DRAFT DECISION
Jemena Gas Networks (NSW) Ltd
Access Arrangement

2020 to 2025

Attachment 10
Reference tariff variation mechanism

November 2019

AUSTRALIAN ENERGY REGULATOR

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Note

This attachment forms part of the AER's draft decision on the access arrangement that will apply to Jemena Gas Networks (NSW) Ltd ('JGN') for the 2020–2025 access arrangement period. It should be read with all other parts of the draft decision.

The draft decision includes the following documents:

Overview

Attachment 1 – Services covered by the access arrangement

Attachment 2 – Capital base

Attachment 3 – Rate of return

Attachment 4 – Regulatory depreciation

Attachment 5 – Capital expenditure

Attachment 6 – Operating expenditure

Attachment 7 – Corporate income tax

Attachment 8 – Efficiency carryover mechanism

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Attachment 10 – Reference tariff variation mechanism

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Attachment 12 – Demand

Attachment 13 – Capital expenditure sharing scheme

Contents

Shortened forms

Shortened form	Extended form
AEMC	Australian Energy Market Commission
AEMO	Australian Energy Market Operator
AER	Australian Energy Regulator
Capex	Capital expenditure
CCP/CCP19	Consumer Challenge Panel, sub-panel 19
CESS	Capital expenditure sharing scheme
CPI	Consumer price index
EBSS	Efficiency benefit sharing scheme
ECM	Efficiency carryover mechanism
EWON	Energy & Water Ombudsman NSW
JGN	Jemena Gas Networks (NSW) Ltd
NER	National Electricity Rules
NGL	National Gas Law
NGO	National Gas Objective
NGR	National Gas Rules
Opex	Operating expenditure
RPP	Revenue and pricing principles
UAG	Unaccounted for gas
WAPC	Weighted average price cap

10 Reference tariff variation mechanism

This attachment sets out our consideration of the reference tariff variation mechanism and cost pass through mechanism proposed by JGN. The reference tariff variation mechanism:

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

The cost pass through mechanism allows us to vary reference tariffs following the occurrence of a specified event which materially increases or decreases the cost of providing the reference service.

The inclusion of a pass through mechanism recognises a service provider can face risks beyond its control, which may have a material impact on costs.

10.1 Annual reference tariff variation mechanism

10.1.1 Draft decision

We do not approve JGN's proposed reference tariff variation mechanism for the 2020–25 access arrangement period. We consider some elements of its proposed mechanism are not consistent with the National Gas Rules (NGR). In particular:

- the proposed initial reference tariffs and X factors must be revised to reflect the changes to the forecast total revenue identified in section 3 of the Overview of this draft decision
- it is not appropriate that the tariff variation mechanism include provision for an annual licence fee automatic adjustment
- the reference tariffs must reflect the relevant specified reference services for the 2020–25 access arrangement and be consistent with the services attachment of this draft decision.[1]

We discuss our reasons for this draft decision below.

[1] See Attachment 1 (Services covered by the access arrangement).

10.1.2 JGN's proposal

JGN proposes a weighted average price cap (WAPC) tariff basket form of price control for the 2020–25 period. This approach is consistent with other gas distributors and JGN's current access arrangement applying in the 2015–20 period. It includes a tariff variation mechanism to allow a series of annual adjustments to tariffs to account for cost pass throughs and true-ups for actual licence fees, unaccounted for gas (UAG) and relevant taxation costs.

JGN is proposing to amend the automatic adjustment factor of the tariff variation mechanism to:

- resolve a timing issue affecting the licence fee factor calculation
- simplify the description of the UAG true-up calculation
- accommodate the outcome of our remade final decision (the 'remittal') for JGN associated with the 2015–20 access arrangement.

10.1.2.1 Licence fees based on 'as accrued' instead of 'as incurred' basis

JGN proposes to change the basis of the calculation of the licence fee adjustment to an 'as incurred' basis, from the current 'as accrued' basis.[2] According to JGN, this change is required to address the common scenario where licence fees for a particular year only become known as invoices are received — often this occurs after JGN submits its annual tariff variation notice. JGN considers adopting an 'as incurred' approach will rectify the timing issue and be consistent with the operating expenditure (opex) forecast approach that relies on a category specific forecast of as incurred opex.

