AUSTRALIAN COMPETITION TRIBUNAL

Application by Jemena Gas Networks (NSW) Ltd [2016] ACompT 5

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| Citation: | Application by Jemena Gas Networks (NSW) Ltd  [2016] ACompT 5 |
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| Review from: | Australian Energy Regulator |
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| Applicant: | **JEMENA GAS NETWORKS (NSW) LTD** |
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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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| Interveners: | AusNet Services (Distribution) Pty Ltd  AusNet Services (Transmission) Ltd  Australian Gas Networks Ltd  Citipower Pty Ltd  Powercor Australia Ltd  SA Power Networks  United Energy Distribution Pty Ltd  Ergon Energy Corporation Ltd  Minister for Resources, Energy and Northern Australia |
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| Date of Determination: | 3 March 2016 |
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| Dates of hearing: | 21-25 September 2015; 28-30 September 2015;  1-2 October 2015; 6-9 October 2015 |
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| Place: | Adelaide |
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| Catchwords: | **ENERGY AND RESOURCES** – application under s 245 of the National Gas Law (NGL) for review of an access arrangement decision by the Australian Energy Regulator (AER) – consideration of the legislative background to the NGL and the National Gas Rules (NER) – amendments to the NGR made in 2012 by the Australian Energy Market Commission (AEMC) – amendments to the NGL made in 2013 – role of the AER - national gas objective (NGO) - consultation and notification obligations under s 261(1)(b) – interrelationship of constituent components and preferable reviewable regulatory decision by the AER under s 28(1)(b)(i) and (1)(b)(iii) – role of the Tribunal on review - interrelationship of constituent components and materially preferable NEO decision under s 259(4a) and (4b) – conduct of consultation process under 261(a) – topics for review – return on equity – return on debt – gamma – market expansion capital expenditure (ME capex)  **ENERGY AND RESOURCES** – return on debt - transition between methods of deciding the return on debt - where the AER did not allow revision of the service providers proposal - transition to trailing average approach - whether the AER is able to adopt an approach which corrects for discrepancies in past access arrangement periods - determination of future measurement periods - choice of data series - reference to single benchmark credit rating  **ENERGY AND RESOURCES** – market expansion capital expenditure (ME capex) – whether the proposed forecast ME capex represented the best forecast or estimate possible in the circumstances – natural justice – where issues raised in the Final Decision had not previously been raised with the network service provider – AER discretion not to approve proposed ME capex and to substitute its own decision – obligations of the AER under r 74 of the NGR - use of historical cost information – where current contractual rates accepted as prudent and efficient - exclusion of certain cost categories |
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| Legislation: | *National Electricity Law*  *National Electricity Rules*  *National Gas (New South Wales) Act 2008* (NSW)  *National Gas (South Australia) Act 2008* (SA)  *National Gas Law*  *National Gas Rules*  *Statutes Amendment (National Electricity and Gas Laws – Limited Merits Review) Act 2013* (SA)  *National Gas Amendment (Price and Revenue Regulation of Gas Services) Rule 2012* |
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| Cases cited: | *Applications by Public Interest Advocacy Centre and Ausgrid* [2015] ACompT 1  *Applications by Endeavour Energy and by Public Interest Advocacy Centre Ltd* [2015] ACompT 2  *Applications by Essential Energy and by Public Interest Advocacy Centre Ltd* [2015] ACompT 3  *Application by ActewAGL Distribution* [2015] ACompT 4  *Application by Envestra (No 2)* [2012] ACompT 3  *Minister for Aboriginal Affairs & Anor v Peko-Wallsend Ltd & Other* (1986) 162 CLR 24 |
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| Category: | Catchwords |
| Number of paragraphs: | 201 |
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| IN THE AUSTRALIAN COMPETITION TRIBUNAL |  |
|  | ACT 8 of 2015 |

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| RE:  by: | APPLICATION UNDER SECTION 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) LTD PURSUANT TO RULE 64 OF THE NATIONAL GAS RULES  JEMENA GAS NETWORKS (NSW) LTD  Applicant |

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| TRIBUNAL: | MANSFIELD j, president  MR r davey, member  DR d abraham, member |
| DATE OF DETERMINATION: | 26 FEBRUARy 2016 |
| WHERE MADE: | DARWIN (via videolink to SYDNEY, MELBOURNE, BRISBANE AND ADELAIDE) |

THE TRIBUNAL DETERMINES THAT:

1. Pursuant to s 259(2) of the *National Gas Law*, the *Final Decision – Jemena Gas Networks (NSW) Ltd Access Arrangement 2015-20 Overview*, June 2015, including attachments (the Final Decision) is set aside and remitted to the Australian Energy Regulator (AER) to make the decision again in accordance with the following directions:

(a) the AER is to make the constituent decision on debt having regard to the position of Jemena Gas Networks (NSW) Ltd in its Revised Regulatory Proposal concerning the trailing average approach in accordance with the reasons for this determination;

(b) the AER is to make the constituent decision on estimated cost of corporate income tax (gamma) in accordance with the reasons for this determination, including by reference to an estimated cost of corporate income tax based on a gamma of 0.25;

(c) the AER is to make the constituent decision on capital expenditure in accordance with the reasons for determination, including by reference to the current and ongoing contractual rates known, and accepted by the AER to be, prudent and efficient; and

(d) the AER is to consider, and to the extent to which it considers appropriate, to vary the Final Decision in such other respects as the AER considers appropriate having regard to s 28(1)(b) of the *National Gas Law* in the light of such variations as are made to the Final Decision by reason of (a)-(c) hereof.

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| RE:  by: | APPLICATION UNDER SECTION 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) LTD PURSUANT TO RULE 64 OF THE NATIONAL GAS RULES  JEMENA GAS NETWORKS (NSW) LTD  Applicant |

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| TRIBUNAL: | MANSFIELD J, PRESIDENT  MR R DAVEY, MEMBER  DR D ABRAHAM, MEMBER |
| DATE: | 3 MARch 2016 |
| PLACE: | ADELAIDE |

**REASONS FOR DETERMINATION**

# INTRODUCTION

1 This determination relates to an application to the Australian Competition Tribunal (the Tribunal) by Jemena Gas Networks (NSW) Ltd (JGN) to review a full access arrangement decision of the Australian Energy Regulator (AER) made on 3 June 2015 under the *National Gas Law* (NGL) *Final Decision – Jemena Gas Networks (NSW) Ltd Access Arrangement 2015-20 Overview*, June 2015, including attachments (JGN Final Decision). JGN provides natural gas transportation and associated services to users via a gas distribution network in New South Wales. 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 The issues relating to the JGN Final Decision were heard together with seven applications made to review decisions of the AER made on 30 April 2015 under the *National Electricity Law* (NEL) with respect to Ausgrid, Endeavour Energy (Endeavour), Essential Energy (Essential) (collectively, Networks NSW) and ActewAGL Distribution (ActewAGL): *Final Decision Ausgrid distribution determination 2015-16 to 2018-19, Overview*, April 2015; *Final Decision Endeavour Energy distribution determination 2015-16 to 2018-19, Overview*, April 2015; and *Final Decision by Essential Energy distribution determination 2015-16 to 2018-19, Overview*, April 2015, including attachments to those decisions. Each of the Networks NSW businesses and ActewAGL sought review of the AER’s Final Decisions relating to it. The remaining three applications were made by the Public Interest Advocacy Centre Ltd (PIAC), which sought review of each of the AER’s Final Decisions concerning Networks NSW.

3 It was appropriate for these matters to be heard together because some of the issues relating to this determination are common to issues in relation to the other review applications referred to, although there are a few issues particular to one or more of the applications, and in some respects the matters raised on certain issues differed slightly. It was common ground that the substantial commonality of issues raised in the eight applications made it preferable for them to be heard together. On this basis, and pursuant to the Tribunal’s directions of 5 August 2015, JGN prepared common written submissions with Networks NSW and ActewAGL in relation to those issues and grounds of review which were said to be common to each of those parties.

4 This determination of the Tribunal deals only with the application to review the JGN Final Decision. It is intended to be read in conjunction with the determination of the Tribunal relating to the AER’s decision concerning Ausgrid, *Applications by Public Interest Advocacy Centre Ltd and Ausgrid* [2015] ACompT 1 (the *PIAC-Ausgrid Decision*). That decision serves as the “lead” decision insofar as the Tribunal’s general considerations, on the significant matters of common concern, and its consideration of aspects of particular topics are not required to be repeated in full. The Tribunal adopts, where appropriate, the definitions and abbreviations used in the *PIAC-Ausgrid Decision* without repeating them.

