access arrangement. The latter can be a lengthy process and is generally only reserved for making amendments on account of errors in, or omissions from, access arrangements. It is also noteworthy that the process recommended by JGN (and now accepted by us) is similar to amendments made to the NER. These allow electricity distributors to make changes to tariff structures via their tariff structure statements without amendments to their revenue determinations."*

ActewAGL Distribution agrees with the AER's comments and considers that they apply equally to ActewAGL Distribution. Allowing ActewAGL Distribution to add or remove tariffs during the access arrangement period will align it with the approved approaches for other gas distribution businesses (for example JGN and Envestra) and also with electricity distribution businesses which have scope to add or remove tariffs via the new Tariff Structures Statement process.

13.4.8 Intra-year variations to reference tariffs

Under clause 7.5 of the 2016-21 access arrangement ActewAGL Distribution can propose to vary reference tariffs during a financial year to apply at a date prior to the start of the next financial year, including for the purposes of passing through an amount relating to a cost pass through event. The variation must comply with the WAPC formula set out in clause 7.4 of the access arrangement.

The provision for intra-year variations to reference tariffs is consistent with that approved by the AER for JGN. The AER said in its draft decision for JGN:[21]

> *"We approve JGN's proposal for an intra-year reference tariff variation mechanism because we have approved a similar variation mechanism for SP AusNet's 2013–17 Access Arrangement and*

[20] AER 2015, *Final decision, Jemena Gas Networks Access Arrangement, Reference tariff setting, Attachment 10*, June, p. 10-6

[21] AER 2014, *Draft decision, Jemena Gas Networks Access Arrangement 2015-20, Attachment 11 Reference tariff variation mechanism*, November, p. 11-24

> *JGN's current Access Arrangement. We acknowledge that retailers require price stability and that any reference tariff adjustments within a period may be costly and problematic to them. However, in our discussion with JGN, it submitted that reference tariff variation proposals are time consuming and costly for regulated businesses too. As such, it is only in extraordinary circumstances that JGN would submit an intra-year reference tariff variation."*

ActewAGL Distribution confirms that reference tariff variation proposals are time consuming and costly. Where possible, ActewAGL Distribution prefers to adjust reference tariffs as part of the annual tariff variation process. A recent exception is ActewAGL Distribution's tariff variation which took effect from 1 September 2014. In this case ActewAGL Distribution sought to lower tariffs as soon as possible following the repeal of the carbon tax.

13.5 Cost pass through mechanism

Cost pass through mechanisms provide network service providers an opportunity to recover (and return) unexpected and uncontrollable changes in cost. The purpose is to allow recovery of efficient costs, thereby promoting the efficient operation and use of, and efficient investment in, network services and thus the NGO.[22]

Without a well-functioning cost pass through mechanism (or compensation elsewhere in the regulatory framework), service providers faced with an uncontrollable and unexpected increase in costs have the incentive to not respond in a manner that meets the long term interests of consumers. If an event results in uncontrollable and unexpected cost increases which cannot be recovered then the service provider is faced with two options.

First, a service provider could reduce expenditure below efficient levels. This could be achieved by either limiting measures to address the impact of the event or inefficiently reducing expenditure elsewhere. For instance, if an insurer became insolvent and premiums materially increased, a service provider could simply not obtain insurance. This option would not be in the long term interests of consumers as it could leave the service provider (and in turn consumers) exposed to insurable risks. Alternatively, expenditure in another area (such as maintenance) could be inefficiently reduced or postponed to offset the increase in costs, which could ultimately result in higher long terms costs. Both of these outcomes would not be in the long term interests of consumers as they would result in the inefficient operation of network services with respect to the price, quality, safety, reliability and security of supply of gas.

The second option service providers have is to absorb the impact of the cost impact lowering the return on investment. As a result, service providers would no longer expect to recover the efficient costs of future investments in the network, such as the replacement of assets as they reach the end of their economic life. This creates the incentive to reduce or cease future

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[22] AEMC 2012, *National Electricity Amendment (Cost pass through arrangements for Network Service Providers) Rule 2012 Rule Determination,* November, p.18, where the AEMC recognized that cost pass throughs enable the service provider to recover the efficient unforeseen costs of events outside the provider's control and that the inability to recover these efficient costs would, over the long term, adversely affect the efficient investment in, and operation of, the provider's network.

investment resulting in the delivery of services that are not in the long term interests of consumers with respect to price, quality, safety, reliability and security of supply.

13.5.1 Proposed revisions to the cost pass through mechanism

ActewAGL Distribution has reviewed the cost pass through events defined in the 2010-15 access arrangement having regard to the NGO, the revenue and pricing principles and, although they do not form part of the gas regulatory framework, the *nominated pass through event considerations* as defined in the NER (chapter 10). The nominated pass through event considerations are:

a) *whether the event proposed is an event covered by a category of pass through event specified in clause 6.6.1(a1)(1) to(4) (in the case of a distribution determination) or clause 6A.7.3(a1)(1) to(4) (in the case of a transmission determination);*

b) *whether the nature or type of event can be clearly identified at the time the determination is made for the service provider;*

c) *whether a prudent service provider could reasonably prevent an event of that nature or type from occurring or substantially mitigate the cost impact of such an event;*

d) *whether the relevant service provider could insure against the event, having regard to:*

   (1) the availability (including the extent of availability in terms of liability limits) of insurance against the event on reasonable commercial terms; or

   (2) whether the event can be self-insured on the basis that:

      i. *it is possible to calculate the self-insurance premium; and*

      ii. *the potential cost to the relevant service provider would not have a significant impact on the service provider's ability to provide network services; and.*

e) *any other matter the AER considers relevant and which the AER has notified Network Service Providers is a nominated pass through event consideration.*

Taking these considerations into account, as well as the NGO and the revenue and pricing principles, ActewAGL Distribution proposes the following revisions to the cost pass through events in the 2010-15 access arrangement:

- Remove four cost pass through events (see 13.5.2.1). These events are no longer needed as cost changes would be captured by the regulatory change and general pass through events (in the case of the National Energy Customer Framework/National Gas Connections Framework Event) or will be captured by the introduction of the automatic adjustment factor (in the case of the Carbon Pollution Reduction Scheme, and Specified Uncontrollable Cost Event).
- Retain five cost pass through events. ActewAGL Distribution is proposing changes to the definition of some events to enhance consistency with other access arrangements, and address the AER's previously stated concerns (see 13.5.2.2).