10.1.2.2 Simplifying the UAG true-up calculation definition

JGN proposes to amend the UAG factor component of the automatic adjustment factor compared to that applying in the current access arrangement. [3] JGN considers this change will simplify the description of how the UAG factor is calculated.

Currently, JGN's opex forecast includes a series of target UAG 'loss rates' that act to incentivise JGN to minimise UAG costs. This forecast relies on assumptions of gas consumption and wholesale prices that are trued-up for the actual outcomes as part of the annual tariff variation process.[4] Specified through the tariff variation mechanism, the UAG factor calculation description relies on written terms to describe the calculation. JGN proposes to instead include a table that specifies the different target rates for the respective years. In its proposal, JGN has also included separate target

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2 JGN, *2020–25 Access Arrangement Proposal, Attachment 4.1 Our reference service and tariffs*, June 2019, p. 44.

3 JGN, *2020–25 Access Arrangement Proposal, Attachment 4.1 Our reference service and tariffs*, June 2019, p. 45.

4 This is because the opex forecast is a volume based incentive. By correcting the forecast for actual consumption and prices, the incentive is confined to that which is within JGN's direct control and not influenced by volatility in wholesale prices.

rates for 2018–19 and 2019–20 as these true-ups are scheduled to take place in the 2021–22 regulatory year, the reasons for this are discussed below in section 10.1.5.2.

10.1.2.3 Accommodating the 2015–20 remittal outcome

JGN proposes changes to the automatic adjustment factor to include true-ups for the 2018–19 and 2019–20 regulatory years. JGN proposes that these true-ups are required to accommodate our remade final decision on JGN's 2015–20 access arrangement.[5] These true-ups will occur in the second year of the 2020–25 access arrangement period.[6] Table 10.1 below illustrates JGN's proposal.

Table 10.1 Administrative true-ups occurring in the 2020–25 period

	Year of true-up (year in table body)				
Year cost incurred (this row)	**2018–19**	**2019–20**	**2020–21**	**2021–22**	**2022–23**
Licence fee factor	2021–22	2021–22	2022–23	2023–24	2024–25
UAG factor	2021–22	2021–22	2022–23	2023–24	2024–25
Carbon cost factor	N/A	2021–22	2022–23	2023–24	2024–25
Relevant tax factor	N/A	2021–22	2022–23	2023–24	2024–25

Source: Adapted from JGN, *Regulatory proposal 2020–25, Attachment 4.1 Our reference service and tariffs,* June 2019, p. 46.

JGN considers its proposal to undertake 'true-ups' for the current access arrangement is necessary to unwind changes to the tariff variations associated with a one-off adjustment that occurred as part of the remade decision.[7] With JGN's automatic adjustments occurring on a 'time minus 2' (T–2) basis, the timing of our remade decision means there are outstanding reconciliations required as actuals become known in the 2020–25 period.

10.1.2.4 Other aspects of the tariff variation mechanism being maintained

JGN proposes to maintain other aspects of the tariff variation mechanism. These include the cost pass through factor and other aspects of the automatic adjustment factor.

[5] AER, *Final Decision Jemena Gas Networks (NSW) Ltd 2015–20 Access Arrangement*, February 2019.

[6] JGN, *Regulatory proposal 2020–25, Attachment 4.1 Our reference service and tariffs,* June 2019, p. 46.

[7] Ibid.

JGN also proposes to maintain the same tariff variation process that currently applies. That is, JGN will submit its annual reference tariff variation proposal to us for approval by 15 March of each year, allowing tariffs to be updated for the return on debt adjustment. JGN will also submit to us a pricing model to demonstrate compliance with the tariff variation mechanism.

10.1.3 Assessment approach

Under the NGR, a reference tariff variation mechanism for an access arrangement:[8]

- must be designed to equalise (in present value terms):
  - forecast revenue from reference services over the access arrangement period, and
  - the portion of total revenue allocated to reference services for the access arrangement period, and
- may provide for variation of a reference tariff:
  - in accordance with a schedule of fixed tariffs, or
  - in accordance with a formula set out in the access arrangement, or
  - as a result of a cost pass through for a defined event, or
  - by the combination of two or more of these operations.