5 The remaining applications for review concern the Final Decisions of the AER in relation to Endeavour, Essential and ActewAGL. The determination made by the Tribunal in each of those matters is recorded in: *Applications by Endeavour Energy and by Public Interest Advocacy Centre Ltd* [2015] ACompT 2, *Applications by Essential Energy and by Public Interest Advocacy Centre Ltd* [2015] ACompT 3 and *Application by ActewAGL Distribution* [2015] ACompT 4.

# THE LEGISLATIVE SCHEME

6 This application, and the seven applications under the NEL, were made in respect of a regulatory decision-making process by the AER, and a regulatory review process by the Tribunal, which were each significantly different from the regulatory decision-making process and the review process previously existing. That is largely due to the substantial amendments to the NGL and the NEL made by the *Statutes Amendment (National Electricity and Gas Laws – Limited Merits Review) Act 2013* (SA) (the 2013 Legislative Amendments), and in respect of the processes governing the national gas market, by the introduction by the Australian Energy Market Commission (AEMC) of the *National Gas Amendment (Price and Revenue Regulation of Gas Services) Rule 2012* (the 2012 Rule Amendments).

7 The parties understandably spent considerable time addressing those changes and their significance. The Tribunal’s consideration of those submissions are outlined in the *PIAC-Ausgrid Decision*. Much of that consideration is directly relevant to this determination. To that extent, it is not repeated.

8 For present purposes the significant legislative alteration concerning the AER’s process of decision-making was made by the substitution of s 28(1)(b)(i), the addition of s 28(1)(b)(ii) and, perhaps more importantly, the addition of s 28(1)(b)(iii) in the NGL. Section 28(1)(b)(i) requires extensive consultation and notification obligations to be fulfilled by the AER for the purposes of interested persons (including users or prospective users of the pipeline services, and any user or consumer associations that have an interest in the determination) being given an opportunity to address the issues being considered by the AER. Section 28(1)(b)(ii) requires the AER to specify in its decision the manner in which the constituent components of the decision relate to each other and how that interrelationship has been taken into account.

9 Section 28(1)(b)(iii) provides:

If the AER is making a designated reviewable regulatory decision---

(1) The AER must, in performing or exercising an AER economic regulatory function or power –

(b) If the AER is making a designated reviewable regulatory decision—

(iii) if there are 2 or more possible designated reviewable regulatory decisions that will or are likely to contribute to the achievement of the national gas objective---

(A) make the decision that the AER is satisfied will or is likely to contribute to the achievement of the national gas objective to the greatest degree (the ***preferable designated reviewable regulatory decision***); and

(B) specify reasons as to the basis on which the AER is satisfied that the decision is the preferable designated reviewable regulatory decision.

10 The national gas objective (NGO) is set out in s 23 of the NGL:

**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.

11 Apart from the NGO the AER is also required to consider the revenue and pricing principles set out in s 24 of the NGL: s 28(2) of the NGL. Both ss 23 and 24 of the NGL were not altered by the 2013 Legislative Amendments.

12 Also, s 246 of the NGL, specifying the grounds for review of an AER decision by the Tribunal, did not change.

13 However, the additional recognition of the need for the regulatory decision to reflect the “materially preferable designated NGO decision”, whether by the AER as noted or on review by the Tribunal, (as defined in s 259(4a)(c)), and the desirability of ensuring that the long term of interests of consumers are properly identified and addressed through the consumer groups was reinforced. It is worth repeating s 246(1) setting out the (unchanged) grounds of review, and reciting s 246(1a). They provide:

(1) An application under s 245(1) may be made only on 1 or more of the following grounds:

(a) the original decision maker made an error of fact in the decision maker’s findings of facts, and that error of fact was material to the making of the decision;

(b) the original decision maker made more than 1 error of fact in the decision maker’s findings of facts, and those errors of fact, in combination, were material to the making of the decision;

(c) the exercise of the original decision maker’s discretion was incorrect, having regard to all the circumstances;

(d) the original decision maker’s decision was unreasonable, having regard to all the circumstances.

(1a) An application under section 245(1) that relates to a designated reviewable regulatory decision must also specify the manner in which a determination made by the Tribunal varying the designated reviewable regulatory decision, or setting aside the designated reviewable regulatory decision and a fresh decision being made by the AER following remission of the matter to the AER by the Tribunal, on the basis of 1 or more grounds raised in the application, either separately or collectively, would, or would be likely to, result in a materially preferable designated NGO decision.

14 Section 248 prescribes the matters of which the Tribunal must be satisfied before it grants leave to apply for review. Those circumstances were extended by adding in (b) the additional criterion that it must appear to the Tribunal that the applicant for review has established a prima facie case that any determination by the Tribunal varying the designated reviewable regulatory decision or setting it aside and remitting the matter back to the AER to make the decision again, on the basis of one or more grounds of review raised in the application:

... either separately or collectively, would, or would be likely to, result in a materially preferable designated NGO decision.

15 The obligation of the Tribunal to make a determination under s 259 has also been substantially refined. It is necessary to set out ss 259(4a) and (4b) in full to understand their significance. Those provisions in broad terms mirror the obligations imposed upon the AER by s 28(1)(b)(iii) of the NGL. There are also parallel obligations upon the Tribunal as upon the AER imposed by s 259(4c) requiring the Tribunal to explain how it has taken into account the inter-relationship between constituent components of the reviewable regulatory decision and why it has proceeded to make the order which it has determined to make in that light.

16 Section 259(1)-(4b) of the NGL now provides:

(1) If, following an application, the Tribunal grants leave in accordance with section 245, the Tribunal must make a determination in respect of the application.

(2) Subject to subsections (4) and (4a), a determination under this section may –

(a) affirm the reviewable regulatory decision; or

(b) vary the reviewable regulatory decision; or

(c) set aside the reviewable regulatory decision and remit the matter back to the original decision maker to make the decision again in accordance with any direction or recommendation of the Tribunal.

(3) For the purposes of making a determination of the kind in subsection (2)(a) or (b) the Tribunal may perform all the functions and exercise all the powers of the original decision maker under this Law or the Rules.

(4) In deciding whether to remit a matter back to the original decision maker to make the decision again, other than in a case where the decision is a designated reviewable regulatory decision, the Tribunal must have regard to the nature and relative complexities of –

(a) the reviewable regulatory decision; and

(b) the matter the subject of the review.

(4a) In a case where the decision is a designated reviewable regulatory decision, the Tribunal may only make a determination –

(a) to vary the designated reviewable regulatory decision under subsection (2)(b); or

(b) to set aside the designated reviewable regulatory decision and remit the matter back to the AER under subsection (2)(c),

if –

(c) the Tribunal is satisfied that to do so will, or is likely to, result in a decision that is materially preferable to the designated reviewable regulatory decision in making a contribution to the achievement of the national gas objective (a ***materially preferable designated NGO decision***) (and if the Tribunal is not so satisfied the Tribunal must affirm the decision); and

(d) in the case of a determination to vary the designated reviewable regulatory decision – the Tribunal is satisfied that to do so will not require the Tribunal to undertake an assessment of such complexity that the preferable course of action would be to set aside the decision and remit the matter to the AER to make the decision again.

(4b) In connection with the operation of subsection (4a) (and without limiting any other matter that may be relevant under this Law) –

(a) the Tribunal must consider how the constituent components of the designated reviewable regulatory decision interrelate with each other and with the matters raised as a ground for review; and

(b) without limiting paragraph (a), the Tribunal must take into account the revenue and pricing principles (in the same manner in which the AER is to take into account these principles under section 28); and

(c) the Tribunal must, in assessing the extent of contribution to the achievement of the national gas objective, consider the designated reviewable regulatory decision as a whole; and

(d) the following matters must not, in themselves, determine the question about whether a materially preferable designated NGO decision exists:

(i) the establishment of a ground of review under section 246(1);

(ii) consequences for, or impacts on, the average annual regulated revenue of a covered pipeline service provider;

(iii) that the amount that is specified in or derived from the designated reviewable regulatory decision exceeds the amount specified in section 249(2).