- Add five cost pass through events, including the insurance cap event, insurer credit risk event, terrorism event, and natural disaster event and network user failure event which have been largely accepted by the AER in other regulatory decisions (see 13.5.2.3).

A summary of how each pass through event is consistent with the nominated pass through event considerations is provided in appendix 13.01.

ActewAGL Distribution also proposes changes to the cost pass through notification and approval process specified in the 2010-15 access arrangement to provide for greater consistency with JGN's access arrangement to reduce the administrative burden for both the AER and ActewAGL Distribution.

Finally, ActewAGL Distribution proposes to introduce a fixed principle to allow cost pass through amounts incurred in one access arrangement period to be recovered in subsequent access arrangement periods, consistent with the cost pass through provisions in the NER. Under the 2010-15 access arrangement this cannot occur. As a result, cost pass through amounts are not recovered (or returned) unless an administratively costly mid-year tariff variation is implemented.

The proposed revisions are explained in the following sections.

13.5.2 Cost pass through events

Cost pass through events proposed to be included in the 2016-21 access arrangement are:

a) a Regulatory Change Event;

b) a Service Standard Event;

c) a Short Term Trading Market Event;

d) a Supply Curtailment Event;

e) a General Pass Through Event;

f) an Insurance Cap Event;

g) an Insurer Credit Risk Event;

h) a Terrorism Event;

i) a Natural Disaster Event; and

j) a Network User Failure Event.

These events follow the removal of cost pass through events from the 2010-15 access arrangement, the retention of cost pass through events (with definition changes) for that arrangement and the addition of certain events. The definitions are provided in Table 13.2 below.

Table 13.2 Cost pass through events in the proposed 2016-21 access arrangement

Cost pass through event	Definition
Regulatory Change Event	Regulatory Change Event means a change in a regulatory obligation or requirement that affects the manner in which the ActewAGL provides the Reference Service.
Service Standard Event	Service Standard Event means a legislative or administrative act or decision that has the effect of: (a) varying the manner in which ActewAGL is required to provide the Reference Service; or (b) imposing, removing or varying the minimum service standards applicable to the Reference Service; or (c) altering the nature or scope of the Reference Service provided by ActewAGL.
Short Term Trading Market Event	Short Term Trading Market Event occurs if ActewAGL participates in the Short Term Trading Market, resulting in: (a) changes in costs that ActewAGL incurs directly or indirectly (including under statute or contract); or (b) the need to change services provided to accommodate the market, leading to additional costs.
Supply Curtailment Event	Supply Curtailment Event means the occurrence of a period when insufficient gas is delivered to ActewAGL's gas network due to reasons beyond ActewAGL's control, and gas cannot be supplied to meet demand requirements as represented by ActewAGL's forecasts used to derive the Reference Tariffs in this Access Arrangement, resulting in: (a) supply restrictions directed under the Utilities (Gas Restrictions) Regulations 2005 (ACT); and/or (b) widespread domestic load shedding, gas rationing or curtailment within ActewAGL's Network.
General Pass Through Event	General Pass-Through Event means an event that: (a) was not reasonably foreseeable at the time this Access Arrangement is approved by the Relevant Regulator under the National Gas Rules; (b) could not have been efficiently and economically insured against on reasonable commercial terms or self insured, at the time this Access Arrangement is approved by the Relevant Regulator under the National Gas Rules; (c) could not have been prevented, nor any increase in costs as a result thereof substantially mitigated, by ActewAGL using reasonable endeavours; and (d) does not fall within any other category of Cost Pass-Through Event. For the purposes of this definition, an event will be considered unforeseeable if, at the time the Relevant Regulator makes its final decision in respect of this Access

	Arrangement, regardless of whether the occurrence of the event was a possibility, there was no reasonable basis for the Relevant Regulator to conclude the event was more likely than not to occur during the Applicable Access Arrangement Period.
Insurance Cap Event	Insurance Cap Event means the occurrence of an event whereby: (a) ActewAGL makes a claim or claims under a relevant insurance policy that satisfies the conditions of insurance under that policy; and (b) ActewAGL incurs costs beyond the actual policy limit of the relevant insurance policy as a result of the event that gives rise to the relevant claim. For the purposes of this definition: (c) A relevant insurance policy is an insurance policy held during the Applicable Access Arrangement Period or a previous period in which access to the Network was regulated; and (d) ActewAGL will be deemed to have made a claim on a relevant insurance policy if a claim is made by a related party of ActewAGL in relation to any aspect of the Network or ActewAGL's business.
Insurer Credit Risk Event	Insurer Credit Risk Event means the occurrence of an event whereby an insurer becomes insolvent and, as a result, ActewAGL: (a) incurs higher or lower costs for insurance premiums than would have otherwise applied; (b) is subject to a materially higher or lower claim limit or a materially higher or lower deductible than would have otherwise applied under the relevant policy; or (c) incurs additional costs associated with self-funding an insurance claim, which would otherwise have been covered by the insolvent insurer. Note for the avoidance of doubt, in making a determination on an Insurer Credit Risk Event pursuant to clause 7.11 of this Access Arrangement, the AER will have regard to, amongst other things: (a) the Service Provider's attempts to mitigate and prevent the event from occurring by reviewing and considering the insurer's track record, size, credit rating and reputation; and (b) in the event that a claim would have been made after the insurance provider became insolvent, whether the Service Provider had reasonable opportunity to insure the risk with a different provider.
Terrorism Event	Terrorism Event means an act (including, but not limited to, the use of force or violence, the threat of force or violence, attacks or other disruptive activities against, or the deliberate introduction of harmful code or viruses to, computer systems, computer networks, data and/or communication systems, or the threat of such attacks or disruptive activities, or of the deliberate introduction of such harmful code or viruses) of any person or group of persons (whether acting alone or on behalf of or in connection with any organisation or government), which from

