Jemena Gas Networks (NSW) Ltd

2020-25 Access Arrangement Proposal

Attachment 4.2

Cost pass through mechanisms

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Abbreviations

AA	Access Arrangement
AEMC	Australian Energy Market Commission
AER	Australian Energy Regulator
Capex	Capital expenditure
DNSPs	Distribution Network Service Providers
GDBs	Gas distribution businesses
JCARS	Jemena Compliance and Risk System
NERL	National Energy Retail Law
NGR	National Gas Rules
Opex	Operating expenditure
RoLR	Retailer of Last Resort
RY	Regulatory year
SCUs	Self-contracting Users
UAG	Unaccounted for Gas

Overview

Our 2020 Plan includes our proposed revenue requirement to deliver reference services for the 2020-25 Access Arrangement (**AA**) period. We forecast our revenue requirement using the building block approach, which, amongst other things, relies on forecasts of our capital and operating expenditure (capex and opex) and an allowed rate of return. Attachment 7.1 details our forecast revenue requirement.

We recover revenue from our customers based on tariffs for our reference services. Attachment 4.1 details our proposed tariffs for the regulatory year (**RY**) 2020-21. We adjust our tariffs annually in accordance with a reference tariff variation mechanism. We propose retaining this mechanism, as further described in Attachment 4.1, for the 2020-25 period.

Our current mechanism deals with two types of costs that are passed through:

- those that pass-through automatically each year based on updates to observable data – we refer to these as 'Automatic Adjustments'.
- those that are contingent on the occurrence of an external event (e.g. terrorism, natural disaster, retailer insolvency) – which we refer to as a 'Cost Pass Through Event'.

The Automatic Adjustments, which is an administrative annual true-up, ensure tariffs increase or decrease when our (or benchmark) actual and forecast costs vary for licence fees, unaccounted for gas (**UAG**), carbon costs or new or changed relevant taxes. As this mechanism has a zero threshold, customers are assured to pay no more than the actual costs for any of these items. JGN monitors external change through its Regulation and Corporate Affairs teams to understand the impact of change on its costs and whether these warrant a negative pass through.[1] Further detail on the Automatic Adjustments is set out in Attachment 4.1.

In the case of Cost Pass Through Events, it is not a precise science to forecast costs to determine our revenue requirement for the next five years. We do not know whether certain events will occur – such as natural disasters, shifts in Government policy and changes in the way the energy market works – and if they do, how they will change our costs of providing pipeline services over the 2020-25 period.

We have therefore not included in our forecast revenue the unforeseen and uncontrollable costs that might arise in the 2020-25 period. Instead, the Australian Energy Regulator (**AER**) can approve cost pass through events which enable us to vary our tariffs if these events do occur. These are the safeguards the AER allows to adjust our tariffs up, or down, in response to the impact of unforeseen, uncontrollable and material changes. They mean that our forecast opex and capex do not include any large or speculative allowances for events that may not actually happen and therefore customers should not pay. The cost pass through mechanism keep the focus on affordability, as it is in our customers' best interests only to pay what is necessary for us to deliver the pipeline services they need.

This document details our proposed Cost Pass Through Events for the 2020-25 period, as well as the fixed principle which applies for cross-period events. For completeness, we note that the tariff variation mechanism which adjusts tariffs for Cost Pass Through Events (as well as the Automatic Adjustments) approved by the AER is described in Attachment 4.1.

As we are not expecting a material change in our operating environment between the current and next period, we have only made minor changes to the Cost Pass Through Events as a response to:

- the AER's recent regulatory decisions that indicate its preference to harmonise how equivalent risks are treated across businesses it regulates
- one specific risk – retailer insolvency – now explicitly being dealt with in the National Gas Rules (**NGR**).

Table OV–1 details our proposed positions on the Cost Pass Through Events for the 2020-25 period.

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[1] For example, in 2014, JGN proposed a negative cost pass through event to recognise the repeal of the Clean Energy Act 2011 (Cth) on 17 July 2014.