…

17 The consideration of what constitutes a “materially preferable designated NGO decision” is discussed in detail in the *PIAC-Ausgrid Decision* in relation to a “materially preferable NEO decision”. It is not necessary to repeat that discussion here. There was no suggestion that the NGO, in concept, had any different meaning.

18 Section 261 defined, and still defines, review related matter in the same way. In one significant respect, the material relevant to a review has been extended to include matters arising as a result of the consultation required by s 261(1)(b). That provision obliges the Tribunal, before making a determination, to take reasonable steps to consult with users and prospective users of the relevant services, and any user or consumer associations or user or consumer interest groups that the Tribunal considers to have an interest in the determination (excluding a user or consumer association or interest group that is a party to the review). In addition, the opportunity for the Tribunal to seek additional information relevant to the relief which it might otherwise contemplate granting has been extended by amendments to s 261(3) and by the addition of ss 261(3b) and (3c).

19 The consultation process referred to in s 261(1)(b) of the NGL is an additional procedural step which the Tribunal must take and, ideally, be accommodated within the target time prescribed by s 260 of the NGL.

20 The Tribunal sought information from the AER as to all of the interest groups or persons who might have an interest in the review by the Tribunal under paragraph (b) of s 261(1) of the NGL.

21 The Tribunal then corresponded directly with each of those entities or persons to invite them to indicate whether they wished to consult with the Tribunal, as to the nature of their proposed participation, and as to how the consultation might best be carried out. Some of those entities or persons sought to be consulted in relation to JGN’s application for review as well as the NEL applications for review. In the light of that material, the Tribunal consulted with all of those persons who sought to be consulted in relation to one or more of those applications for review on 6 and 7 August 2015. To ensure a satisfactory process, the Tribunal issued a Consultation Agenda under which it provided an opportunity for those who wished to speak to the Tribunal on that occasion, either personally or on behalf of an organisation, to do so. It arranged for the speakers to be listed randomly, so that there was no bias in the sequence of presenting particular perspectives, other than (of course) endeavouring to accommodate the personal circumstances and convenience of each of the proposed participants. During those consultations, members of the Tribunal sought clarification, and sometimes supplementation of comments or submissions or further development in the views expressed, so that they were better understood or appreciated by the Tribunal. The transcript of that consultation process has been included by the Tribunal on the Community Consultation page of its website relating to the applications. A list of those persons or entities who chose to make submissions, during the consultation process or in writing as a complement or supplement to oral submissions, or only by making written submissions or comments, is also listed on the Tribunal’s website.

22 In the course of the consultation process, a number of significant issues of concern to consumers and consumer interests were identified. Those issues and the assistance of the consultation process to the Tribunal are outlined in the *PIAC-Ausgrid Decision* so far as they are common. Of course, the emphasis on the reliability of supply of electricity was somewhat stronger than of gas, because of the more immediate or pressing consequences of a breakdown in supply. It would also be a fair comment that those organisations representing the less well-off members of society placed somewhat more emphasis on the adverse consequences of electricity being unaffordable than on gas being unaffordable. They were matters of degree, rather than of principle.

# BACKGROUND

23 As indicated, on 3 June 2015, the AER published the JGN Final Decisionpursuant to r 62 of the NGR including the revisions the AER proposed under r 64.

24 That decision was not made in a vacuum. The NGL and the NGR specify the procedure which must be followed prior to the JGN Final Decision being made. Relevantly, on 30 June 2014, pursuant to r 52 of the NGR, JGN submitted an access arrangement revision proposal to the AER for the 2015-20 access arrangement period (JGN AA Proposal). On 27 November 2014, the AER made an access arrangement Draft Decision in relation to the JGN AA Proposal entitled *Draft Decision: Jemena Gas Networks (NSW) Ltd 2015-20* (the Draft Decision) and invited written submission on the Draft Decision. On 27 February 2015, JGN submitted a revised access arrangement revision proposal to the AER, including additions and other amendments to the JGN AA Proposal to address matters raised in the Draft Decision (the JGN Revised Proposal).

25 By the JGN Final Decision, the AER did not approve JGN's Revised Proposal for a total revenue requirement of $2605.2m ($nominal, smoothed) and instead determined that JGN could recover $2,229.0m ($nominal, smoothed) from consumers over the 2015-20 access arrangement period.

26 That represents a decrease in revenue, out of which JGN must cover its costs, compared with both past levels and the amount proposed by JGN. Gas distribution charges are levied by JGN on retailers of gas and are passed on to the retailers’ customers. The charges represent approximately 50 percent of a customer’s annual bill.

27 For residential and small business customers, the AER estimated that:

(1) average annual gas bills would fall by around 9.2 percent, translating into a $96 reduction in bills for residential customers and a $462 reduction for small business customers;

(2) bills will continue to fall over the following three years; and

(3) there would be a small increase of 1 percent in 2019-20.

28 The JGN Final Decision is a “reviewable regulatory decision” within the meaning of paragraph (d) of the definition in s 244 of the NGL.

29 On 24 June 2015, JGN filed an application for leave to review the JGN Final Decision. JGN sought to raise each of the four grounds specified in s 246(1) of the NGL in relation to:

(1) the rate of return on equity;

(2) the rate of return on debt;

(3) the value of imputation credits (gamma); and

(4) market expansion capital expenditure (ME capex).

30 On 30 July 2015, the Tribunal gave leave to JGN to apply review the JGN Final Decision in respect of the matters identified in its application and on the grounds it specified in its application.

31 AusNet Services (Distribution) Pty Ltd, AusNet Services (Transmission) Ltd, Australian Gas Networks Ltd, Citipower Pty Ltd, Powercor Australia Ltd, SA Power Networks and United Energy Distribution Pty Ltd (Vic/SA Network Interveners) and Ergon Energy Corporation Ltd (Ergon) were each granted leave to appear before the Tribunal in the JGN review application (and in the other applications referred to above), clearly because regulatory review determinations concerning those businesses were in the process of being made by the AER.

32 In addition, the Commonwealth Minister for Resources, Energy and Northern Australia (the Minister) was granted leave to intervene, confined (as the Minister specified) to making submissions on the proper construction and application of the relevant provisions of the NGL and the NGR in relation to this matter, and the NEL and NER in the seven NEL applications. It was appropriate, of course, for the Minister to intervene, given the substantial amendments to the regulatory decision-making process and the regulatory review process which required application, both by the AER and the Tribunal as noted above.

33 As noted, the 2013 Legislative Amendments introduced the consumer consultation process referred to in s 261(1)(b) of the NGL. The Tribunal, having given leave to apply for review in this matter, and in the seven applications under the NEL, undertook that consultation, relevantly under s 261(1)(b) of the NGL as described above.

34 As the Tribunal observed in the *PIAC-Ausgrid Decision*, the matters which emerged in the course of the consultation process, apart from informing the Tribunal about the concerns or views expressed, provided the foundation for matters the Tribunal raised with the applicants, the AER and the interveners during the hearing. They also served as the focus for questions of the Minister, during the hearing, as to how the various concerns or matters raised were to be taken into account by the Tribunal in making its determination in respect of the several applications.

# THE STRUCTURE OF THE DETERMINATION

35 The review applicants (variously supported by the interveners) take issue with aspects of the following components of the AER’s Final Decisions, which encompass the issues raised by JGN:

(1) Return on equity: ActewAGL; Networks NSW; JGN; PIAC

(2) Return on debt: ActewAGL; Networks NSW; JGN; PIAC

(3) Gamma: ActewAGL; Networks NSW; JGN

(4) Market Expansion Capital Expenditure (ME capex): JGN

36 PIAC did not itself apply to review the JGN Final Decision, but its submissions on the two issues referred to which were common (return on equity and debt) have not been dissected out of the consideration of those two topics for the purposes of this determination. The Tribunal has ensured that its conclusion on the issues of rate of return on equity and debt in relation to JGN would be no different if the PIAC submission on those topics had not been addressed.

37 As noted above, where there is a “shared” issue or topic, the Tribunal has endeavoured to incorporate by reference the general or common consideration or matters addressed above. The particular aspects of the application are of course separately addressed. The topic of ME capex is particular to JGN.

# RETURN ON DEBT

## Introduction

38 The Tribunal has discussed much of the relevant background to this topic in the *PIAC-Ausgrid Decision*. It is not necessary to repeat it in detail.