A formula for varying reference tariffs may (for example) provide for variable caps on the revenue to be derived from a particular combination of reference services; or tariff basket price control; or revenue yield control; or a combination of all or any of these factors.[9]

We must have regard to various factors in deciding whether an access arrangement's reference tariff variation mechanism is appropriate.[10] These are:

- the need for efficient reference tariff structures
- the possible effects of the reference tariff variation mechanism on administrative costs
- the regulatory arrangements (if any) applicable to the relevant reference services before the commencement of the proposed reference tariff variation mechanism
- the desirability of consistency between regulatory arrangements for similar services
- any other relevant factor.

Further, the reference tariff variation mechanism must give us adequate oversight and powers to approve reference tariff variations.[11]

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8 NGR, r. 92(2).

9 NGR, r. 97(2).

10 NGR, r. 97(3).

We made our decision on JGN's proposed reference tariff variation mechanism having regard to each of these factors, and their implications for natural gas consumers, potential users, JGN and other stakeholders. In doing so, we took into account the nature and scope of pipeline reference services to which reference tariffs are applicable. Our assessment also included a comparison of:

- the proposed reference tariff variation mechanism with those in JGN's current access arrangement
- consistency with other recent gas distribution access arrangement decisions (and electricity determinations under the National Electricity Rules (NER))
- consistency in JGN's approach across the provision of similar services.

We assessed the potential impact of JGN's proposal for meeting the National Gas Objective (NGO) and the revenue and pricing principles (RPP).

We have taken into account the expected changes in gas demand over the 2020–25 period, the impact this can have on price stability over the period, and incentives on the service provider to develop efficient tariffs.

We have also taken into account submissions provided to us by stakeholders, including our Consumer Challenge Panel (CCP19).

10.1.4 Interrelationships

The haulage reference tariff variation mechanism has interrelationships across other key parts of our draft decision. For example, it interrelates with the total revenue JGN can earn, the services JGN provides to its customers to recover those revenues, and the tariffs it charges for the use of those services.

JGN's haulage reference tariffs are adjusted annually by the application of a weighted average price cap formula. The X factor in the formula is revised annually to reflect the updates to the return on debt as a result of the adoption of a trailing average approach to determining the cost of debt.

JGN's haulage reference tariffs are derived from the total revenue requirement after consideration of demand for each tariff category. Specific automatic adjustments occur on an annual basis to adjust JGN's total revenue requirement as certain expenses are 'trued-up' to reflect actual outcomes. This means the tariffs we determine (including the means of varying the tariffs from year to year) are the binding constraint across the 2020–25 period, rather than the total revenue requirement set out in our decision.

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[11] NGR, r. 97(4).

10.1.5 Reasons for draft decision

We do not approve JGN's proposed reference tariff variation mechanism for the 2020–25 period. Our draft decision is to amend the licence fee component of the automatic adjustment factor to ensure consistency with our decision on the forecast of JGN's required opex for these costs.

However, we are satisfied that JGN's two other proposed changes to the reference tariff variation mechanism are appropriate. That is, to:

- amend the UAG factor calculation
- accommodate the 2015–20 access arrangement remittal outcome.

10.1.5.1 Licence fee factor

As described above in section 10.1.2.1, JGN is proposing changes to the licence fee factor component of the automatic adjustment factor.

While we are satisfied JGN's proposed change to calculate the licence fee factor on an 'as incurred' basis is appropriate, we are not satisfied the expenditure included in the factor calculation meet the criteria in the NGR to be included in the tariff variation mechanism.

We have amended the licence fee factor to remove references to Energy & Water Ombudsman NSW (EWON), AER, and Australian Energy Market Operator (AEMO) fees, while extending it to include local government mains tax charges. We consider these changes are necessary to ensure the licence fee factor is consistent with the implied risk sharing arrangement between JGN and customers in the access arrangement – a factor we must have regard to under the NGR.[12]

'As incurred' timing basis for licence fees calculation is appropriate

We are satisfied JGN has justified its change to the basis of the licence fee factor calculation described above in section 10.1.2.1. We recognise our opex forecast approach for government levies trends forward 'as incurred' historical government levy expenditure.[13] We are therefore satisfied that JGN's proposed change to the tariff variation mechanism is justified in terms of consistency with the opex forecast approach.[14]

Change to licence fee costs opex forecast reflected in licence fee factor

JGN includes certain government levies costs to provide reference services as part of its opex forecast. Our opex draft decision has substituted a different forecasting approach to JGN's with respect to the fees paid as part of the EWON ombudsman

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[12] NGR, r. 97(3)(d1).