Table OV–1: Proposed Cost Pass Through Events

Cost Pass Through Event	Position	Action
Terrorism event	Retain	No change to definition as already consistent with recent AER decisions
Natural disaster event	Retain	Amend definition for consistency with recent AER decisions
Insurance cap event	Retain	Amend definition for consistency with recent AER decisions
Insurer credit risk event	Retain	No change to definition as already consistent with recent AER decisions
Network user failure event	Discontinue	Apply rule 520 of the NGR, which deals with retailer insolvency
Regulatory change event	Retain	Amend definition to provide additional clarification for when a regulatory change event may be triggered
Service standard event	Retain	Amend definition for consistency with recent AER decisions

Section 1 provides further detail on the proposed Cost Pass Through Events and section 2 describes the continuance of the fixed principle applying to cross period events which exists now in our 2015-20 AA.

Appendix A details our Risk Management Framework to identify risks that cannot be fully mitigated or prevented through appropriate controls or commercial insurance, and which informs the need for certain cost pass through events.

1. Cost pass through events

We propose:

- retaining six of the seven cost pass through events: terrorism event; natural disaster event; insurance cap event; insurer credit risk event; regulatory change event; and service standard event
- discontinuing the network user failure event.

We also propose to retain the current process for application and AER approval of a Cost Pass Through Event, including the materiality threshold, which the AER specified in its Final Decision for the 2015-20 AA period as follows:

> *….costs claimed in relation to a pass through event in any given year must be at least one per cent of the smoothed annual revenue requirement for that year specified in the final decision.*[2]

This materiality threshold is consistent with what currently applies to cost pass through events for other gas distribution businesses (**GDBs**) and electricity distribution network service providers (**DNSPs**). We apply this threshold for both positive events that increase our costs and negative events that decrease our costs.

1.1 Terrorism event

"Terrorism event" is defined in Schedule 1 of the 2015-20 AA. We proposed the "terrorism event" because:

- we have a risk assessment framework to proactively mitigate the security risk to our network and non-network assets
- full insurance coverage via external insurance is prohibitive.[3]

Both of these justifications continue to apply to JGN's circumstances in the 2020-25 period. We therefore propose retaining this event as currently drafted in the 2015-20 AA. We note that the Victorian GDBs each have a terrorism event and that the current definition is consistent.

1.2 Natural disaster event

We included a "natural disaster event" in our AA for the first time in 2015-20. We proposed a "natural disaster event" because it:

- is a key category of uncertain, potentially high cost-impact events that are outside of our control
- typically results in us incurring substantial costs for emergency response, repair and rectification works
- is not covered by our proposed opex allowance for emergency response, which relates to the base year
- is mitigated through our resilience framework and associated plans and available insurance
- is prohibitively costly to cover by full insurance.[4]

Each of these justifications equally apply to the 2020-25 period. We therefore propose retaining this event, but amending the definition to fully harmonise it with the Victorian GDBs AAs. Specifically, we propose amending our current definition in Schedule 1 of our 2015-20 AA to delete the declaration criterion as follows:

> ***Natural Disaster Event*** *means ~~Any~~any major fire, flood, earthquake or other natural disaster that occurs during the ~~2015-20~~ Access Arrangement Period and increases the costs to the Service*

2 AER, Attachment 11 – Reference tariff variation mechanism | Final decision: Jemena Gas Networks 2015–20, June 2015, page 11-25

3 *Ibid*, page 11-16

4 *Ibid*, page 11-17

Provider in providing the Reference Service, provided the fire, flood or other event was not a consequence of the acts or omissions of the Service Provider.

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

Note for the avoidance of doubt, in making a determination on a Natural Disaster Event pursuant to clause 3.4(i), the AER will have regard to, amongst other things:

(i) whether the Service Provider has insurance against the event; and

(ii) the level of insurance that an efficient and prudent ~~s~~Service ~~p~~Provider would obtain in respect of the event~~, and~~.

~~(iii) whether a relevant government authority has made a declaration that a natural disaster has occurred.~~

1.3 Insurance cap event

We included an "insurance cap event" also in our AA for the first time in 2015-20. We proposed an "insurance cap event" because:

- we hold efficient levels of insurance cover commensurate with our assessment of business risk and undertake periodic reviews of our insurances
- it is necessary to properly manage our exposure to the risk of liabilities crystallising over and above our insurance levels.[5]

These justifications equally apply to the 2020-25 period. We therefore propose retaining this event, but amending its definition to fully harmonise it with that which applies to the Victorian GDBs, as well as the AER's most recent decisions for other networks.[6] Specifically, we propose amending our current definition in Schedule 1 of our 2015-20 AA as follows:

Insurance Cap Event means an event where:

(a) the Service Provider makes a claim or claims and receives the benefit of a payment or payments under a relevant insurance policy;

(b) the Service Provider incurs costs beyond the relevant policy limit; and

(c) the costs beyond the relevant policy limit increase the costs to the Service Provider of providing the Reference Service.

