AUSTRALIAN COMPETITION TRIBUNAL

Application by Jemena Gas Networks (NSW) Limited [2015] ACompT 4

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| Citation: | Application by Jemena Gas Networks (NSW) Limited [2015] ACompT 4 |
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| Review from: | Australian Energy Regulator |
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| File number: | ACT 8 of 2015 |
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| Tribunal: | **MANSFIELD J, PRESIDENT****MR R DAVEY, MEMBER****DR D ABRAHAM, MEMBER** |
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| Date of decision: | 30 July 2015 |
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| Catchwords: | **CONSUMER LAW** – application for leave to review regulatory determination of Australian Energy Regulator – consideration of criteria for leave in s 248 of the *National Gas Law* – consideration of whether serious issue or issues to be heard and determined – consideration of whether asserted grounds of review, if made out, would, or would be likely to, result in a materially preferable NGO (National Gas Objective) decision – consideration of adequacy of identification of grounds of review  |
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| Legislation: | *National Gas Law**National Gas (New South Wales) Act 2008* (NSW)*National Gas (South Australia) Act 2008* (SA)*National Electricity Law*  |
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| Cases cited: | *Applications by Public Interest Advocacy Centre Ltd, Ausgrid, Endeavour Energy and Essential Energy* [2015] ACompT 2*Application by ActewAGL Distribution* [2015] ACompT 3 |
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| Solicitor for Jemena Gas Networks (NSW) Limited: | Gilbert + Tobin Lawyers |
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| Solicitor for the Australian Energy Regulator: | Corrs Chambers Westgarth |

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| AUSTRALIAN COMPETITION TRIBUNAL | ACT 8 of 2015 |

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| re: | APPLICATION UNDER S 245 OF THE NATIONAL GAS LAW FOR A REVIEW OF A FULL ACCESS ARRANGEMENT DECISION MADE BY THE AUSTRALIAN ENERGY REGULATOR IN RELATION TO JEMENA GAS NETWORKS (NSW) LIMITED PURSUANT TO RULE 64 OF THE NATIONAL GAS RULES |
| BY: | JEMENA GAS NETWORKS (NSW) LIMITEDApplicant |

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| tribunal: | MANSFIELD J, presidentMR R DAVEY, memberDR D ABRAHAM, member |
| DATE OF DIRECTION: | 30 JULY 2015 |
| WHERE MADE: | ADELAIDE |

THE TRIBUNAL GIVES LEAVE TO:

1. Jemena Gas Networks (NSW) Limited to apply for review of the Full Access Arrangement Decision of the Australian Energy Regulator published on 3 June 2015 in respect of the matters identified in its application and on the grounds it has specified in its application.

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| IN THE AUSTRALIAN COMPETITION TRIBUNAL | ACT 8 of 2015 |

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| re: | APPLICATION UNDER S 245 OF THE NATIONAL GAS LAW FOR A REVIEW OF A FULL ACCESS ARRANGEMENT DECISION MADE BY THE AUSTRALIAN ENERGY REGULATOR IN RELATION TO JEMENA GAS NETWORKS (NSW) LIMITED PURSUANT TO RULE 64 OF THE NATIONAL GAS RULES |
| by: | JEMENA GAS NETWORKS (NSW) LTDApplicant |

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| tribunal: | MANSFIELD J, presidentMR R DAVEY, memberDR D ABRAHAM, member |
| DATE: | 30 JULY 2015 |
| PLACE: | ADELAIDE |