[13] AER, *Draft Decision, JGN access arrangement 2020–25, Attachment 6 Operating expenditure,* November 2019.

[14] NGR, r. 97(3)(d).

scheme. We have included these fees in our base year opex estimate, rather than as part of a government levies category specific forecast as JGN proposed.[15] Further, our opex forecast also includes local government mains tax charges in the government levies category specific forecast. Our opex draft decision discusses this further in Attachment 6.

These changes to our opex forecasting approach mean we need to amend the licence fee factor calculation to reflect these differences. Whether or not licence fees are part of the base year estimate or treated as a separate category specific forecast will determine whether they are included in our opex incentive scheme, the efficiency carryover mechanism (ECM). With the ECM applying to opex included in the base year estimate, 'base opex' is subject to a risk sharing arrangement between consumers and JGN over differences between actual and forecast opex.[16] With the EWON fees now included in the base opex estimate, we have removed these from the licence fee true-up as we consider that the ECM is a risk sharing arrangement implicit in the access arrangement between JGN and customers in respect of actual and forecast charges. We must have regard to such risk sharing arrangements when determining the factors to include in the tariff variation mechanism.[17] We consider it is appropriate to remove EWON fees from the licence fee true-up to ensure the integrity of this risk sharing mechanism, and its consistency with the rest of the access arrangement.

Additionally, we have included local government mains tax charges to ensure consistency with the opex category specific forecast, as well as removing AEMO fees as JGN does not expect to incur these charges going forward.[18] Section 10.4 below describes the revisions we require to the licence fee factor amount calculation description in the access arrangement.

10.1.5.2 Other changes to tariff variation mechanism appropriate

UAG factor change simplifies

We are satisfied that JGN's proposed change to the UAG factor, described above in section 10.1.2.2, is appropriate as it makes the tariff variation clearer and has no other effect on the application of the tariff variation mechanism.

The change includes the UAG target rate figures in a table in the tariff variation mechanism rather than in written terms. The figures are consistent with our opex draft decision. However, if JGN proposes to revise these target rates as part of its 2020–25 revised proposal, the tariff variation mechanism would need updating.

15 AER, *Draft Decision, JGN access arrangement 2020–25, Attachment 6 Operating expenditure,* November 2019.

16 Ibid.

17 NGR, r. 97(3)(d1).

18 JGN, *Response to AER information request #041,* 3 October 2019, p. 3.

True-ups providing for 2015–20 remittal outcome consistent with expectations

We are satisfied JGN's proposal to include true-ups for 2018–19 and 2019–20 as part of the tariff variations for the 2021–22 regulatory year is appropriate. This is consistent with our expectations as these automatic adjustments occur on a T–2 basis, meaning that it is typical for these to occur across access arrangement periods.

We initially understood JGN's proposal suggested these changes were required because some 'true-ups' for the current (2015–20) access arrangement were deferred, as enforceable undertakings were in place through this period and the actual and outturn true-ups have not been reconciled.[19] We clarified this with JGN. We are now satisfied that this is not the case. Rather, any outstanding true-ups for years prior to the 2018–19 regulatory year were achieved as part of the 2019–20 annual tariff variation.[20]

10.1.5.3 Aspects of tariff variation being maintained are appropriate

We are satisfied with JGN's proposal to maintain other aspects of the tariff variation mechanism described above in section 10.1.2.4.

10.2 Weighted average price cap formula

10.2.1 Draft decision

Our draft decision is to approve the weighted average price cap formula within JGN's 2020–25 access arrangement proposal, subject to the changes to the automatic adjustment factor calculations discussed above in section 10.1.