	its nature or context is done for, or in connection with, political, religious, ideological, ethnic or similar purposes or reasons (including the intention to influence or intimidate any government and/or put the public, or any section of the public, in fear). Note for the avoidance of doubt, in making a determination on a Terrorism Event pursuant to clause7.11 of this Access Arrangement, the AER will have regard to, amongst other things: (a) whether the Service Provider has insurance against the event; (b) the level of insurance that an efficient and prudent service provider would obtain in respect of the event; and (c) whether a declaration has been made by a relevant government authority that a terrorism event has occurred.
Natural Disaster Event	Natural Disaster Event means any fire, flood, earthquake or other natural disaster that increases the costs to the Service Provider in providing the Reference Service, provided the fire, flood or other event was not a consequence of the negligent acts or omissions of the Service Provider. For the purposes of this definition, the term 'major' means an event that is serious and significant. Note for the avoidance of doubt, in making a determination on a Natural Disaster Event pursuant to clause 7.11 of this Access Arrangement, the AER will have regard to, amongst other things: (a) whether the Service Provider has insurance against the event; (b) the level of insurance that an efficient and prudent service provider would obtain in respect of the event; and (c) whether a relevant government authority has made a declaration that a natural disaster has occurred.
Network User Failure Event	Network User Failure Event means the occurrence of an event whereby a User becomes insolvent or is unable to continue to supply gas to its customers, and those customers are transferred to another User. Notwithstanding the definition of Change in Cost, the Change in Cost associated with a Network User Failure Event is deemed to: (a) include amounts that ActewAGL is entitled to be paid (but which are or will be unpaid as a result of a Network User Failure Event) for the provision of the Reference Service, including the revenue impact ActewAGL sustains or will sustain as a result of those unpaid amounts; and (b) exclude costs that could be the subject of a pass through amount pursuant to rule 531 of the National Gas Rules or section 167 of the National Energy Retail Law.

13.5.2.1 Cost pass through events to be removed

ActewAGL Distribution proposes to remove the following cost pass through events:

- Change in Tax event;

- Carbon Pollution Reduction Scheme;
- National Energy Customer Framework/National Gas Connections Framework Event; and
- Specified Uncontrollable Cost Event.

ActewAGL Distribution considers that the National Energy Customer Framework/National Gas Connections Framework events are unnecessary as the event has now occurred. ActewAGL Distribution expects that any further changes in costs related to these events would likely fall within either the regulatory change or service standard event.

The Specified Uncontrollable Cost Event and Change in Tax Events will no longer be needed as differences between forecast and actual costs for the Energy Industry Levy, UNFT, AEMO fees and differences in benchmark UAG costs will be adjusted through the automatic adjustment factor in the reference tariff variation mechanism formulae (as discussed in section13.4.5).

13.5.2.2 Cost pass through events to be retained

ActewAGL Distribution proposes to retain the following cost pass through events:

- Regulatory Change;
- Service Standard;
- Short Term Trading Market;
- Supply Curtailment; and
- General Pass Through.

ActewAGL Distribution's consideration of these events is provided in turn below.

Regulatory Change Event

The Regulatory Change Event, based on the regulatory change event specified in the NER, operates to ensure that any cost changes (which exceed the Administrative Cost Threshold) due to changes in regulatory obligations can be recovered or returned.

ActewAGL Distribution considers that the word 'substantially' included in the NER definition adds uncertainty[23] and, in any event, is unnecessary given that an Administrative Cost Impact threshold applies. To remove this uncertainty ActewAGL Distribution has removed 'substantially' from the event definition.

The words 'fall within no other category of cost pass through events' have not been added to the definition of Regulatory Change Event. These words appear in the definition of General Pass Through Event and so should not also appear in the definition of Regulatory Change Event. For efficacy, there can only be one pass through event which includes these words. Further, these words are superfluous as the opening words of clause 7.6 of the 2016-21 access arrangement provide that an event that falls within more than one of the pass through events defined in the

[23] JGN 2015, *Response to the AER's draft decision & revised proposal,* p.127

access arrangement constitutes a single 'Cost Pass Through Event' for the purposes of clause 7.6. ActewAGL Distribution is replacing the Regulatory Change Event definition in the 2010-15 access arrangement to enhance consistency JGN's approved access arrangement to lower the administrative burden on ActewAGL Distribution and the AER.

Service Standard Event

The Service Standard Event is triggered when a legislative or administrative act or decision changes how Reference services are to be provided. This enables the consequent cost changes (which exceed the Administrative Cost Threshold) to be recovered or returned.

ActewAGL Distribution has replaced the definition of this event to enhance consistency with JGN's access arrangements in turn lowering the administrative burden on ActewAGL Distribution and the AER.

Short Term Trading Market Event

ActewAGL Distribution's 2010-15 access arrangement included a cost pass through for a trading hub to be established in Canberra at some point during the access arrangement period.

To ensure that any costs arising from this event are recovered, if it occurs in the 2016-21 access arrangement period, this event has been retained.