**REASONS FOR DECISION**

# INTRODUCTION

1. This is an application made by Jemena Gas Networks (NSW) Ltd (Jemena) on 24 June 2015 pursuant to s 245 of the *National Gas Law* (NGL) for leave to apply to review a decision made by the Australian Energy Regulator (AER). Section 7 of the *National Gas (New South Wales) Act 2008* (NSW) provides that the NGL, as set out in the Schedule to the *National Gas (South Australia) Act 2008* (SA), applies as a law of New South Wales. Section 26 of the NGL gives the *National Gas Rules* (NGR) the force of law in New South Wales.
2. On 3 June 2015, the AER published an access arrangement final decision entitled *Final Decision – Jemena Gas Networks (NSW) Ltd Access Arrangement 2015-20* pursuant to r 62 of the *National Gas Rules.* That decision includes the revisions proposed by the AER under r 64(1) and (4) of the NGR (the Final Determination). It is accepted that those revisions are a “reviewable regulatory decision” within the meaning of that term in s 244 of the NGL and that Jemena has the status under s 245 to make this application. It is accepted that there is no issue that this application was made within the time prescribed by s 247 of the NGL.
3. This is the first application under the NGL to the Australian Competition Tribunal (the Tribunal) under the revised limited merits review processes of the Tribunal following amendment to the NGL effected by the *Statutes Amendment (National Electricity and Gas Laws Limited Merits Review) Act 2013* (SA) (the 2013 Amendments). The 2013 Amendments also introduced a substantially similar revised limited merits review process under the *National Electricity Law* (NEL). These amendments, in respect of the requirements for when the Tribunal may give leave, have been considered by the Tribunal in the context of seven applications for leave under s 71B of the NEL and the *National Electricity Rules* (NER) (proceeding ACT Nos 1-7 of 2015). Those proceedings relate to four decisions published on 30 April 2015 by the AER relating to ActewAGL Distribution, Ausgrid, Endeavour Energy and Essential Energy. Each of them has applied for leave to review the decisions which affect them under the NEL and the NER. In addition, the Public Interest Advocacy Centre Ltd (PIAC) also applied for leave to review the decisions relating to the applicants operating in New South Wales (relevantly, Ausgrid, Endeavour Energy and Essential Energy (together, Networks NSW)). The Tribunal published its decisions on those applications on 17 July 2015, granting leave to each of the applicants in respect of the matters identified in their applications (*Application by ActewAGL Distribution* [2015] ACompT 3 (*ActewAGL Decision*); *Application by Public Interest Advocacy Centre Ltd, Ausgrid, Endeavour Energy and Essential Energy* [2015] ACompT 2 (*PIAC/Networks NSW Decision*)).
4. It is intended that this application, if leave for review is granted, and proceeding ACT Nos 1-7 of 2015 be partly heard together where certain grounds raised by Jemena are substantially similar to the grounds raised by ActewAGL Distribution and Networks NSW. The Tribunal has adopted this procedure with the agreement of Jemena, the AER and the applicants in proceeding ACT Nos 1-7 of 2015.
5. The particular matters which Jemena contends give rise to a serious issue to be heard and determined are:
6. value of imputation credits (gamma)
7. allowed rate of return;
	1. return on equity; and
	2. return on debt
8. capital expenditure forecast for connections and market expansion
9. The significant overlap between Jemena’s application and proceeding ACT Nos 1-7 of 2015 relates to matters (1), (2)(a) and (2)(b) above. In particular, Jemena has adopted all of the joint written submissions of Networks NSW in relation to matters (1) and (2)(a), and paragraphs 89-97, 103(b), 103(d) and 107 of Jemena’s application, which relate to matter (2)(b) raise grounds for review that are similar to grounds raised by Networks NSW.
10. Jemena raises each of the four grounds specified in s 246(1) of the NGL in relation to each of those matters. It says that, having regard to all the circumstances, the exercise of the AER’s discretion was incorrect, that the Final Determination was unreasonable and that the AER made an error or errors of fact that were material to the making of the Final Determination in respect of each of the topics listed at [5] above.
11. The AER opposes the granting of leave to apply for review in relation to each of the grounds advanced by Jemena. It repeats and relies on the submissions it made in proceeding ACT Nos 1-7 of 2015 and has not provided any additional written submissions.
12. In its Notice Regarding Applications For Leave, dated 3 July 2015, the AER says at [6] that it intends to oppose the grant of leave by reference to the criteria in s 258A(3) of the NGL (the equivalent to s 71O of the NEL) and it says there are some grounds of review in relation to a number of matters that Jemena did not raise or maintain in submissions to the AER prior to the reviewable regulatory decision being made (e.g. in [145(e)(ii)(iv) and (vii)] of Jemena’s application). During the hearing of the leave applications in proceeding ACT Nos 1-7 of 2015, the AER indicated that it did not intend to raise these issues at the leave stage in relation to those applications, but at p 139 of the transcript of that hearing counsel for the AER said “with respect to Jemena’s application, there is a discrete 71O issue which will need to be determined on leave.”
13. It is not clear if the AER is seeking for this matter to be raised on Jemena’s leave application because it does not appear to have exhaustively listed the paragraphs in Jemena’s application. Apart from the paragraph reference, the submission is not further developed concerning Jemena’s submissions to the AER. At this stage, it is sufficient to note that the point is not so clear that it leads to the Tribunal not having the level of satisfaction which it otherwise has in respect of the matters referred to in Jemena’s application and submissions.
14. For the reasons which are set out below, it appears to the Tribunal that the requirements of s 248 of the NGL have been met in respect of the matters in [5] above. That is, in terms of s 248(a), it appears that each gives rise to a serious issue to be heard and determined as to whether a ground or grounds of review set out in s 246(1) exists. It also appears to the Tribunal that there is a prima facie case that any determination made by the Tribunal varying the Final Determination or setting it aside so that a fresh decision may be made by the AER upon remittal to it, on the basis of one or more of those ground being successful, either separately or collectively, would, or would be likely to, result in a materially preferable National Gas Objective (NGO) decision as required by s 248(b).
15. Consequently, the Tribunal grants leave to Jemena to apply to review the Final Determination in respect of the issues which it has identified, based upon the errors which it asserts in its application and the grounds which it relies upon.