10.2.2 JGN's proposal

JGN is proposing a weighted average price cap (or 'WAPC') tariff basket form of control. This mechanism also includes a cost pass through and a series of automatic adjustments to allow for certain 'true-ups'.

In its submission, AGL supports JGN's proposal noting that this arrangement provides greater certainty for retailers and customers, unlike the revenue cap approach in electricity distribution determinations which it considers has created significant price variations from one year to another due to the reconciliation of actual electricity consumption.[21]

10.2.3 Reasons for draft decision

We are satisfied that the weighted average price cap formula within JGN's 2020–25 access arrangement proposal is appropriate. This mechanism is consistent with the

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19 JGN, *2020–25 Access Arrangement Proposal, Attachment 4.1 Our reference service and tariffs*, June 2019, p. 46.

20 JGN, *Response to AER information request #014,* 20 August 2019, pp. 6–7.

21 AGL, *Submission on JGN 2020–25 AA Proposal,* August 2019.

current access arrangement period and other gas distributors. We note that we assess compliance with the price cap control formulae as part of the annual tariff variation mechanism and apply the assessment approach set out in section 10.1.3 above.

10.3 Cost pass through mechanism

10.3.1 Draft decision

We accept all of JGN's proposed cost pass through events, but require JGN to amend the definition of 'natural disaster event' as set out in Table 10.2, so that it is consistent with our recent decisions.[22] JGN's proposed cost pass through events are consistent with those applicable in the current access arrangement period.

10.3.2 JGN's proposal

JGN proposes to retain the current processes for application, and our approval, of cost pass through events. Under its current access arrangement, JGN may seek our approval to pass through costs arising from the occurrence of a pass through event. It has 90 business days from becoming aware that a pass through event has occurred to submit a pass through application. Notification is mandatory for events that decrease JGN's costs but optional for events that increase JGN's costs provided it wishes to submit a pass through application.

To qualify for a cost pass through, the costs JGN has incurred, or is likely to incur, as a result of the relevant pass through event must exceed one per cent of JGN's smoothed total revenue for the financial year in which the costs were incurred. JGN's access arrangement provides that we must notify JGN of our decision as to whether a cost pass through event has occurred, and the amount that should be passed through in JGN's reference tariffs, within 40 business days unless the time limit is extended.

JGN proposes the following pass through events for the 2020–25 period:

- Terrorism event
- Natural disaster event
- Insurance cap event
- Insurer credit risk event
- Regulatory change event
- Service standard event.[23]

[22] See for example, AER, *Draft decision – Energex distribution determination 2020–25 – Attachment 14 Pass through events*, October 2019, p. 13.

[23] JGN, *2020–25 Access Arrangement Proposal – Attachment 4.2 Cost pass through mechanisms*, June 2019.

All of these events are in the current access arrangement. In its proposal, JGN states that it amended some of its proposed pass through event definitions to be consistent with our recent decisions.

JGN proposes to delete the Network user failure event, relating to retailer insolvency, as it is now dealt with under rule 520 of the NGR.

10.3.3 Assessment approach

The NGR state that a reference tariff variation mechanism may provide for the variation of a reference tariff:[24]

> "…as a result of a cost pass through for a defined event (such as a cost pass through for a particular tax)."

As a component of the reference tariff variation mechanism, a cost pass through mechanism must be assessed having regard to the matters in rule 97(3)[25] of the NGR and must give us adequate oversight and power to approve reference tariff variations.[26]

We must approach this assessment in a manner likely to contribute to the achievement of the NGO,[27] which states that the purpose of the National Gas Law (NGL) is to promote efficient investment, operation and use of natural gas services for the long term interest of consumers with regard to price, quality, safety and security of supply.[28]

In addition, we must take into account the RPP whenever we exercise discretion in approving or making those parts of an access arrangement relating to a reference tariff.[29] The RPP include a principle that the service provider should be provided with a reasonable opportunity to recover at least the efficient costs incurred in providing reference services and complying with a regulatory obligation or requirement.[30] They also provide incentives to promote economic efficiency.[31] The RPP require us to have regard to the economic costs and risks of the potential for under- and over-investment by a service provider, to promote efficient investment.[32]

In the context of pass through events, we interpret the NGO as requiring us to have particular regard to the impact on price, quality, safety, reliability and security of supply

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24 NGR, r. 97(1)(c)

25 In summary: efficient reference tariff structures; administrative costs; prior regulatory arrangements; consistency between regulatory arrangements; any other relevant factor.