Supply curtailment event

ActewAGL Distribution has retained the supply curtailment event as it relates to an event that continues to be uncontrollable and the potential consequences could be material. The AER has recognised this as a business risk previously concluding that:

> *…the AER considers that it is appropriate for costs associated with market shortfall event to be covered by the proposed supply curtailment event in certain circumstances. In particular, the risk needs to be identified as a business risk of the service provider, the service provider incurs costs in relation to the event and the service provider is not otherwise compensated for this event.*[24]

General Pass Through Event

ActewAGL Distribution proposes to retain the General Pass Through Event from the 2010-15 access arrangement. The purpose of the General Pass Through Event is to ensure that costs from events unable to be forecast are recovered.

As foreshadowed earlier, it is in the long term interests of consumers for service providers to have the opportunity to recover at least efficient costs. Otherwise if an unforecastable and uncontrollable event occurs service providers have the incentive to either:

- reduce expenditure below efficient levels, either by inefficiently limiting measures to address the impact of the unforeseen event or inefficiently reduce expenditure elsewhere; or

[24] AER 2010, *ACT, Queanbeyan and Palerang gas distribution network Access arrangement proposal Final Decision,* p.120

- absorb the impact of the cost impact lowering the return on investment. The lower return on investment creates disincentives for future investment resulting in the delivery of services that are not in the long term interests of consumers with respect to price, quality, safety, reliability and security of supply.

The General Pass Through Event provides ActewAGL Distribution with certainty that if action is taken to address the impact of an unforecastable event in the long term interests of consumers it will have the opportunity to recover efficient costs. Without the pass through event ActewAGL Distribution is not provided with the opportunity to recover the costs of unforeseen events creating incentives which are not in the long term interests of consumers and outcomes which are not consistent with the revenue and pricing principles.

The AEMC has recognised that not allowing service providers to recover costs is not in the long term interests of consumers reasoning that:[25]

> *…NSPs [Network Service Providers] should be provided the opportunity to recover their efficient costs in those limited circumstances where insurance is limited or not available on commercial terms and self-insurance is not appropriate. Not to do so would, over the long term, be likely to affect the efficient investment in, and efficient operation of, those networks. This is because, NSPs that cannot recover their efficient costs are reluctant to invest in their networks.*
>
> *… This should; [sic] however, be limited to instances where efficient costs are incurred because unforeseen costs arise as a result of events outside an NSP's control.*

The AEMC introduced into the NER (but not the Rules) a series of nominated pass through event considerations which are mandatory considerations and not preconditions to the acceptance by the AER of a nominated pass through event as part of a distribution determination.[26] The AEMC explains that:[27]

> *…the intention of the nominated pass through event considerations was to incorporate and reflect the essential components of a cost pass through regime in the NER. 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 is the least efficient option for managing the risk of unforeseen events.*

[25] AEMC 2012, Rule Determination National Electricity Amendment (Cost pass through arrangements for Network Service Providers) Rule 2012, 2 August 2012, p. 18

[26] The legal character of the nominated event pass through considerations is evident from clause 6.5.10(b) of the NER and is affirmed by the relevant Rules extrinsic material: see AEMC 2012, Rule Determination National Electricity Amendment (Cost pass through arrangements for Network Service Providers) Rule 2012, 2 August 2012, p. 20

[27] AEMC 2012, Rule Determination National Electricity Amendment (Cost pass through arrangements for Network Service Providers) Rule 2012, 2 August 2012, p. 20

The intention is not to negate the need for cost pass throughs, or limit the AER's ability to respond to changes in the regulatory environment in a flexible and adaptive way. The nominated pass through event considerations are of a high level and do not stipulate any specific action.[28]

and

…the intention of the nominated pass through event considerations, is 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 the risks between NSPs and end consumers. However, these are considerations only, therefore the NSP and the AER can come to a mutual understanding that a cost pass through event is inconsistent with the factors for consideration, but may still be the more efficient mechanism.

These passages disclose that the intent of the nominated pass through event considerations is to ensure that appropriate incentives are maintained. However, the AEMC highlights in both passages the AER's discretion, noting the AER's ability to 'respond to changes in the regulatory environment in a flexible and adaptive way', that the relevant considerations 'do not stipulate any specific action' and that the AER together with an NSP can 'come to a mutual understanding that a cost pass through event is inconsistent with the factors for consideration but may still be the more efficient mechanism.'

While ActewAGL Distribution considers that the consistency of an event with the considerations concerning the nature and type of event can be clearly identified, it is acknowledged that it is difficult to determine whether passing through the costs of an unforecastable event would ensure appropriate incentives for service providers to effectively and efficiently manage their risk are maintained. The solution is making this assessment ex-post as part of the cost pass through assessment process rather than ex-ante in determining whether a cost pass through event should be accepted.

This solution is implemented through revisions to the definitions of the cost pass through events in the access arrangement such that the general cost pass through event is only triggered when an event:

- was not reasonably foreseeable at the time the access arrangement is approved by the AER under the Rules;
- could not have been efficiently and economically insured against on reasonable commercial terms or self-insured, at the time the access arrangement is approved by the AER under the Rules;
- could not have been prevented, nor any increase in costs as a result thereof substantially mitigated, by ActewAGL Distribution using reasonable endeavours; and
- does not fall within any other category of Cost Pass Through Event.

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[28] AEMC 2012, Rule Determination National Electricity Amendment (Cost pass through arrangements for Network Service Providers) Rule 2012, 2 August 2012, p. 19

These characteristics ensure that efficient costs arising from an event can only be passed through when event avoidance, mitigation, commercial insurance and self-insurance are unavailable achieving the AEMC's policy intent. Further, not only does the AER have the power to accept the event but it is the AEMC's specific policy intent for the AER (in making distribution determinations) to have the flexibility and discretion to ensure that the most efficient mechanism is implemented.