39 The return on debt that the AER estimated under r 87(8) of the NGR comprises both a risk free or base rate and a risk premium over the base rate, called the debt risk premium (DRP).

40 As noted, in the JGN Final Decision, as in the Final Decisions for the other Network Applicants, the AER decided to move its estimation methodology from the on-the-day approach to a trailing average approach. Those alternative approaches are described in the *PIAC-Ausgrid Decision*.

41 The AER was required by r 87(11)(d) to consider the impacts of the change of methodology on a benchmark efficient entity (BEE).

42 Following the 2012 Rule Amendments, the AER, as required, developed the *Better Regulation Rate of Return Guideline*, December 2012 (RoR Guideline). The RoR Guideline proposed the use of the trailing average approach (which is not contentious) and proposed adopting a transition which, in the JGN Final Decision and in the other Final Decisions and in submissions was referred to as “Option 2”. Under Option 2, in the first regulatory year of the transitional period, the allowed rate of return on debt is determined based on the estimated prevailing rate of return on debt for that year (similar to the on-the-day approach). There is then the assumption over what was determined to be a 10 year period in successive regulatory years for 10 percent of the debt to be assumed to be retired and replaced by debt raised at the estimated prevailing rate of return on debt. That progressive process meant that, at the end of the 10 year transition period, the return on debt is a simple averaging of prevailing interest rates during the service providers averaging periods over the previous 10 years. As explained in the *PIAC-Ausgrid Decision*, Option 2 was based on an approach to debt transition proposed by the Queensland Treasury Corporation.

43 The alternatives considered by the AER in the development of the RoR Guideline included Option 1 – continuing the on-the-day approach; Option 2 as noted; Option 3 – a hybrid transition starting with an on-the-day rate for the base rate component and gradually transitioning into a trailing average approach over 10 years combined with a backwards looking trailing average DRP (that is, a base rate transition only); and Option 4 – involving the adoption of the trailing average approach with no transition.

44 In the JGN Final Decision, the AER did not approve JGN’s proposed approach (Option 3) to the estimation of the return on debt, as presented in its Revised Regulatory Proposal, which would have resulted in a return on debt of 5.22 percent (nominal pre-tax) for the first year of the 2015-20 regulatory period, but instead adopted an approach which resulted in a return on debt of 4.28 percent for that year.

45 In its overview of its contentions on return on debt, JGN asserts that its review application raises the “important question” of whether the rate of return provisions of the NGR under the 2012 Rule Amendments can be construed to permit the AER to impose an approach to correct for perceived discrepancies between allowed returns and market outcomes in past access arrangement periods, and that the AER’s approach is based on a serious misunderstanding of the applicable provisions of the NGR, particularly r 87, and is inconsistent with the allowed rate of return objective in r 87(3) (RoR Objective). The AER, for its part, apart from resisting those contentions and asserting that its election to adopt Option 2 in the JGN Final Decision (and in the other Final Decisions) involved no reviewable error, also contended that JGN was not entitled to revise its AA Proposal in relation to debt transition, where it had supported Option 2 in its AA Proposal and then sought to change its approach to debt transition to Option 3 only in its Revised Regulatory Proposal. In the JGN Final Decision, the AER did not permit JGN to adopt the position it proposed in its Revised Regulatory Proposal in that regard.

46 The issues raised by JGN in relation to return on debt therefore involve consideration of the following:

(1) whether the AER erred in refusing to allow JGN to revise its proposal by seeking to change its approach to debt transition from Option 2 to Option 3;

(2) if that ground of review is made out, whether the AER erred in deciding to apply Option 2 to the transition, rather than Option 3;

(3) whether the AER erred in not agreeing to “lock in” the use of a trailing average methodology for future regulatory control periods;

(4) whether the AER erred in determining that future measurement periods should be locked in at the time of the AER’s Final Decision;

(5) whether the AER erred in using a simple average of the data series published by the RBA and Bloomberg, adjusted to reflect a 10 year estimate and other adjustments, and should instead have used only the RBA data series; and

(6) whether the AER erred in estimating debt by reference to a benchmark credit rating of BBB+ and should instead have used BBB.

47 It is convenient to deal with issues (5) and (6) immediately. Those issues were common to matters raised by Networks NSW and were determined adversely to the contentions of Networks NSW as explained in detail in the *PIAC-Ausgrid Decision*. For the same reasons, the Tribunal does not consider that those two grounds of review have been made out by JGN. It does not need to repeat those reasons which should be taken as applicable to the JGN application in relation to them.

48 Issue (6) concerns the credit rating. In addition to the issues common to JGN and Networks NSW, JGN also contended that the AER incorrectly exercised its discretion in adopting a single benchmark credit rating assumption of BBB+ across electricity and gas network businesses, when (it was said) gas businesses have a higher degree of risk and on average a lower rating.

49 The Tribunal has considered in detail the material referred to by JGN in support of that proposition. It is not persuaded that the AER’s conclusion that a BEE operating in a gas distribution network faces a different degree of risk than that of an electricity transmission or electricity distribution business is erroneous. There was evidence available to it to support its conclusion: Lally, *Implementation issues of the cost of debt*, November 2014 at p 31.

50 The Tribunal therefore is not persuaded of the additional element of error in that regard.

51 However, as the Tribunal proposes to set aside the JGN Final Decision, including in relation to the AER’s Determination on return on debt, obviously it is appropriate that the AER should have the opportunity to address those matters afresh to the extent to which it considers it appropriate to do so.

## Regulatory Framework

52 As noted in the *PIAC-Ausgrid Decision*, there are substantial parallels in the relevant provisions of both the NGL and the NGR on the one hand and the NEL and the NER on the other hand.

53 Rule 87(1) requires a calculation of the allowed rate of return to be calculated in accordance with the terms of r 87 itself. Rule 87(2) and (3) are the main provisions. They provide:

(2) The *allowed rate of return* is to be determined such that it achieves the *allowed rate of return objective*.

(3) The *allowed rate of return objective* is that the rate of return for a service provider is to be commensurate with the efficient financing costs of a benchmark efficient entity with a similar degree of risk as that which applies to the service provider in respect of the provision of reference services (the *allowed rate of return objective*).

54 As discussed at some length in the *PIAC-Ausgrid Decision*, the benchmark efficient entity (BEE) is to be one with a similar degree of risk as that which applies to the relevant service provider. The Tribunal has determined that that there is not necessarily one standard BEE to encompass the circumstances of all service providers at material times.

55 It is not necessary to refer, at this point, to further parts of r 87. They are relevantly the same as those applicable under the NER.

56 However, having regard to issue (1), it is necessary to refer to some earlier provisions of the NGR.

57 Rule 72(1g) of the NGR required JGN to submit its AA Proposal, including the “proposed return on equity, return on debt and *allowed rate of return*” for each regulatory year of the access arrangement period.

58 Rule 59(2) of the NGR required the AER to make its Draft Decision, indicating whether the AER approved the access arrangement proposal as submitted, and, if not, to set out the nature of the amendments required to make the proposal acceptable to the AER.

59 Rule 60(1) of the NGR then provided that a service provider such as JGN could, within the revision period, submit “additions or other amendments” to the access arrangement proposal to address matters raised in the Draft Decision. Rule 60(2) says that such additions or other amendments “must be limited to those necessary to address matters raised in the access arrangement draft *decision* unless the AER approves further amendments”.

60 The Tribunal accepts the view of the AER that rr 59 and 60 therefore limit the amendment to the AA Proposal of JGN to those “required to make the proposal acceptable to the AER.”. The real area of debate is the extent to which the AER’s Draft Decision gave rise to matters which may have entitled JGN to amend its AA Proposal in relation to the selection of Option 3, rather than Option 2 for the introduction of the trailing average approach.

61 Having regard to the discretion provided to the AER under r 60(2), it is broadly correct to say that the purpose of r 60 is to confine network providers to the position taken in the initial proposal, except where there is a proper reason to change that position as a result of some content in the relevant draft decisions, or where fairness otherwise requires that the change should be permitted by the AER. The AER, in its written submission, introduced the “fairness” concept.

62 There are parallel provisions in the NER, in particular in r 6A.12.1(c). The AEMC said in its *Draft National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006*, 16 November 2006 at pp 112-113 that the rule requires:

Revisions to DNSPs’ Revenue Proposals following a draft determination be restricted to those necessary to substantially incorporate the changes required or address matters identified as being of concern to the regulator in its draft determination.