For this Insurance Cap Event:

~~(a) the relevant policy limit is the greater of:~~

~~(i) the Service Provider's actual policy limit at the time of the event that gives, (i)or would have given rise to the claim; and~~

~~(ii) the policy limit that is explicitly or implicitly commensurate with the (ii)allowance for insurance premiums that is included in the forecast operating expenditure allowance approved in the AER's final decision for the Access Arrangement Period;~~

5 *Ibid*, page 11-14

6 See, Attachment 15 – Pass through events | Draft decision: Ausgrid distribution determination 2019-24, November 2018, page 14-5, 14-11

(d~~b~~) a relevant insurance policy is an insurance policy held during the Access Arrangement Period or a previous period in which access to the pipeline services was regulated; and

(e~~c~~) the Service Provider will be deemed to have made a claim on a relevant insurance policy if the claim is made by a related party of the Service Provider in relation to any aspect of the Network or the Service Provider's business

Note for the avoidance of doubt, in making a determination on an Insurance Cap Event pursuant to clause 3.4(j), the AER will have regard to, amongst other things:

(i) the insurance policy for the event, and

(ii) the level of insurance that an efficient and prudent Service Provider would obtain in respect of the event.

1.4 Insurer credit risk event

"Insurer credit risk event" is defined in Schedule 1 of our AA for the 2015-20 period. We included an "insurer credit risk event" in our AA for the first time in 2015-20. We proposed an insurer credit risk event because:

- we take precautions to mitigate our exposure to an insurer's credit risk event, including:
  - Appointing a global insurance broker, which ensures that all of our insurers are rated Standard and Poor's (or equivalent) A- or better
  - Receiving quarterly insurer security rating reports, and
  - Diversifying our insurance portfolio across different third-party insurance providers.
- despite these efforts, an insurer may fail and leave us exposed in circumstance beyond our control
- despite being a prudent GDB, we cannot always anticipate the failure of an insurance provider.

The above justifications continue to apply to the 2020-25 period. We therefore propose retaining this event as currently drafted in the 2015-20 AA. We note that the Victorian GDBs each have a terrorism event and that the current definition is already consistent.

1.5 Network user failure event

Schedule 1 of our AA for the 2015-20 period includes a "network user failure event".

This event covers costs that we incur in following required procedures in a Retailer of Last Resort (**RoLR**) event under the National Energy Retail Law (**NERL**). In September 2016, the AER approved the pass through of unpaid distribution charges for the GoEnergy retailer insolvency event.

The AER made its Final Decision for our 2015-20 AA in June 2015.[7] In February 2017, the Australian Energy Market Commission (**AEMC**) approved a rule change that allows GDBs to recover revenue following the insolvency of a retailer via a cost pass through (in particular, rule 520 of the NGR).[8] We had also made a related rule change request (which was rolled into the AEMC's approved rule change) that sought to ensure that:

- the pass through amount covers both the cost impact of retailer insolvency as well as the amount the gas distributor is entitled to be paid. This is now addressed in the definition of "retailer insolvency costs" in rule 520(5) of the NGR

7 This Final Decision was remade by the AER .

8 See, AEMC, National Gas Amendment (Retailer-Distributor Credit Support Requirements) Rule 2017 No 1.

- if the retailer insolvency event occurred, the amount would be reflected in tariffs through the tariff variation mechanism. This is also addressed in rule 520(4) of the NGR.

Given that these issues are now addressed in the NGR, there is no need to retain this event in relation to retailers.

However, self-contracting users (**SCUs**) are not covered by rule 520 of the NGR, which means that we may be exposed if a SCU becomes insolvent. While we can terminate our contract with the SCU, we may still incur some losses in such an event, particularly for invoiced but unpaid network charges. Rather than have a new pass through event, we propose that this risk be dealt with by:

- clarifying the credit worthiness requirements as part of the request for service process in Schedule 6 of the proposed 2020-25 AA; and
- for existing SCUs, we have proposed that, if reasonably requested by JGN, the SCU must provide security of an amount to be not less than six, rather than two, months' of charges. More detail on this is included in Attachment 9.2.