Accepting the cost pass through event achieves the NGO to the greater degree as not only does it ensure appropriate incentives are maintained for services provider to effectively and efficiently manage their risk but also preserves the incentives for service providers to respond appropriately to any unforecastable events and provides the opportunity to recover at least efficient costs in the long term interests of consumers.

13.5.2.3 Cost pass through events to be added

ActewAGL Distribution proposes to add the following cost pass through events to those in the 2010-15 access arrangement:

- Insurance Cap Event;
- Insurer Credit Risk Event;
- Terrorism Event;
- Natural Disaster Event; and
- Network User Failure Event.

Insurance Cap Event

ActewAGL Distribution proposes to include an Insurance Cap Event which occurs if ActewAGL Distribution makes a claim under an insurance policy but the actual costs to ActewAGL Distribution exceed the policy limit. The AER has previously accepted that a pass through event should be included for electricity[29] and gas networks to ensure that network service providers can recover costs that would be uneconomical to insure against. The AER considered '…consumers benefit because they are not required to fund excessive premiums where insurance, if available, would be uneconomic.' [30]

As part of ActewAGL Distribution's electricity distribution determination process, the AER altered ActewAGL Distribution's proposed insurance cap definition to define the relevant policy limit to be the greater of the actual policy limit and the policy limit that is explicitly or implicitly commensurate with the allowance for insurance premiums in ActewAGL Distribution's forecast opex allowance. In its final decision on ActewAGL Distribution's electricity distribution

[29] AER 2015, *Final Decision ActewAGL Distribution Determination: ActewAGL Distribution Determination: Attachment 15*, April, p. 15-11

[30] AER 2015, *Final decision, Jemena Gas Networks 2015-20 Access Arrangement, Reference tariff variation mechanism*, Attachment 11, June, p. 11-15

determination 2015/16-2018/19, the AER describes the policy intent of its proposed definition to:

> *…counter purchasing insurance at a lower level than that which informed its approved opex forecast. It does this by adopting, as a threshold, the greater of the assumed insurance level and that which the distributor goes on to purchase. In this way, consumers will not bear the cost of an insurance cap event where the distributor has chosen to spend less on insurance than was prudent and efficient given its approved opex.*[31]

ActewAGL Distribution raised significant concerns with the AER's alternative definition as it:

- lacks certainty of meaning in that the policy limit commensurate with the allowance for insurance premiums in ActewAGL Distribution's forecast opex allowance is incapable of being ascertained; and
- is, in any event, unnecessary to address the AER's policy concern.[32]

ActewAGL Distribution, while considering the policy concern unobjectionable, outlined significant concerns with the AER's alternate definition as it required a policy limit that is 'explicitly or implicitly commensurate' with the allowance to be ascertained.[33] The difficulty in determining this amount was highlighted by the AER itself in its Final Decision on ActewAGL Distribution's electricity distribution determination where it stated its '…task is to determine an efficient level of total opex for a prudent service provider to meet the opex objectives over a five year regulatory control period' and not to 'approve specific projects.'[34]

ActewAGL Distribution considers that the AER's policy concern is addressed by the operation of the pass through event definition together with the pass through framework in the access arrangement. The AER in making a pass through decision is required to take matters into account which include the efficiency of ActewAGL Distribution's decision and actions. This consideration could include the policy limit of the relevant insurance policy. Clause 7.12(c) of ActewAGL Distribution's access arrangement requires the AER in determining the Determined Pass Through to take into account:

> *the efficiency of the Service Provider's decisions and actions in relation to the risk of the Cost Pass Through Event, including whether the Service Provider:*
>
> > *(A) has failed to take any action that could reasonably have been taken in respect of that event; or*

[31] AER 2015, *Final Decision ActewAGL Distribution Determination: ActewAGL Distribution Determination:* Attachment 15, p. 15-12 - 15-13

[32] ActewAGL Distribution 2015, *Revised Regulatory Proposal 2015-19,* January, pp. 541-542

[33] ActewAGL Distribution 2015, *Revised Regulatory Proposal 2015-19,* January, p.542

[34] AER 2015, *Final Decision ActewAGL Distribution Determination: ActewAGL Distribution Determination: Attachment 7*, April, pp.7-37 – 7-38

(B) *has taken or omitted to take any action in response to the event, where such action or omission has materially increased the magnitude of the change in costs in respect of the event;*

ActewAGL Distribution considers that its proposed definition for this event achieves the NGO to a greater degree as, combined with the operation of the pass through framework in the access arrangement, it addresses the AER's policy concern and avoids creating unnecessary uncertainty.

Insurer Credit Risk Event

ActewAGL Distribution is proposing a cost pass through event for circumstances whereby an insurer becomes insolvent and, as a result, ActewAGL Distribution:

- incurs higher or lower costs for insurance premiums than would have otherwise applied;
- 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
- incurs additional costs associated with self-funding an insurance claim, which would otherwise have been covered by the insolvent insurer.

While ActewAGL Distribution takes precautions to mitigate its exposure to an insurer credit risk event, there remains an ongoing risk that an insurer may fail. Accordingly, ActewAGL Distribution undertakes a series of precautions including, where possible, scrutinising market developments, insurer reputation, credit rating and financial stabilities of potential insuring entities. If an insurer does fail, ActewAGL Distribution could face considerable exposure, in circumstances that would be beyond its ability to control. To ensure that ActewAGL has the opportunity to recover at least its efficient costs, ActewAGL Distribution is proposing an Insurer Credit Risk event.

The AER has recognised that a network service provider, having adopting risk management measures, may nonetheless incur significant costs.[35] The AER has also recognised that the options available to network 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.[36]

Terrorism Event

ActewAGL Distribution has included a cost pass through event which is trigged if a terrorism act occurs and results in a material increase in costs.