# GENeRAL OBSERVATIONS

1. The task confronting the Tribunal in deciding whether to grant leave to apply to Jemena under s 248 of the NGL, is mirrored by the requirements of s 71E of the NEL. These requirements are discussed at some length in the *ActewAGL Decision* and the *PIAC/Networks NSW Decision*. While the context of this application is necessarily different from those under the NEL in proceedings ACT Nos 1-7 of 2015 and requires separate consideration by the Tribunal, the issues of principle which the Tribunal has generally considered in relation to this application are the same, and it has proceeded upon the basis of its consideration as discussed in those decisions.
2. It notes that the NGO is in essence the same as the National Electricity Objective. Section 23 of the NGL provides:

**23 – National gas objective**

The objective of this Law is 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.

1. The Tribunal also notes that, in essence, the specified criteria for the grant of leave to apply in s 248 of the NGL, and the other provisions of the NGL, are the same as those requiring consideration under the NEL.
2. There is no issue that the matters which Jemena seeks to raise satisfy the revenue threshold requirement of s 249 and there are no factors which might be enlivened under ss 250 or 251 so as to disentitle it from being given leave to apply for review.
3. It therefore remains to explain why it has the view expressed above at [11] in terms of s 248 of the NGL.
4. That requires a consideration of each of the four topics of concern to Jemena, to see whether each or any gives rise to a serious question to be heard and determined and, if so, whether Jemena has established a prima facie case as required by the section.
5. As with Networks NSW, the contentions of Jemena that the correction of the asserted errors (if it makes out its grounds of review or one or more of them) centred on the need for a regulated business to recover its efficient costs for providing the regulated services, and the assertion that the Final Determination did not do so. Hence, it is said the Final Determination, unless altered, will not be in the long term interests of consumers because it is less likely to secure the safety, quality and reliability of natural gas to which they are entitled. The Final Determination will have, it said, an escalating detriment to those elements because it may not be sufficient to continue to attract sufficient investment to maintain network reliability and service standards, and may lead to an increase in prices to accommodate the need for reactive maintenance. Its focus on the need for a legally correct application of the NGR was, if anything, more forceful than that of Networks NSW. It said a non-lawful application of the NGR could not produce a materially preferable NGO decision compared to a lawful one.
6. The Tribunal cannot decide those matters of fact at this stage. It is not required to. As with the *PIAC/Networks NSW Decision*, it appears that each of those matters prima facie would, or would be likely to, result in a materially preferable NGO decision. There is, however, a long distance from taking that step to establishing that in fact the making out of any or all of the grounds of review would in fact fall within that prescription.