## The JGN Proposal

63 In the JGN AA Proposal of 30 June 2014, JGN broadly accepted the approach to transitioning to the trailing average approach as set out in the RoR Guideline, that is, Option 2.

64 It noted that it favoured the hybrid portfolio approach, but said it was “comfortable with the trailing average approach”. In para 66 of the AA Proposal it said:

JGN still considers that a hybrid portfolio approach better reflects efficient financing practice for a benchmark efficient entity with a similar degree of risk as that which applies to JGN in the provision of reference services. However, for the purposes of estimating the return on debt for the next AA period, JGN adopts the trailing average approach and transitions set out in the guidelines, provided that this approach is applied properly and results in reasonable estimates of the return on debt for the benchmark efficient entity.

65 In the JGN Draft Decision, the AER determined to adopt the approach to debt transition set out in the RoR Guideline, that is Option 2, consistent with JGN’s AA Proposal.

66 However, in the JGN Revised Regulatory Proposal of February 2015, JGN sought to withdraw from its support of Option 2, and proposed that the 10 year incremental transition only applied to the base rate and not to the DRP, that is, it supported Option 3. It said that its change was because of “recent changes to debt yields, and the AER’s findings on current efficient debt financing practices”. Not surprisingly, given the terms of r 60(2) of the NGR, it also said that its modification of its approach was in response to matters raised in the Draft Decision in relation to the AER’s reasons for applying a transition to the DRP, and the change in market conditions.

67 It is common ground that the changed market conditions meant that, by February 2015, the prevailing return on debt (including the DRP) was lower than it was in June 2014.

68 As noted, in the JGN Final Decision the AER did not accept that JGN was entitled to revise its proposal in that way. It pointed out that in its Draft Decision, it had accepted the JGN proposal. Consequently, it did not accept that any amendment to the proposal was necessary by reason of the Draft Decision, and that it had not otherwise approved JGN making arrangements to its access arrangement proposal on that topic.

## SHOULD JGN BE PERMITTED TO PROPOSE OPTION 3?

69 The AER separately considered whether, if JGN’s submission of its revised access arrangement proposal, in that respect, constituted an implied request for approval of those amendments, it should exercise its discretion to approve them. It did not do so. See generally JGN Final Decision, Attachment 3, pp 3-145 to 3-146 and pp 3-152 to 3-156.

70 The respective submissions of JGN on the one hand and the AER on the other addressed at length whether JGN was entitled, in its Revised Regulatory Proposal, to propose the adoption of Option 3.

71 There is much to be said for the AER view that, because the Draft Decision simply adopted the proposal of JGN in its AA Proposal on this topic, no amendments under r 59(2) were either required or permitted to be made by JGN to that element of its proposal. As the AER pointed out, if JGN were permitted to make the change reflected in its Revised Regulatory Proposal because of the additional reasoning, based on expert views, that the AER provided in its Draft Decision for adopting Option 2 in the case of JGN, r 60(2) would have little or no effect in confining network providers in a revised regulatory proposal to issues which the AER had determined adversely to a network provider in relation to its initial regulatory proposal. It might also have the consequence of restricting the AER in expressing in a draft decision its reasons for accepting a particular element of an initial access arrangement proposal, at the expense of not having foreclosed that topic.

72 However, it is not necessary for the Tribunal to rehearse at length, and to carefully consider, the particular matters which JGN put on the topic.

73 That is because the Tribunal has taken the view that the discretion exercised by the AER under r 60(2) not to approve the further amendment because fairness did not require that should have been exercised differently. That is, JGN should be entitled to have made that amendment or revision in its Revised Regulatory Proposal. The AER’s discretion was exercised in a way with which the Tribunal does not agree.

74 The AER took the view, as it said in its submissions, that the recent changes to debt yields, and the AER’s findings on current efficient debt financing practices, did not involve any relevant change in JGN’s circumstances or provide any other reason which justified JGN in “reneging” on its prior acceptance to the AER’s selection of Option 2. It did not regard the decline in the prevailing DRP as a change in circumstances, or other reason, why it should have permitted JGN to make that change. It pointed out that JGN would have been aware of the possibility of interest rates rising, falling or remaining at about the same level at the time of its initial AA Proposal. Thus, the AER said, the fact that as at February 2015 JGN might have expected to receive a lower return on debt than it may have originally anticipated it would receive did not justify the exercise of the discretion available to the AER in JGN’s favour: see generally JGN Final Decision, Attachment 3 at pp 3-153 to 3-154.

75 The AER had a second reason in response to JGN’s assertion as to the significance of the Draft Decision involving “new findings”. It said there was no new matter, but simply an expansion of reasons for its adoption of Option 2. As noted, that is an issue with which the Tribunal is provisionally in agreement with the AER’s approach.

76 However, in the view of the Tribunal, JGN raised with the AER not simply the fact of the change of interest rates in the period between its AA Proposal and its Revised Regulatory Proposal as affecting its position, but also that the change in rates would have the consequence that the return on debt which would be determined would be below the efficient financing costs of a BEE in the 2015-20 access arrangement period. The evidence before the AER, and referred to in submissions, indicated a significant drop in the DRP between the time of the AA Proposal and February 2016. That drop was such that, as JGN contends, the application of Option 2 in the circumstances of a BEE with the risk exposure like that of JGN would mean that the return on debt to be determined would be inconsistent with the RoR Objective itself and with the revenue and pricing principles in ss 24(2), (3), (5) and (6) of the NGL.

77 That is not a matter which the AER appears to have taken into account in the exercise of its discretion. In the view of the Tribunal, it is a matter which the AER should have considered. It is a matter which the Tribunal has taken into account, and as presented, it is a matter which would lead the Tribunal on review to exercise that discretion differently. If the proposition is correct, as it appears on the submissions to be, in the view of the Tribunal the AER could be said to have made a determination which was not consistent with the RoR Objective.

78 In those circumstances, it is the Tribunal’s view that the reasons of the AER for declining to exercise its discretion to permit JGN to present the alternative Option 3 in its Revised Regulatory Proposal was a material error in the exercise of a discretion. Obviously, it is a material error if, as JGN contends, that may have led to a significantly different outcome in the determination of the appropriate rate of return estimate for JGN for the current and ongoing regulatory years.

79 The Tribunal therefore concludes that the AER’s exercise of its discretion was erroneous, because of its focus on what might or should have been apparent to JGN at the time of its AA Proposal in relation to prospective interest rate changes. That is, of course, an appropriate consideration. However, the consideration as to whether the effect of the determination of the AER would, in the circumstances, result in an estimate of the amount to be allowed for return on debt being less in fact than the RoR Objective would accommodate is a separate consideration.

## Other Grounds of Review

80 Having taken that step, the question of whether the transition under Option 2 should have been applied, as it was applied by the AER including the progressive transition to the trailing average approach in the case of JGN, in particular whether that means of transition should have applied to the DRP element of the cost of debt, is a matter which is common to JGN as with Networks NSW, and ActewAGL. It is a matter which was supported by the Vic/SA Interveners.

81 JGN’s approach was a little different. JGN urged that the appropriate approach could encompass a transition of the base or risk-free rate, but the transition approach adopted by the AER in respect of the DRP component of JGN’s cost of debt and return on debt was erroneous both at law and in effect shut JGN out of receiving a proper and efficient DRP component that pertains to its existing debt portfolio.

82 For reasons given in the *PIAC-Ausgrid Decision*, it would also follow that the decision of the AER to determine the estimate for DRP for JGN on the basis of Option 2 should be set aside and the matter remitted to the AER for reconsideration. The issue, in particular, of the proper construction and application of r 87 of the NGR to JGN’s circumstances is a common one.

83 So too is the issue as to whether or not it is appropriate to apply a standard or across the board transition to the DRP component of the return on debt. That applies also to the AER’s identification of the standard BEE.

84 It is necessary to make some brief observations about the other grounds of review.

85 As to the averaging period, the AER was satisfied that it was appropriate to adopt an approach where, for each regulatory year, an averaging period of between 10 business days and 12 months should be nominated by the service provider, with that period being as close as practical to the start of each regulatory year. That is consistent with the RoR Guideline.

86 In its Revised Regulatory Proposal, JGN proposed that the average periods for the 2016-17 and successive years should be nominated by it annually throughout the access arrangement period, rather than fixed by the AER in its Final Decision. The AER approach accorded with the RoR Guideline.