The AER accepted a similar event for ActewAGL Distribution's electricity network[37]. Further, the AER accepted a terrorism event for JGN's gas network on the basis that it supported the NGO

[35] AER 2015, *Final Decision ActewAGL Distribution Determination: Attachment 15*, April, p.15-14

[36] AER 2015, *Final Decision ActewAGL Distribution Determination: Attachment 15*, April, p.15-14

[37] AER 2015, *Final Decision ActewAGL Distribution Determination: Attachment 15*, April, pp.15-8 – 15-9

and the revenue and pricing principles.[38] ActewAGL Distribution has incorporated a similar definition to the AER's, with clarifications to ensure cyber terrorism is included.

Natural Disaster Event

ActewAGL Distribution has included a cost pass through event for natural disasters. The AER accepted a similar Natural Disaster Event for ActewAGL Distribution's electricity network.[39] It also accepted a Natural Disaster Event for JGN's gas network on the basis that it is consistent with the NGO and revenue and pricing principles.[40] ActewAGL Distribution has made two changes to the AER's definition in those decisions:

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

Network User Failure Event

ActewAGL Distribution has proposed a Network User Failure Event. As JGN outlined the Network User Failure Event:

> *is intended to cover the cost impacts that arise as a result of the significant administrative and logistical tasks that JGN is required to perform under NSW/ACT Retail Market Procedures to support the transfer of customers in retail market systems from one retailer to another – in a sudden and non-standard manner. Whilst retailer insolvency is an obvious example of when this might be required, it may also be relevant in various other circumstances, as highlighted in the definition of "RoLR event" in the NERL, which extends to cover the following (in addition to retailer insolvency):*
>
> - *the revocation of a retailer's retailer authorisation (e.g. where a regulator revokes this authorisation as a consequence of one or more material breaches of licence conditions, which are unrelated to solvency, or pursuant to NERL s107(2)b), which provides for revocation of retailer authorisation where it is apprehended that a retailer will not be able to meet its statutory obligations in the future)*
> - *the right of the retailer to acquire gas in either the declared wholesale gas market or the STTM is suspended (once again, this is possible in a non-insolvency context, where market rules or procedures are breached – for example the various default events under rule 486 of the NGR can result in suspension of a network user's right to acquire gas from the STTM under rule 488, which in many cases does not require the retailer to be insolvent (e.g. a retailer may be solvent but has not maintained AEMO's required level of security))*

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[38] AER 2015, *Final decision, Jemena Gas Networks 2015-20 Access Arrangement, Reference tariff variation mechanism*, Attachment 11, June, p. 11-15 - 11-16

[39] AER 2015, *Final Decision ActewAGL Distribution Determination: Attachment 15*, April; p 15-15

[40] AER 2015, *Final decision, Jemena Gas Networks 2015-20 Access Arrangement, Reference tariff variation mechanism*, Attachment 11, June, p. 11-13

- *where there is no declared wholesale gas market or STTM, the retailer's registration as a registered participant in a retail gas market is revoked*
- *the retailer ceases to sell energy to customers, other than by transferring or surrendering its retailer authorisation in accordance with the NERL, or as a consequence of transferring some or all of its customers to another retailer, or by selling its business of the sale of energy to another retailer.*

In any scenario leading to a RoLR event (irrespective of whether or not it involves insolvency of a retailer) which then leads to AEMO applying the RoLR procedures in the NSW/ACT Retail Market Procedures, JGN will be required to perform its obligations under those roles to facilitate the transfer of customers in retail market systems.[41]

These obligations on JGN also apply to ActewAGL Distribution. Like JGN, ActewAGL Distribution has acted efficiently to avoid the cost of a project to change systems to automate the RoLR customer transfer process but also consider that the low probability of occurrence does not justify the significant cost of doing so. While changes to the NGL and the Rules have reduced the range of circumstances in which cost pass through is needed those changes only extend to circumstances of retailer insolvency, and not to other RoLR categories, and therefore there is a need for the Network User Failure Event.

13.5.3 Fixed principles

ActewAGL Distribution proposes that the principle in clause 7.16 of the 2016-21 access arrangement concerning the inter-period treatment of cost pass throughs be specified as a fixed principle for the purposes of Rule 99 to ensure that costs associated with cost pass through events in the 2016-21 access arrangement period which are not passed through in the 2016-21 access arrangement period may be passed through in the subsequent access Arrangement period.

The fixed principle is appropriate and necessary for ActewAGL Distribution as it will:

- allow ActewAGL Distribution the opportunity to recover its efficient costs should a pass through event occur late in the 2016–21 access arrangement period; and
- provide for consistency with the pass through regime in the NER as amended by the AEMC in August 2012, where the same risks and regulatory functions to govern that risk (cost pass throughs) exist.[42]

For analogous reasons, the AER has approved the same fixed principle for JGN.[43] In so doing, the AER did not accept JGN's proposal that this fixed principle also apply for the subsequent access

[41] JGN 2015, 2015-21 access arrangement response to the draft decision and revised proposal, p.141

[42] AEMC 2012, Rule Determination National Electricity Amendment (Cost pass through arrangements for Network Service Providers) Rule 2012, 2 August 2012

[43] AER 2015, *Final decision, Jemena Gas Networks 2015-20 Access Arrangement, Reference tariff variation mechanism*, Attachment 11, June, pp. 11-26 and 11-27

arrangement period, commenting that the applicability of this principle in the subsequent period was more appropriately considered as part of consultation on JGN's proposal for that period.

In the proposed 2016-21 access arrangement, ActewAGL Distribution fixes the principle concerning the inter-period treatment of cost pass throughs so that a pass through event occurring within the 2016-21 access arrangement period can be recovered over both the 2016-21 access arrangement period and the subsequent 2021-26 access arrangement period. This principle addresses the AER’s concern and ensures that there is provision for pass through of costs in the subsequent 2021-26 access arrangement period that are associated with cost pass through events occurring late in the 2016-21 access arrangement period.