1.6 Regulatory change event

"Regulatory change event" is defined in Schedule 1 of our AA for the 2015-20 period. We propose amendments to it for the 2020-25 period as follows:

> *Regulatory Change Event means the introduction of, or a change in, a regulatory obligation or requirement that falls within no other category of Cost Pass Through Event and substantially affects the manner in which the Service Provider provides the Reference Service.*

We propose a minor and clarifying amendment to ensure the pass through event includes not just changes in an existing regulatory obligation or requirement, but also the introduction of a new regulatory obligation or requirement. This change is required because it is not clear that the current definition covers the latter circumstance.

1.7 Service standard event

Our 2015-20 AA includes a "service standard event". Our current definition is very similar to what applies to other GDBs and the electricity DNSPs. However, in order to harmonise it fully, we propose the following minor change to subclause (a):

> *Service Standard Event means a legislative or administrative act or decision that has the effect of:*
>
> *(a) substantially ~~V~~varying, during the course of an Access Arrangement Period, the manner in which the Service Provider is required to provide the Reference Service; or*
>
> *(b) ~~Imposing~~imposing, removing or varying, during the course of an Access Arrangement Period, minimum service standards applicable to the Reference Service; or*
>
> *(c) ~~Altering~~altering, during the course of an Access Arrangement Period, the nature or scope of the Reference Service provided by the Service Provider.*

The inclusion of the word "substantially" results in consistent language with the regulatory change event and the service standard event for the 2020-25 period.

2. Access arrangement fixed principle

The AER approved a fixed principle in clause 3.5 of our 2015-20 AA in relation to cross period cost pass throughs – that is, for cost pass through events that apply in the immediately prior period, but which are passed through via tariffs charged in the subsequent period. This fixed principle applies for the 2015-20 period only.

As the AER noted in its Final Decision, this fixed principle was:

> *…required to potentially allow the financial impact of an approved cost pass through event that occurs late in one access arrangement period to be addressed in the reference tariffs that apply in the next access arrangement period.*[9]

The AER went on to add in its Final Decision that it approved the fixed principle because it:

- *allows JGN the opportunity to recover its efficient costs should a pass through event occur late in the 2015–20 access arrangement period*
- *provides for consistency between the electricity and gas regulatory regimes, where the same risks and regulatory functions to govern that risk (cost pass throughs) exist.*[10]

The AER rejected our request for the fixed principle also to apply to the 2020-25 period. It stated:

> *The application of this fixed principle in subsequent access arrangement periods is more appropriately considered as part of our consultation on JGN's proposals for those periods.*[11]

The fixed principle remains necessary in the 2020-25 period for the same reasons as we sought it, and the AER approved it, for the 2015-20 period. We note that, whereas a change was made to the National Electricity Rules in August 2012 to allow electricity DNSPs to recover the costs associated with approved pass through events in the subsequent regulatory control period, no equivalent change has been made to the NGR.

We therefore propose retaining clause 3.5 of our AA as a fixed principle for the 2020-25 period. Given the AER's previous rejection of our proposal to have this fixed for multiple periods, we have not sought this change for the 2025-30 period.

We also propose a minor modification to the wording of the fixed principle, so that it specifically references the Automatic Adjustments in Schedule 3 of our 2020-25 AA. In the 2010-15 period, the Automatic Adjustments were incorporated within the definition of "cost pass through events" so the current wording of this fixed principle worked effectively. However, in the 2015-20 period, the Automatic Adjustments do not fall within the definition of a "cost pass through event". Our proposed updates to this fixed principle (as set out below) address this unintended definitional gap:

> *(b) Costs incurred in the immediately prior access arrangement period but which are not passed through in Reference Tariffs in the immediately prior access arrangement may, in accordance with Schedule 3, be included in the calculation of the automatic adjustment factor applicable in the subsequent access arrangement period.*
>
> *~~(b)~~(c)The principle in this clause 3.5 (that costs associated with cost pass through events in one access arrangement period which are not passed through in that period and costs relating to the prior access arrangement period and subject of the automatic adjustment factor may both be passed through in a later access arrangement period) is a fixed principle (as provided for in Rule 99 of the National Gas Rules). This fixed principle remains in force for the Access Arrangement Period covered by this Access Arrangement.*

9 *Ibid*, page 11-26.