87 The Tribunal is not satisfied that JGN’s contention in this regard demonstrates that any ground of review is made out. It is the Tribunal’s view that the AER’s approach accorded with r 87(12) of the NGR requiring the annual return on debt to be determined through the automatic application of a formula specified in the Final Decision. It is an approach which accords a balance between flexibility and certainty in a sensible way, and so in a way that would promote efficient investment decisions including those responsible for managing risk in the arrangement of financial arrangements. The relevant service providers have the flexibility of nominating the length of their averaging periods. It is a process which it not overly complex.

88 Accordingly, to the extent to which this issue may involve reconsideration by the AER by reason of the remittal to its JGN Final Decision generally, the Tribunal indicates that it does not accept that the AER’s approach involved any error on its part.

# RETURN ON EQUITY

# GAMMA

89 JGN prepared common written submissions with Networks NSW and ActewAGL on the issues of return on equity and gamma.

90 Counsel for Networks NSW also addressed the grounds of review raised in relation to these issues on behalf of JGN at the same time as addressing those topics for Networks NSW. The issues that arise for JGN in respect of those topics are the same issues as those that arise for Networks NSW.

91 In relation to the return on equity, JGN proposed a return on equity estimate of 10.71 percent in the JGN AA Proposal, based on a weighted average of the return on equity estimates produced from the four financial models: the SL CAPM, the Black CAPM, the Fama French three factor model, and its consultant’s construction of the DGM. The precise weighting is not important for present purposes. In its Revised Regulatory Proposal, the first three models’ estimates were equally weighted and a 9.83 percent (nominal post tax) estimate made.

92 This approach was much the same as that taken by ActewAGL, but the different averaging period from that used by ActewAGL led to a slightly different revised estimate.

93 In the JGN Final Decision, the AER decided upon a risk free rate of 2.53 percent, based on the averaging period of 19 January 2015 to 16 February 2015, together with an MRP of 6.5 percent and an equity beta of 0.7 so as to give an overall return on equity of 7.1 percent. That represented a significant reduction from the return on equity for JGN in the Draft Decision, and considerably less than the 11.05 percent allowed to JGN in the previous regulatory period.

94 In relation to gamma, there were minor differences in the figures used by the AER for the JGN Final Decision and the Final Decisions for the other Network Applicants, which were a consequence of the slightly different timing leading to slightly different data sets. However, the AER gamma estimate of 0.4 made in each of the Final Decisions (including that of JGN) has been found to have been in error, and the Tribunal’s analysis in the *PIAC-Ausgrid Decision* of the AER’s reasons and of the appropriate path or method to determining gamma is common to all the Network Applicants. Each contended that the value for gamma should be 0.25, based on a distribution rate of 0.7.

95 The Tribunal’s reasons on why it does not consider that any grounds of review have been made out with respect to the rate of return on equity are set out in the *PIAC-Ausgrid Decision*. It is not necessary to repeat those reasons here.

96 The same step may be taken with respect to gamma. The Tribunal’s reasons why it considers that grounds of review have been made out are set out in the *PIAC-Ausgrid Decision*. Again, it is not necessary to repeat those reasons here. They apply equally to this application.

# MARKET EXPANSION CAPITAL EXPENDITURE (ME CAPEX)

## Introduction

97 The dispute in relation to ME capex concerns the AER’s decision:

(a) not to approve JGN’s ME capex forecast of $368.0m ($2015 unescalated, excluding overheads) produced through the use of the JGN unit rate derivation model (the JGN model); and

(b) to approve its own proposal to adopt an ME capex forecast of $285.6m ($2015 unescalated, excluding overheads) produced by its own, alternative model (the AER ME Capex Decision).

98 JGN alleges that numerous errors were made by the AER both in the AER ME Capex Decision itself and in the steps taken by the AER in arriving at that decision.

99 It is helpful to consider the concept of ME capex and the context in which JGN’s ME capex forecast and the AER’s ME Capex Decision were developed.

## Relevant provisions

100 The AER’s decision falls within the “return on the projected capital base for the year” building block: r 76(a) of the NGR. The return on the projected capital for the year includes forecast conforming capex for the period (r 78(b)), which is defined in r 79(1) and (2) of the NGR as:

(1) Conforming capital expenditure is capital expenditure that conforms with the following criteria:

(a) the capital expenditure must be such as would be incurred by a prudent service provider acting efficiently, in accordance with accepted good industry practice, to achieve the lowest sustainable cost of providing services;

(b) the capital expenditure must be justifiable on a ground stated in subrule (2).

(2) Capital expenditure is justifiable if:

(a) the overall economic value of the expenditure is positive; or

(b) the present value of he expected incremental revenue to be generated as a result of the expenditure exceeds the present value of the capital expenditure; or

(c) the capital expenditure is necessary:

(i) to maintain and improve the safety of services; or

(ii) to maintain the integrity of services; or

(iii) to comply with a regulatory obligation or requirement; or

(iv) to maintain the service provider’s capacity to meet levels of demand for services existing at the time the capital expenditure is incurred (as distinct from projected demand that is dependent on an expansion of pipeline capacity); or

(d) the capital expenditure is an aggregate amount divisible into 2 parts, one referable to incremental services and the other referable to a purpose referred to in paragraph (c), and the former is justifiable under paragraph (b) and the latter under paragraph.

101 The AER’s discretion to make a determination of whether capex is “conforming capital expenditure” in accordance with r 79(1) is limited: r 79(6).

102 Where, as in r 79(6), the NGR provide that the AER’s discretion is limited, the AER may not withhold its approval to JGN’s proposal in relation to ME capex if it is satisfied that JGN’s proposal (r 40(2)):

(1) complies with applicable requirements of the NGL*;* and

(2) is consistent with applicable criteria (if any) prescribed by the NGL.

Relevantly, this includes a requirement that any forecast or estimate made by JGN in the JGN Revised Proposal must be arrived at on a reasonable basis and must represent the best forecast or estimate possible in the circumstances: r 74(2).

103 If the AER is not satisfied that these requirements have been met, it must propose an access arrangement or revision to the access arrangement, as the case may be. In undertaking that task, r 64(2) requires the AER to have regard to:

(1) the matters that the NGL requires an access arrangement to include;

(2) the service providers’ access arrangement proposal; and

(3) the AER’s reasons for refusing that proposal.

104 The extent in which the AER considered r 74(2) in making its ME Capex Decision is considered in further detail below.

105 As part of its decision-making process, the AER also has certain procedural obligations. In performing or exercising its economic regulatory functions or powers, the AER must comply with s 28(1) of the NGL. Relevantly, s 28(1)(b)(i)(A), (D) and (E) requires the AER, in making a reviewable regulatory decision, to ensure that JGN was informed of the material issues under consideration by the AER, and was given a reasonable opportunity to make submissions in respect of the decision before it is made.

106 The AER’s general obligations are outlined in more detail in the *PIAC-Ausgrid Decision*.

## The Steps Leading to the ME Capex Decision

107 ME capex is expenditure for new assets that are required for the connection of new customers to the network. Natural gas is supplied to a property newly connected to the network through pipe work that is installed from an existing gas main into the property. Works required for new connections typically include:

(1) extending gas mains (pipes) where needed;

(2) installation of services (a pipe that runs from JGN’s mains network to a customer’s property); and

(3) installation of meters and associated equipment.

108 The scope of this work varies, including because of the differing proximity of existing mains to the site being connected, whether the connection is routine or non-routine, and the connection type. Therefore, when estimating the cost or rate for a particular category of connection, a representative bundle of activities and materials (“volume mix”) is used. Connection types can be classified as new estate (residential), medium/high density apartments, electricity-to-gas conversions (E-G), industrial and commercial (small to moderate-sized business customer) (I&C), and I&C - contract (major industrial customers).

109 The JGN AA Proposal included a forecast capex model which was used to forecast the total proposed capex for the 2015-20 regulatory period, including ME capex of $356.6m ($2015 unescalated, excluding overheads). In relation to its proposed unit rates, JGN’s AA Proposal included the following:

(1) Appendix 6.7, which reported on forecast capex, JGN made submissions to the effect that:

(i) its unit rates were “based on JGN’s historical average for unit rates for each connection type and contract rates applicable from 1 July 2013”;

(ii) the 13 percent increase in total ME capex between the current and the next regulatory periods reflected a 15 percent increase in the number of connections forecast.