13.5.4 Cost pass through application and approval process

The cost pass through application and approval process is set out in clauses 7.7 to 7.16 of the 2016-21 access arrangement. In the 2010-15 access arrangement the application and approval process for cost pass through events was combined with the process for seeking to vary reference tariffs (see clauses 6.6 and 6.10).

In the 2016-21 access arrangement the application and decision process for pass through events is separated from the process for seeking to vary reference tariffs (clauses 7.17 to 7.27). The proposed cost pass through application and approval processes and timelines are aligned with JGN’s approved access arrangement. Consistency lowers the administrative burden and regulatory complexity for both ActewAGL Distribution and the AER.

13.6 Materiality

A materiality threshold of one per cent has been incorporated into 2016-21 access arrangement proposal, consistent with the NER and AER regulatory practice.[44]

13.7 The annual reference tariff variation process

Clauses 7.17 to 7.27 of the 2016-21 access arrangement set out the process for ActewAGL Distribution to notify the AER of a tariff variation and for the AER to assess the proposal. The clauses also specify the information that ActewAGL Distribution must provide, in order to give the AER adequate oversight, as required under Rule 97(4).

The proposed changes make ActewAGL Distribution's reference tariff variation process more consistent with that contained in JGN's access arrangement approved by the AER.[45] The key changes to the reference tariff variation process relative to the 2010-15 access arrangement are as follows.

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[44] AER 2015, *Final decision, Jemena Gas Networks 2015-20 Access Arrangement, Reference tariff variation mechanism*, Attachment 11, June, p. 11-25

[45] *Access arrangement JGN's NSW gas distribution networks 1 July 2015 - 30 June 2020 [June 2015] (Incorporating revisions required by AER Final Decision June 2015),* clauses 3.6 to 3.8

- Under clause 7.17 of the 2016-21 access arrangement where ActewAGL Distribution proposes to vary one or more reference tariffs to apply from the start of the next financial year, ActewAGL Distribution will submit a variation notice (containing the matters specified in that clause) to the AER on or before 15 March, prior to the commencement of the next financial year. Clause 6.5 of the 2010-15 access arrangement required ActewAGL Distribution to notify the AER at least 50 business days prior to 1 July in each year of the access arrangement period of the varied reference tariffs to apply in accordance with the annual reference tariff adjustment formula contained in clauses 6.3 and 6.4 of that access arrangement.
- The 2016-21 access arrangement separates the application and decision process for pass through events (clauses 7.7 to 7.15) from the process for seeking to vary reference tariffs (clauses 7.17 to 7.27), whereas clause 6.6 of the 2010-15 access arrangement provided that where ActewAGL Distribution was seeking to vary reference tariffs due to a cost pass through event, the notification under clause 6.5 could include the matters required for a pass through application.
- As set out in section 13.4.8 above, clause 7.5 of 2016-21 access arrangement enables ActewAGL Distribution to propose to vary reference tariffs effective from a date prior to the start of the next financial year. As this is a new provision in the revised access arrangement, clause 7.18 of that access arrangement contains a related new provision requiring ActewAGL Distribution to submit a variation notice to the AER where it proposes to so vary reference tariffs at least 50 business days prior to the date upon which it intends the varied reference tariffs to come into effect and sets out the requirements for that variation notice.
- Similar to clause 6.7 of the 2010-15 access arrangement, under clause 7.19 of the 2016-21 access arrangement, the AER must notify ActewAGL Distribution in writing of its decision on ActewAGL Distribution's variation notice within 30 business days of receiving that notice. However, unlike the 2010-15 access arrangement, clause 7.21 of the 2016-21 access arrangement enables that 30 business day period to be extended by the AER under certain circumstances for a maximum additional 20 business days.
- Under clause 7.22 of the 2016-21 access arrangement, if the AER fails to provide ActewAGL Distribution with written notification of its decision within 50 business days of receiving its variation notice, the AER will be deemed to have approved the variation proposed in the variation notice. Clause 6.8 of the 2010-15 access arrangement contained a similar deeming provision, however, the required time for notification of the AER's decision prior to the deeming taking effect was 30 business days rather than 50 business days.
- Clause 7.23 of the 2016-21 access arrangement requires the AER to provide ActewAGL Distribution with written reasons where it declines to approve any part of the proposal in the variation notice.
- Clause 7.24 of the 2016-21 access arrangement provides for the manner in which the AER should determine the reference tariffs in circumstances where ActewAGL Distribution does not submit proposed reference tariffs to apply from the start of the next financial year, or the AER decides that any part of the proposal in an annual

variation notice is not compliant with the relevant reference tariff variation mechanism for a new financial year.

The 2016-21 access arrangement also includes (in clauses 7.30 and 7.31) provision for correction of a clerical mistake, an accidental slip or omission, or a miscalculation in the determination of a reference tariff.

Appendix 13.01. Proposed cost pass through events and the nominated cost pass through event considerations

How each cost pass through event included in the proposed 2016-21 access arrangement is consistent with the considerations set out in paragraphs (a) to (d) of the NER definition of "nominated pass through event considerations" is set out in the Table 13.1. The AER has not notified electricity network service providers generally of any other nominated pass through event considerations. The additional costs that could be recovered through the proposed pass through events are not included in the opex or capex forecasts, the WACC (which only covers systematic risk) or through another part of the regulatory framework.