26 NGR, r. 97(4).

27 NGL, s. 28(1)(a).

28 NGL, s. 23.

29 NGL, s. 28(2)(a).

30 NGL, s. 24(2).

31 NGL, s. 24(3).

32 NGL, s. 24(6).

that may arise as a result of any change in the efficient operation of, and ability and incentive of, a service provider to invest in its network.[33]

Our decision on the cost pass through mechanism includes a decision on what categories of event to approve.[34] In approaching this part of our task, we also take into account the following considerations:[35]

- whether the type of event is covered by another category of pass through event
- whether the nature or type of event can be clearly identified at the time the access arrangement is approved for the service provider
- 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
- whether the relevant service provider could insure against the event, having regard to:
    - the availability (including the extent of availability in terms of liability limits) of insurance against the event on reasonable commercial terms
    - whether the event can be self-insured on the basis that: it is possible to calculate the self-insurance premium; and the potential cost to the relevant service provider would not have a significant impact on the service provider's ability to provide network services.

These considerations appear in the NER, where they guide our decision on whether to approve additional categories of pass through event beyond those already included in the NER.[36] We consider they are consistent with the factors referred to in the NGR (r. 97(3)), and pertinent to our examination of the degree to which a proposed category of event is likely to contribute to the achievement of the NGO.[37]

The Australian Energy Market Commission (AEMC) described the purpose of these considerations as:

> "…to incorporate and reflect the essential components of a cost pass through regime. It was intended that in order for appropriate incentives to be maintained, any nominated pass through event should only be accepted when event avoidance, mitigation, commercial insurance and self-insurance are

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

34 NGR, r. 97(1)(c).

35 NGR, r. 97(3)(e).

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

37 NGR, r. 100(1).

> unavailable. That is, a cost pass through event is the least efficient option for managing the risk of unforeseen events.[38]
>
> …that a pass through event should only be accepted when it is the least inefficient option and event avoidance, mitigation, commercial insurance and self-insurance are found to be inappropriate. That is, it is included after ascertaining the most efficient allocation of risks between a service provider and end customers."[39]

We consider that viewing pass throughs as a 'last resort' and accepting them only when event avoidance, mitigation and avoidance are unavailable, is consistent with the RPP and will contribute to the achievement of the NGO. This approach maintains the incentives on service providers to use market based mechanisms to mitigate the cost impacts that would arise if the event is triggered.[40] In turn, this promotes the efficient investment in, and efficient operation and use of, natural gas services for the long term interests of consumers with respect to price.[41]

We also look to promote consistency in our approach to pass through categories across our electricity determinations and gas access arrangement decisions.[42]

10.3.4 Interrelationships

Except as provided by a reference tariff variation mechanism, a reference tariff is not to vary during the course of an access arrangement period.[43] In assessing and approving a reference tariff variation mechanism, we consider the potential impact of the proposed mechanism on the service provider's incentives under the access arrangement to operate its network—and manage its risks—in a manner consistent with the NGO and RPP.[44]

The pass through component of the reference tariff variation mechanism is also interrelated with other parts of this decision, in particular with the forecast opex[45] and capex[46] and rate of return[47] included in our forecast revenue requirement. These interrelationships require us to balance the incentives in the various parts of our decision.

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

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

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

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

42 See NGR r. 97(3)(d).

43 NGR, r. 97(5).

44 NGL, ss. 23, 24.

45 See Attachment 6 (Operating expenditure) to this draft decision.

46 See Attachment 5 (Capital expenditure) to this draft decision.

47 See Attachment 3 (Rate of return) to this draft decision.

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

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

An efficient business will manage its risk by employing the most cost effective combination of these strategies. In order to maintain appropriate incentives under an access arrangement, we only accept pass through events where we are satisfied that event avoidance, mitigation, commercial insurance and self-insurance under approved forecasts of prudent and efficient opex and capex are either unavailable or inappropriate.[48]

For smaller expenditure, a service provider should generally utilise its existing expenditure allowance or reprioritise its work program rather than seeking approval of a pass through.[49] This is reflected in the materiality threshold that applies to applications for cost pass through under the approved access arrangement.[50]

Cost pass through amounts approved in an access arrangement period are added to forecast opex for the purpose of calculating efficiency carryover amounts under the ECM in the approved access arrangement.[51]

10.3.5 Reasons for draft decision

JGN's proposed pass through events and their definitions are largely consistent with those we approved in the 2015–20 period and in our recent decisions with respect to other network service providers.