# CONSIDERATION

## Value of imputation credits (gamma)

1. One of the constituent decisions which the AER was required to make was a decision about the estimated cost of corporate income tax of Jemena for each regulatory year: r 72(1)(h) of the National Gas Rules (NGR). The formula the AER was required to follow to make this decision is detailed in r 87A of the NGR and is broadly calculated by considering the estimated amount of corporate tax payable (calculated from corporate taxable income and the tax rate) and the value of imputation credits (gamma). Imputation credits provide a benefit to some investors by reducing their personal tax liabilities. Gamma is deducted from the amount which the business otherwise requires to provide an appropriate return to an investor after meeting costs. This is done to avoid overstating the appropriate revenue and to ensure an appropriate return for investors.
2. It is agreed between the AER and Jemena that gamma is to be calculated as the product of the distribution rate for imputation credits and the value of distributed imputation credits (theta).
3. The dispute concerns the correct interpretation of ‘distribution rate for imputation credits’ and ‘value of distributed imputation credits’ and, consequently, the correct value for these items and the correct interpretation and value of gamma.
4. As companies retain earnings for reinvestment, not all imputation credits are distributed and, consequently, they do not confer any value on investors. The rate at which they are distributed is the distribution rate for imputation credits. Jemena says that the distribution rate for imputation credits was inappropriately calculated by the AER, including because the AER had regard to evidence from equity and/or listed equity in circumstances which were unlikely to be representative of the efficient distribution rate for a benchmark entity.
5. Further, Jemena submits that the AER erred in calculating the value of distributed imputation credits as being the rate of investors who were eligible to utilise imputation credits (the utilisation rate) and that in doing so it misconstrued and misapplied r 87A of the NGR. This, it says, is because the correct value of distributed imputation credits is necessarily lower than the utilisation rate because there are personal tax costs for investors before they can gain the benefits of imputation credits, including the administrative burden and the time delay before the credits provide any benefit to the investor. In addition, Jemena says that the AER failed to give the appropriate weight to evidence including market value results and tax statistics.
6. As indicated at [6] above, Jemena adopted the submissions of Networks NSW on the value of imputation credits and the AER adopted its submissions on the NEL applications, which were carefully considered in the *PIAC/Networks NSW Decision* at [91]- [98]. It is not necessary to repeat here what appears in relation to gamma in the *PIAC/Networks NSW Decision*, both as to the existence of a serious issue to be heard and determined, and as to whether prima facie its correction would, or would be likely to, result in a materially preferable NGO decision.
7. For the reasons there set out, the Tribunal is of the view that there is a serious issue to be heard and determined as to whether a ground for review exists in relation to the allowance made for gamma and that Jemena has established a prima facie case that a determination made by the Tribunal varying or setting aside the reviewable regulatory decision with a fresh decision to be made by the AER on the basis of one or more s 246(1)(a)-(d) grounds, either separately or collectively, would, or would be likely to, result in a materially preferable NGO decision. It notes that the values Jemena proposed for the elements of gamma are not the same as those put forward by Networks NSW, probably due to the timing of its analysis. It also notes that the Jemena application somewhat discursively identifies its grounds of review in relation to its complaints to encompass material errors of fact or facts, errors of discretion, and the making of a decision which is unreasonable in all the circumstances. However, the nature of its complaints and contentions is clear, and it is difficult to characterise them (particularly where complaints overlap) within only one of the grounds of review available. At present, the Tribunal sees no unfairness in permitting the present expression of the asserted grounds of review to stand. That is not to prevent the AER (or an intervener) seeking more particularly if that is required to secure a fair hearing.