(2) Appendix 6.2, which contained JGN’s Asset Management Plan, JGN submitted that costs were “based upon the northern and southern tendered construction unit rates established in 2013.”

110 The JGN AA Proposal did not include detailed information on the forecasting method employed by JGN in calculating its proposed ME capex. Appendix 6.04 included unit rates at a mains/services/meters by connection type without providing a description of how these unit rates had been calculation or a derivation of the unit rates.

111 On 12 October 2014, the AER requested clarification from JGN through ‘AER Information Request 40 to JGN – Connections capex’ in relation to the JGN AA Proposal on ME capex. Relevantly, the AER sought further clarification on:

(1) the rationale for separately estimating non-routine connections;

(2) the relationship between the contract rates applicable from 1 July 2013 onwards and the JGN forecast unit rates; and

(3) costs for Meter Data Loggers (MDLs) and Metreteks.

112 It also requested that JGN:

provide the historical data and contracts specifying the rates that were used to derive the following estimates and please provide the derivation of the forecast expenditure for, these two sources for:

(a) E to G expenditure

(b) Routine and non-routine new estate expenditure

(c) Routine and non-routine medium density expenditure

(d) Routine and non-routine I&C tariff expenditure.

113 JGN responded to this request on 22 October 2014 and 24 October 2014. On 22 October 2015, JGN indicated that:

(1) the predominant rationale for separately estimating non-routine connections and routine connections was the substantial difference between the unit cost of those categories of connections;

(2) the relationship between standard contract rates and forecast unit rates was based on at least 12 months of historical information of works required for each new connection; and

(3) non-routine connections were forecast using a different methodology which took the average of historically-observed costs per connection since JGN’s 2011 financial year (1 April 2010 to 30 March 2011).

114 Further information was provided on 24 October 2014 including concerning meter renewal and upgrade and the costing methodology for MDLs and Metreteks. JGN did not provide unit rate derivations.

115 On 28 October 2015, the AER sought further clarification of the unit rates included in the JGN ME capex forecast. This request was subsequently clarified on 29 October 2014 and became “AER Information Request 40b, Response to connections question”. In relation to routine connections, the AER requested that JGN:

… please provide the annual regional volume, material and method composition by connection type for at least three years of actual data. Direct overheads and related party margins should be separately identified.

116 In relation to non-routine connections, the AER requested that JGN:

Please provide forecast volumes. Please provide current period actual non-routine volume, unit rate and expenditure information. Please confirm that this expenditure is currently captured in the historical expenditure, unit rate and volume information.

117 JGN responded on 30 October 2014 by providing a 9MB spreadsheet model used to translate the contract unit rates into the forecast unit rates. On 31 October 2015 JGN discussed the model through teleconference with the AER and on 3 November 2014, JGN provided an email to the AER concerning forecast I&C contract expenditure. This did not include the derivation or method used to forecast I&C contract connection expenditure.

118 The AER was not familiar with, nor was it provided with, information in relation to the accounting codes that JGN used. In light of the need to understand the codes, the multiple sheets used and in the absence of explanatory material, the spreadsheet did not significantly assist the AER.

119 On 27 November 2014, the AER published its Draft Decision. It accepted that the contract rates used by JGN in forecasting ME capex unit rates were prudent and efficient. Relevantly, in Attachment 6 to the Draft Decision it stated (at p 6-47, without footnotes):

We are satisfied that this was a competitive tender process. As it was a competitive tender price, we are satisfied that the unit rates established in the contracts reflect competitive unit rates prevailing in the market. On this basis we are satisfied that the unit rates drawn from these contracts which form the basis of estimates used in JGN’s proposed capex are efficient.

120 However, despite being satisfied that the contract rates used by JGN in forecasting ME capex unit rates were prudent and efficient, on the material provided by JGN, the AER was not satisfied that the unit rate composition JGN used in determining the cost per connection was arrived at on a reasonable basis or was the best estimate in the circumstances: r 74(2). The AER reached that conclusion for the following reasons:

(1) JGN had relied upon only one year of data for forecasting regional composition, material types and lay methods, whereas the AER considered that more than one year of composition data should be used to forecast unit rates due to the potentially significant differences in each of these factors between years; and

(2) the AER was not satisfied that JGN had adequately justified increases in the metres of mains/connection for medium density/high rise connections and I&C connections, including because JGN did not adequately explain the proposed increases and inconsistencies in the number of years which JGN used to forecast historical averages across categories.

Consequently, the AER did not accept JGN’s AA Proposal in relation to ME capex.

121 As the AER was not satisfied that that the JGN AA Proposal was arrived at in accordance with r 74(2), it did not accept JGN’s AA Proposal. As noted above, it was required and entitled to make its own assessment. In the absence of further information supporting the use of different bases for averaging, and on the basis of available evidence, the AER considered that revealed unit rates provided the best estimate in the circumstances. Accordingly, it calculated the unit rates using five years of actual data between 2008 and 2013. This produced the AER’s draft ME capex forecast of $292.1m.

122 Between the Draft Decision (November 2014) and the JGN Revised Proposal (February 2015), JGN consulted with the AER in relation to JGN’s concerns with AER’s alternative forecast ME capex and the AER’s use of a revealed cost approach. This included explanations by JGN setting out the work that it was undertaking in developing unit rates for the Revised Proposal and how JGN intended to address the AER’s concerns in the Draft Decision regarding JGN’s use of only one year of composition data to forecast unit rates for the 2015-20 regulatory period. That involved both written correspondence and presentations given by JGN to the AER in December 2014 and January 2015,

123 The work that JGN was undertaking in developing unit rates for the Revised Proposal ultimately became the JGN model. JGN developed the JGN model, and forecast ME capex, by multiplying forecast unit rates, volume mixes and connection numbers for each connection type set out above. In response to the AER’s Draft Decision, JGN’s forecasting method incorporated detailed calculations for the unit cost of routine connections, the unit cost of non-routine connections and for forecasting the cost of I&C contract connections.

124 JGN’s model relied on data sets compiled from JGN’s internal system, in order to apply the forward-looking forecast of costs that would be incurred by JGN over the 2015-20 regulatory period. It was based on the relevant existing (and recent) contractual arrangements and on a historical average activity mix compiled over multiple years. In the compilation of forecast costs, the model drew off data generated in multiple years to reflect the fact that different work is generally required for each connection. As in the JGN AA Proposal, the JGN Revised Proposal reflected outsourcing contract rates which were applicable from July 2013.

125 On 27 February 2015, JGN provided its Revised Proposal of $386.0m ($2015 unescalated, excluding overheads) and the JGN model to the AER. The JGN model, the data and the calculations were in the form of spreadsheets. This included soft copies of the spreadsheets, which enabled the calculations and/or data input into each cell in the spreadsheets to be viewed.

126 During the period between the Revised Proposal and the ME Capex Decision, as part of the JGN Final Decision (published on 3 June 2015), there was limited communication between the AER and JGN in relation to JGN’s proposed ME capex and the JGN model. The AER raised specific concerns with JGN in relation to ME capex (relevant to the issues in contention) on two occasions. The first was ‘Information Request 61 – Connections’ in which the AER raised two questions with JGN:

Question 1:

Please confirm that for both north and south regions the cost of meter installation is included in the unit rates as per Schedule B.15.4(k), B15.6.1-B15.6.6 of the supplied contracts.

Question 2:

Please confirm that CPI is the escalation applied to unit rates as per Schedule B, Part 5, para 3 of the supplied contracts.

127 On 8 May 2015, JGN responded to this request. It confirmed the AER’s understanding that that cost was included in unit rates in relation to Question 1. In relation to Question 2, JGN clarified that its proposal was to apply both forecast consumer price index (CPI) inflation and real input cost escalators (labour and materials) to unit rates, and it provided reasons for its approach.

128 The second matter raised by the AER with JGN was whether non-routine connections should be excluded from the capex forecast on the basis that they should be extracted from customers as capital contributions. This was raised orally during a meeting between JGN and the AER on 8 May 2015. It was not followed up.

129 It is in this context that the AER made its ME Capex Decision.

## The ME Capex Decision

130 The AER found, on the basis of the material before it, that the JGN Revised Proposal either was not based on the best estimate in the circumstances and/or revealed inefficiency. Consequently, the AER was not satisfied that JGN’s proposed ME capex was conforming capex, as required by r 79 of the NGR.