10 *Ibid*, pages 11-26 to 11-27.

11 *Ibid*, page 11-27.

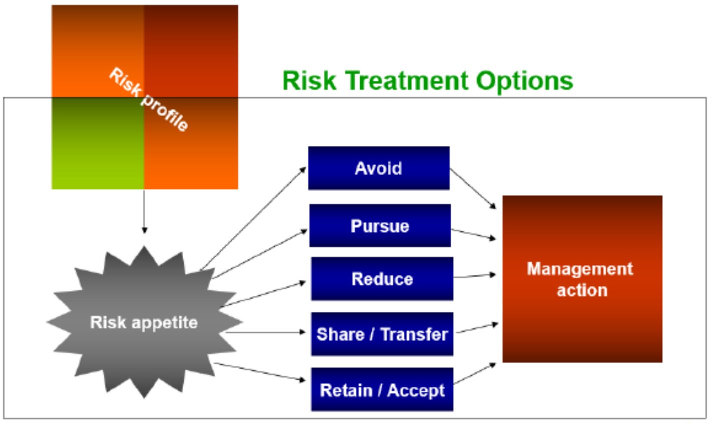
Appendix A
Risk Management Framework

A1. Risk Management Framework

A1.1 Options for managing risk

Most businesses, including ours, seek to manage their risks in one of five ways, as set out in Figure A1–1.

Figure A1–1: Risk treatment options matrix



Generally, we:

- **Avoid** risks that are very likely to occur and would be particularly damaging to the business – we avoid any activity we consider to create an unacceptable health and safety risk to our employees, customers and community.
- **Pursue** risks where the nature and extent of the changes required to achieve desired performance do not exceed our management's tolerance for risk – for example, we may introduce new technologies in order to enhance the reliability of the network and those technologies may create some risk.
- **Reduce** risks where we consider there is a relatively high chance of an event occurring, but we can mitigate against its impact at a relatively low cost – for example, we mitigate the impact of third party hits through our incident response management plans.
- **Transfer** risks that are relatively unlikely to occur and would be particularly damaging to the business if they did eventuate – for example, we may take out third-party insurance to transfer a risk that we are unable to fully mitigate or avoid. The cost pass through mechanism is another example of how risks of uncontrollable and major events are transferred and shared with customers.
- **Accept** (or self-insure) risks that have a reasonably low probability of occurring and would have a low impact.

How we manage a particular risk depends upon the options available, and how efficient and effective the options are. Our decision-making process is founded in our corporate risk management framework and associated policies. We look to the framework and policy to guide us in choosing the most efficient and effective way to manage risks.

Occasionally, we have to share a risk with customers, in a cost pass-through event. Our customers expect us to minimise – to the extent possible – the likelihood of risks being transferred to them, so this is an approach that we look to avoid where we can. Our nominated cost pass through events are discussed in section 1 below.

A1.2 Our approach to risk management

A1.2.1 Risk management framework

Our risk management framework consists of an integrated package of corporate and asset-specific risk management policies, plans, and procedures. Additionally, we are committed to ensuring that risk management is embedded in our business' operations and culture by encouraging the adoption of the following approaches and operating practices:

- It is everyone's responsibility to manage risk.
- Risks are owned by our business as a whole.
- Risk management is embedded in normal business processes.
- Risk management provides early warning that enables us to mitigate the impacts.
- Risks are considered through both top-down and bottom-up approaches, with regular reporting and monitoring of risks up to the Jemena Group (i.e. SGSP (Australia) Assets Pty Ltd) board.

Our approach is underpinned by the following key risk management principles that are set out in ISO 31000:2018. The standard says that risk management is:

- *Integrated* – an integral part of all organisational activities
- *Structured and comprehensive* – which contributes to consistent and comparable results
- *Customised* and proportionate to the level of risk faced by the organisation
- *Inclusive* – stakeholders are consulted in a timely fashion to allow their knowledge, views and perceptions to be considered
- *Dynamic* – it anticipates, detects, acknowledges and responds to changes and events in an appropriate and timely manner
- Based on the *best information available*
- Influenced by *human and cultural factors*, and
- *Continually improved* through learning.