## Allowed rate of return - return on equity

1. The AER was required to determine the return on equity for a benchmark efficient entity: r 87 of the NGR. In doing so, the AER selected a ‘foundation model’ and used this as the basis for its determination. The foundation model selected was the Sharpe-Lintner Capital Asset Pricing Model (SL CAPM). It determined that this approach would contribute best to the allowed rate of return objective as required by r 87(6) of the NGR.
2. Jemena submits that this approach was inconsistent with r 87(5) of the NGR and that a multi-model approach should have been taken. In determining the appropriate models to rely on the AER should have given greater emphasis to studies or applications of the models that used more recent data and larger, more comprehensive data sets, reflected recent advances in econometrics, and had been subject to greater scrutiny. It is said that this would lead the AER to place greater weight on the Black CAPM, the Fama-French Model and the Dividend Growth Model (DGM).
3. Jemena further submits that the AER’s reliance on the SL CAPM model was inappropriate (as it has well-recognised weaknesses and limitations) and that the determination of key variables in the model was incorrect. In particular, Jemena submits that the SL CAPM model is sensitive to choices of the Market Risk Premium (MRP) and the equity beta, and that these inputs were incorrectly calculated. The alleged errors made in the calculation of the MRP include placing too much weight on historical market condition averages and giving insufficient weight to current empirical evidence. The alleged errors in the determination of the equity beta include relying on estimates based on sample sizes that were too small and the appropriate adjustments not being made when comparing companies with different levels of gearing.
4. As indicated at [5] above, Jemena adopted the submissions of Networks NSW on the return on equity and the AER adopted its submissions in proceeding ACT Nos 1-7 of 2015, which were carefully considered in the *PIAC/Networks NSW Decision* at [75]- [83]. It is not necessary to repeat here what appears in relation to the return on equity in the *PIAC/Networks NSW Decision*. It is noted that Jemena’s complaints are slightly different from those of Networks NSW on this topic.
5. For the reasons there set out, the Tribunal considers that there is a serious issue to be heard and determined as to whether a ground for review exists in relation to the allowance made for the return on equity and that there is a prima facie case that a determination made by the Tribunal varying or setting aside the Final Determination with a fresh decision to be made by the AER on the basis of one or more s 246(1)(a)-(d) grounds, either separately or collectively, would, or would be likely to, result in a materially preferable NGO decision. As to the expression of the grounds of review, it repeats what is said at the concluding part of [27].

## Allowed rate of return - return on debt

1. Pursuant to r 87 of the NGR, the AER introduced, uncontroversially, a new methodology for the calculation of the return on debt referred to as ‘the trailing average approach.’ The AER considered that a benchmark efficient entity with efficient financing practices would have staggered borrowing and that it would be likely to have hedging contracts which it would need to unwind in moving to the new approach. Consequently, it adopted a 10 year transitional period which was annually adjusted to shift to this approach from the previous method, the ‘on-the-day approach’. It is the calculation and implementation of the transitional period which is the subject of this dispute.
2. It is accepted that while the return on debt is calculated based on the risk free rate and the debt risk premium (DRP), it is not possible to hedge the DRP component of the return on debt because the level of DRP in respect of a tranche of debt is incurred at the time of issue. Jemena says that, as a result, the AER’s decision to apply its transition methodology to both the base rate and the DRP components of the return on debt was inappropriate and that it should only have applied the transition method to the base rate. Jemena submits that the AER’s decision to include the DRP in the transition was inconsistent with r 87 and r 76 of the NGR including because it was not appropriate to undercompensate for the efficient return on debt in order to ‘clawback’ an alleged windfall gain in the last regulatory period when the DRP was high.
3. Additionally, Jemena submits that:
* The AER’s measurement of the return on debt for all future measurement periods is inflexible and imprudent as there is uncertainty around when refinancing will be required
* The AER incorrectly determined that Jemena’s credit rating should be BBB+ not BBB
* The AER should have allowed it to revise its proposal to the AER under r 60 of the NGR
1. The Tribunal notes that, whilst Jemena generally makes submissions similar to those of Networks NSW on this topic in proceedings ACT Nos 1-7 of 2015, there are differences in its approach concerning the application of the transition to the base rate, and to the use of the trailing average fixed principle.
2. Notwithstanding those differences, in general it appears to the Tribunal broadly for the reasons given in the *PIAC/Networks NSW Decision* on this topic that there are serious issues to be heard and determined. Again, it is fair to observe that the allocation of particular matters in the contentions on this general topic to the available grounds of review is comprehensive and might be said to lack precision. However, the particular contentions and complaints of Jemena are clear, and the Tribunal again repeats its observations at the conclusion of [27] above. It is also satisfied of the additional requirement that the matters raised on this topic, if established, prima facie would, or would be likely to, result in a materially preferable NGO Decision by the determination the Tribunal may make as a result.