Table 13.3 Proposed cost pass through events and the nominated pass through event considerations in the National Electricity Rules

Cost pass through event	(a) Included in the NER	(b) nature or type clearly identified	(c) could a prudent service provider reasonably prefer the event or mitigate the cost	(d) whether the event could be insured
Regulatory Change Event	This pass through event is a category included in the National Electricity Rules. No equivalent is included in the National Gas Rules.	This event can be clearly identified as it requires a change to a regulatory obligation or requirement.	A prudent service provider cannot reasonably prevent regulatory change from occurring or substantially mitigate the cost impact of such an event.	Insurance on commercial terms is not available and it is not possible to calculate a self-insurance allowance for a regulatory change event.
Service Standard Event		This event can be clearly identified as it requires a change to a legislative or administrative act or decision.	A prudent service provider cannot reasonably prevent a legislative or administrative act from occurring or substantially mitigate the cost impact of such an event.	Insurance on commercial terms is not available and it is not possible to calculate a self-insurance allowance for a service standard event.
Short Term Trading Market Event	No equivalent cost pass through event is included in the National Gas Rules.	This event can be clearly identified as it is caused by the establishment of a short term trading market for the ACT.	A prudent service provider cannot reasonably prevent a short term trading market hub from being established.	Insurance on commercial terms is not available and it is not possible to calculate a self-insurance allowance for the short term trading market event.
Supply Curtailment		This event can be clearly identified as it is driven by insufficient gas	A prudent service provider cannot reasonably prevent a supply	It is difficult to appropriately quantify a self-insurance allowance for the

Cost pass through event	(a) Included in the NER	(b) nature or type clearly identified	(c) could a prudent service provider reasonably prefer the event or mitigate the cost	(d) whether the event could be insured
Event		delivered to ActewAGL Distribution's gas network.	curtailment event occurring or substantially mitigate the cost impact of such an event.	supply curtailment event. In some scenarios insurance on commercial terms may be available (subject to relevant caps and conditions) but in other cases mitigation via insurance is not available at all.
General Pass Through Event		The general pass through event provides can be clearly identified as it is one that has the following characteristics: • it is not reasonably foreseeable at the time of making the distribution determination; • it could not be insured against on reasonable commercial terms or self insured, at that time; • it results in ActewAGL Distribution incurring higher or lower costs in providing direct control services; • it could not have been prevented nor the costs thereof substantially	It is part of the definition of the general pass through event that the event could not have been prevented and that ActewAGL Distribution could not substantially mitigate any increase in costs as a result of such an event using reasonable endeavours.	ActewAGL Distribution cannot obtain insurance for unforecastable events. It is not possible to calculate self-insurance amounts for this event.

Cost pass through event	(a) Included in the NER	(b) nature or type clearly identified	(c) could a prudent service provider reasonably prefer the event or mitigate the cost	(d) whether the event could be insured
		mitigated by ActewAGL Distribution; and It is not covered by any other category of pass through event.		
Insurance Cap Event		This event is clearly identifiable as it occurs when ActewAGL incurs costs beyond the actual policy limit of the relevant insurance policy as a result of the event that gives rise to the relevant claim.	A prudent service provider cannot reasonably prevent an insurance cap event from occurring or substantially mitigate the cost impact of such an event.	It would not be economic to obtain insurance for the insurance cap event. ActewAGL Distribution has not included a self-insurance amount for incurring costs beyond the actual policy limit in its forecast opex proposal as, if such an event occurs it would be unlikely to be in a position to pool enough risk to cover the cost impacts from such an event.
Insurer Credit Risk Event		This event is clearly identifiable as it occurs when an insurer becomes insolvent.	A prudent service provider cannot reasonably prevent an insurer credit risk event from occurring or substantially mitigate the cost impact of such an event.	It would not be economic to obtain insurance for the insurance cap event. ActewAGL Distribution has not included a self-insurance amount for insurer credit risks in its forecast opex proposal as, in the event of an insurer becoming insolvent, it would be unlikely to be in a position to pool enough risk to cover the cost impacts from such an event.
Terrorism		This event is clearly identifiable as it is triggered when an act of terrorism	A prudent service provider cannot reasonably prevent a terrorism event	The AER's conclusion in the Ausgrid distribution determination draft

Cost pass through event	(a) Included in the NER	(b) nature or type clearly identified	(c) could a prudent service provider reasonably prefer the event or mitigate the cost	(d) whether the event could be insured
Event		occurs.	from occurring or substantially mitigate the cost impact of such an event.	decision that the commercial market for insurance in Australia is insufficient to cover demand is equally applicable to ActewAGL Distribution[46] ActewAGL Distribution has the option of self-insuring but the relative infrequency and potentially high costs of terrorism events create significant challenges for self-insurance for this type of risk, there is limited data on the basis of which to calculate a credible self-insurance premium and taking out further insurance would likely be inefficient and result in an unnecessary cost increase to customers.
Natural Disaster Event		This event is clearly identifiable as it is triggered when a natural disaster occurs.	A prudent service provider cannot reasonably prevent a terrorism event from occurring or substantially mitigate the cost impact of such an event.	ActewAGL Distribution currently has an appropriate level of commercial insurance for natural disasters within its Property Policy and General Liability Policy. However, this insurance has limitations and exclusions which may mean that not

[46] AER 2014, Draft decision Ausgrid distribution determination 2015-16 to 2018-19, Attachment 15: Cost pass through, p. 15-12

Cost pass through event	(a) Included in the NER	(b) nature or type clearly identified	(c) could a prudent service provider reasonably prefer the event or mitigate the cost	(d) whether the event could be insured
				all costs associated with a natural disaster event are covered and taking out further insurance would likely be inefficient and result in an unnecessary cost increase to customers. ActewAGL Distribution has not included a self-insurance amount for natural disasters in its forecast opex proposal as, in the event of a major natural disaster, it would be unlikely to be in a position to pool enough risk to cover the cost impacts from such an event.
Network User Failure Event		This event is clearly identifiable as it occurs when a User is unable to supply gas to its customers.	A prudent service provider cannot reasonably prevent a network user failure event from occurring or substantially mitigate the cost impact of such an event.	Insurance on commercial terms is not available. ActewAGL Distribution could invest in systems to automate the ROLR customer transfer process but considers the low probability of occurrence does not justify the significant cost of doing so