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48 This is consistent with the AEMC's conclusions in its review of the NER pass through arrangements. See: AEMC 2012, *Cost pass through arrangements for Network Service Providers, Rule Determination,* 2 August 2012, pp. 19–20.

49 This is consistent with the AEMC's conclusions in its review of the NER pass through arrangements. See: AEMC 2012, *Economic Regulation of Network Service Providers, and Price and Revenue Regulation of Gas Services, Final Rule Determination*, 29 November 2012, p. 186.

50 AER, *Approved Access Arrangement for the JGN's NSW gas distribution networks - 1 July 2015 to 30 June 2020*, June 2015, cll. 3.4(b) and 3.4(c).

51 AER, *Approved Access Arrangement for the JGN's NSW gas distribution networks - 1 July 2015 to 30 June 2020*, June 2015, cl. 12.1(i); See Attachment 8 (Efficiency carryover mechanism) to this draft decision.

We have made some minor amendments to JGN's 'natural disaster event' definition, as set out in Table 10.2, to provide greater drafting consistency between JGN and other network service providers.[52]

We are satisfied that these events:

- are not covered by another category of pass through event
- can be clearly identified at the time when we are approving the access arrangement
- are of the nature or type that a prudent service provider could not reasonably prevent from occurring or substantially mitigate their cost impact
- are prohibitively costly to cover by full insurance or that there is no available insurance cover on reasonable commercial terms.

Natural disaster event

In its proposal, JGN amended its 'natural disaster event' definition 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 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.~~*

Our definition of natural disaster event differs slightly from JGN's proposal. It removes the term 'major' from the definition of natural disaster event and is consistent with the definition we have approved in our recent decisions (see Table 10.2).

It is our preference to include the government declaration as a factor of consideration in the natural disaster event definition for transparency, as we have done in our most recent electricity distribution decisions. However, we are satisfied that JGN's 2020–25 access arrangement proposal provides a sufficient basis for us to take into account any relevant factor, including whether a declaration has been made by a relevant

52 See for example, AER, *Draft decision – Energex distribution determination 2020–25 – Attachment 14 Pass through events*, October 2019, p. 13.

government authority, when we make a pass through determination. Therefore, it is unnecessary to explicitly refer to this factor in the definition of this pass through event.

Table 10.2 AER approved pass through event definition

Pass through event	Approved definition
Natural disaster	Natural Disaster Event means any natural disaster including but not limited to cyclone, fire, flood or earthquake that occurs during the Access Arrangement Period 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 acts or omissions of the Service Provider. Note for the avoidance of doubt, in making a determination on a Natural Disaster Event pursuant to clause 3.4(j), 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 service provider would obtain in respect of the event.

10.4 Revisions

We require the following revisions to make the access arrangement proposal acceptable:

Table 10.3 JGN's reference tariff revisions

Revision	Amendment
Revision 10.1	JGN access arrangement schedule 3, clause 2.1 be: **2.1 Licence fee factor amount** a) the actual costs incurred in that financial Year by the Service Provider as a result of IPART's natural gas authorisation fee for the Service Provider's gas reticulation licence, the charges levied by local government areas in New South Wales as permitted by Section 611 of the Local Government Act 1993 and the annual licence fees for individual pipelines charged by the Department of Planning and Environment which are related to the ownership or operation of the Network minus b) the forecast costs incurred in that financial Year by the Service Provider as a result of IPART's natural gas authorisation fee for the Service Provider's gas reticulation licence, the charges levied by local government areas in New South Wales as permitted by Section 611 of the Local Government Act 1993 and the annual licence fees for individual pipelines charged by the Department of Planning and Environment which are related to the ownership or operation of the Network