## Capital expenditure (capex) forecast for connections and market expansion

1. This is an issue specific to Jemena. It is not shared with Networks NSW.
2. Rule 76(a) of the NGR requires the AER to determine the return on the projected capital base for the year. This calculation requires the AER to forecast the appropriate level of capital expenditure (capex), including the level of new capex: in accordance with r 74 of the NGR.
3. Jemena submits that one category of capex for new assets is market expansion capital expenditure (ME capex), which is a function of the number of new connections during a regulatory period and the amount of capex per new connection. The amount of capex required depends on the type of premises and the connections required including mains which typically run along roads, network services which run from the mains to a customer’s property, and metering.
4. Jemena developed a forecasting approach for ME capex in its proposal to the AER. This involved the development of standard contract rates, based on financial records of the costs incurred by Jemena under third party contracts and calculations for the unit cost for mains, services, meters and associated equipment. In its Draft Decision, the AER found that Jemena’s contract rates were efficient and agreed with Jemena’s forecasting approach for ME capex. The AER did not accept Jemena’s proposed unit rates and instead developed a forecast of ME capex based on a five-year average of historical unit rates. The ME capex dispute concerns the AER’s calculation of unit rates and an alleged lack of consultation with Jemena concerning the correct approach to unit rates.
5. Jemena submits that the AER did not produce the best possible forecast or estimate of connection costs in accordance with r 74, including because the unit rates did not reflect actual increased contractor costs. In addition, Jemena says that the AER did not identify or bring to Jemena’s attention, the input and data errors in Jemena’s proposal it had identified and consequently failed to comply with s 28(1)(b)(i)(D) and (E) of the NGL. Jemena submits that these errors would have been easily correctable had they been brought to its attention and that the AER’s decision to exclude certain costs as a result of these errors was unreasonable because these costs were not incorporated in Jemena’s meter unit rates.
6. Jemena’s complaints focus on an incorrect or inappropriate use of historical costs, rather than estimated current costs; the failure to allow properly for future cost increases; and the need for a proper allowance for capitalised overhead costs. There is a significant issue about what r 74 of the NGR either allows or requires.
7. The Tribunal has considered carefully the respective material put forward by Jemena and by the AER. It appears to the Tribunal that there is a significant issue to be heard and determined on this topic, with of course a significant number of submissions or factual issues to be addressed. As the contentions of Jemena are clearly identified, as in other instances, it regards those issues as confining Jemena in the presentation of its claim, and does not consider – as presently it appears – that it is unfair to the AER (or any intervener) to address them, although they are variously said to enliven each of the available grounds of review. As in other instances, the precise identification or characterisation of the relevant ground of review may depend upon which – if any – of the detailed contentions of Jemena is made out. In addition, whilst prima facie it appears to the Tribunal that the asserted errors, or a mix of some one or more of them, if established, would, or would be likely to, result in a materially preferable NGO decision, that view is of course necessarily and by its own description provisional. There may also be a range of other considerations, of which the Tribunal is presently unaware, which may inform its final conclusions on that topic.

# CONCLUSION

1. For the reasons given, the Tribunal grants to Jemena the leave to apply referred to in [12] above.

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| I certify that the preceding forty-five (45) numbered paragraphs are a true copy of the Reasons for Judgment herein of the Honourable Justice Mansfield, Mr R Davey and Dr D Abraham. |

Associate:

Dated: 30 July 2015