A1.2.2 Risk management policy

Our risk management policy ensures that we take a strategic and systematic approach to balancing the need to meet business objectives with the need to assess and manage risk effectively.

The policy and the approaches adopted are also consistent with best-practice principles and the Australian risk management standard, ISO 31000:2018. The policy is designed to protect:

- Our employees and customers
- The environment in which we operate, and
- Our position as a provider of quality products and services.

The policy explicitly recognises that our business must take some risks in undertaking its core functions and pursuing opportunities. The risk profile we have adopted is balanced against the potential rewards from taking risks.

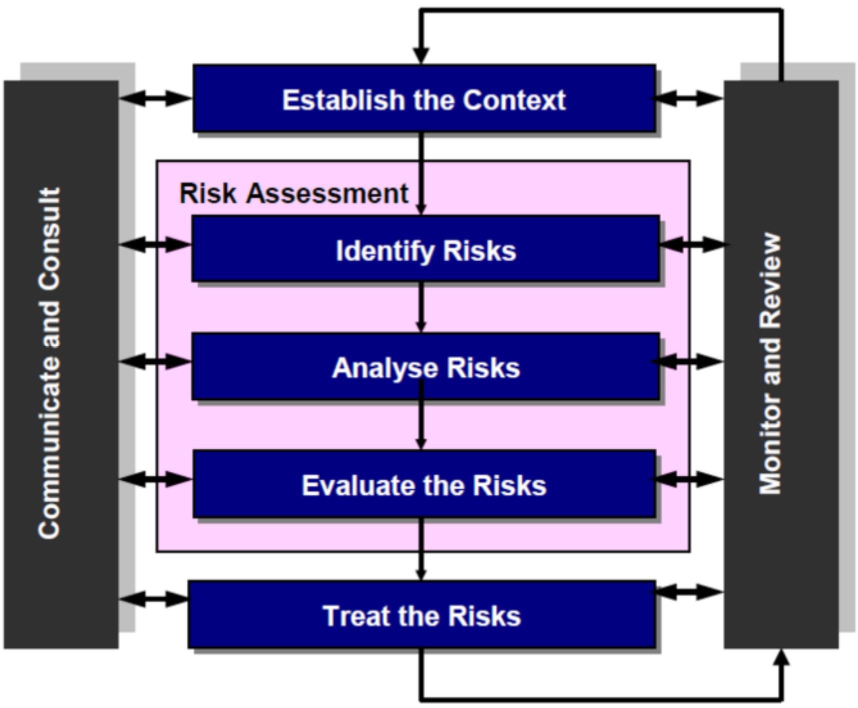
The Jemena risk management manual is a dynamic document that is designed to ensure the policy is implemented, and risk management is embedded in our practices and processes, Together, they formalise and set out our risk management framework. The framework is also supported in our organisation by the following policies and procedures:

- Code of Conduct
- Compliance Policy and Program
- Delegated Financial Authority Policy
- Disciplinary Policy
- Environment Policy
- Finance Policies and Procedures
- Fraud Control Policy
- Health and Safety Governance Framework
- Health and Safety Policy, and
- Asset Management Policy.

A1.2.3 Risk management process

Risk management is ultimately achieved through our risk management process, set out in Figure A1–2.

Figure A1–2: JGN's risk management process



Risk management at Jemena is an iterative process, in which risk facilitators – nominated by us – ensure the key risk management activities are implemented, reviewed and re-assessed at a reasonable and appropriate frequency. The risk management process involves:

- Establishing the context
- Assessing the risk by defining it correctly and identifying its causes

- Analysing the likelihood and potential consequences of the risk, as well as the impact of not treating it – this also includes an assessment of the controls in place, identifying mitigation actions and other potential controls, assessing the overall effectiveness of control and assessing the residual risks
- Evaluating the risk including priority, escalation level and reporting requirements, and
- Treating the risk through a series of risk treatment options.

Communication is key to our risk management process. In the early stages, when a risk has been identified, it is down to the relevant employees and relevant stakeholders to assess the nature of the risk. Where the consequences of the risk are deemed unacceptable, it is the identifier's responsibility to alert the appropriate level of management about the risk.

Both monitoring and review are also part of the risk management process, and can be periodic or ad hoc.

We use the Jemena compliance and risk system (**JCARS**) as a risk register for high and extreme risks, and all other risks are maintained by the respective JGN or Jemena Group business units.