131 Relevantly, the AER found that:

(1) JGN’s volume forecasts were marginally overstated in relation to E-G conversions where the connection is to a pre-existing main passing the customer’s premises, new estates, medium density residential developments, and main extensions where the network is extended to connect one or more new customers;

(2) the JGN model built up unit rates from a mix of historical and forecast data such that the AER was not satisfied that the unit rates that JGN forecast had been arrived at on a sufficiently reasonable basis and were the best estimates in the circumstances because:

(i) the JGN model drew off three data sets, the data sets had no unique identifiers that could facilitate their reconciliation (for example common job numbers), and there were significant differences in the unit rates estimated depending on which was used;

(ii) there were changes in contract inclusions, levels of insourcing and outsourcing, and accounting policies across time which would lead to changes in the category in which costs were captured over time, potentially leading to the under-or-over-forecast;

(iii) JGN had not justified the inclusion of some costs (including internal labour allocated from opex to capex for mains and metering) while it was unclear on what basis other costs (real material and labour escalation, metering labour costs, energisation costs, quoted works and non-routine costs) had been included; and

(iv) JGN was unable to justify its forecast on average historical I&C expenditure, and based its forecast on five year average of actual data on historical I&C expenditure.

132 On this basis, the AER withheld its approval of JGN’s proposal in relation to ME capex and produced an alternative ME capex forecast which appears in the AER’s ME Capex Decision. As indicated above, the AER’s final ME capex forecast was $285.6m ($2015 unescalated, excluding overheads) and JGN’s final ME capex forecast was $368.0 ($2015 unescalated, excluding overheads). The allowance that the AER made for ME capex was 22.4 percent less than the amount JGN proposed for ME capex ($2015 unescalated, excluding overheads). The reduction was driven by:

(1) the application of five year average of actual data on historical unit rates rather than the unit rates built up in JGN’s connections model;

(2) the AER’s estimate of the cost of forecast new connections, which was lower than JGN’s forecast (including because of the exclusion of certain categories of costs); and

(3) not including JGN’s proposed additional expenditure for non-routine connections.

133 It is clear that the concerns with JGN’s Revised Proposal identified by the AER in its Decision extend beyond those matters directly raised by the AER with JGN between JGN’s Revised Proposal being submitted and the publication by the AER of the JGN Final Decision.

## The Dispute

134 JGN is seeking review of two aspects of the AER’s ME Capex Decision: the AER’s decision not to approve the ME capex forecast produced through the use of the JGN model, and the AER’s adoption of its own ME capex forecast proposal.

135 JGN says that the reasoning and conclusions in the AER’s ME Capex Decision means that it is attended by errors of fact, was unreasonable having regard to all the circumstances, and/or involved an incorrect exercise of the AER’s decision: s 246 of the NGL. The alleged errors made by the AER are outlined in JGN’s Application for Leave to Review at [143]-[145] and summarised at [41]-[43] of *Application by Jemena Gas Networks (NSW) Limited* [2015] ACompT 4. The alleged errors can be said to fall within four categories.

136 Firstly, JGN says that the AER erred by not approving the JGN model as an appropriate unit rate derivation model, as it should have found that JGN arrived at its forecast ME capex on a reasonable basis and represented the best forecast or estimate possible in the circumstances: r 74(2).

137 Secondly, JGN says that s 28(1)(b)(i)(A), (D) and (E) of the NGL, which formalises the hearing rule of natural justice, requires the AER to ensure that, in accordance with the NGR, JGN was informed of the material issues under consideration by the AER and was given an opportunity to make submissions on them before the Final Decision was made. As indicated above, the AER in its Final Decision has raised issues which had not previously been raised with JGN.

138 Thirdly, JGN says that as its Revised Proposal complied with the NGR, the AER’s discretion not to approve JGN’s forecast and to substitute its own decision was not enlivened and it did not have the power to make a substitute forecast.

139 Finally, JGN submits that the AER’s approval of its own ME capex forecast (based on its own model) is unreasonable and involves the incorrect exercise of discretion, in that:

(1) the AER’s model is overwhelmingly weighted with out-of-date cost information that is materially lower that the true costs JGN faces in the forthcoming access arrangement period; and

(2) the AER excluded certain cost categories when compiling its own model drawn from a five-year average of ME capex costs.

140 Each of JGN’s allegations will be considered in turn.

141 Before addressing the parties’ submissions in relation to each of JGN’s claims, it is appropriate to record how the dispute was framed by JGN and the challenges it says have arisen in relation to the evidence open to JGN to rely upon.

142 The limited merits review process requires the Tribunal not to consider any matter other than review related matter (and any matter arising as a result of the consumer consultation process) (s 261(1)(a) of the NGL) when establishing whether or not a ground of review under s 246 of the NGL is made out. The Tribunal may only allow new information or material to be submitted if it is of the view that a ground for review has been made out: s 261(3a). During the course of the hearing, counsel for JGN submitted that this limitation significantly affected JGN’s ability to lead evidence in support of its model and to persuade the Tribunal of certain errors in the ME Capex Decision in circumstances where the AER had not raised each of its concerns with JGN prior to the ME Capex Decision. It was submitted that, to some extent, it would be necessary to rely on fresh information to respond to the AER’s concerns with the JGN model, which even though it may not be permissible material before the Tribunal unless, and until, a ground of review is made out. It is not necessary to expand on those submissions further at this stage.

143 A separate matter relating to the conduct of the hearing was the approach taken JGN in relation to the findings it sought from the Tribunal. As JGN indicated, one approach that was open to it was to make out its grounds of review in relation to the AER’s rejection of the JGN forecast and model, and on that basis alone, to invite the Tribunal to set aside or vary the AER’s ME Capex Decision. However, in the circumstances, JGN sought to make out grounds of review in relation to the AER’s adoption of its own forecast, and on that basis alone, to invite the Tribunal to consider what form of determination should be made under s 259 of the NGL. Consequently, the focus of the parties’ submissions concerned the AER’s ME Capex Decision and how the AER arrived at that decision.

144 The Tribunal has considered the parties’ submissions in this context.

## The AER’s consideration of the JGN revised proposal

145 The AER had several concerns about the JGN model and the data provided in JGN’s revised proposal which led it to find that the Revised Proposal did not comply with r 79 of the NGR. Its primary concern was the absence of material enabling the AER comprehensively to assess the reasonableness of the data and the JGN model, including because of the use of different data sets without the provision by JGN of any unique identifiers or other related data such as would enable the AER to audit it and JGN’s provision of hard coded data (which comprises numbers in a spreadsheet cell which cannot be traced back to the underlying source data) and derived costs (comprising calculations from underlying source data) without the underlying data.

146 The AER submitted that the use of multiple data sets enables data to be collected under different assumptions, with different inclusion or exclusion conditions with different levels of error. It says that in order to avoid error, both cost data (also referred to as ‘financial data’) and ‘volume mix’ data should be derived from a single job data set as the potential for biases if different elements of different data sets are used to derive unit rates is readily apparent. It says that related data for cost and volume mix were, as required for job invoicing and payment, not presented by JGN either together or with a unique identifier (eg job number) so that the AER could audit it, there was no accompanying explanation as to how the data sets had been reconciled or otherwise calibrated so as to ensure consistency of treatment, and the original data was not provided.

147 The AER says the absence of explanatory material in combination with concerns about the presence in the model of particular data errors and the inclusion of certain categories of costs (including for MDLs, Metreteks, non-routine connections costs and opex to capex) led the AER to conclude that JGN’s model was not sufficiently reliable.

148 JGN says that the data errors identified by the AER were not material and would have been easily correctable had they been identified and brought to the attention of JGN prior to the Final Decision (and still are easily correctable if the Tribunal finds in favour of JGN and remits or substitutes this decision). JGN also submitted that there were simple explanations for the inclusion of each of the categories of costs and that this would have been evident had the AER had engaged with JGN prior to making the ME Capex Decision. This assertion is disputed by the AER, which claims that, in addition to those errors acknowledged by JGN, the model included records for areas that did not have supporting contracts and the AER was unable to identify whether the rates specified for those areas were based on competitively determined contracts.

149 For these reasons, the AER found that the allowed ME capex in JGN’s Revised Proposal was not conforming capex.

150 During the course of oral submissions the AER and JGN spent a significant proportion of time explaining the material provided to the AER in detail, including the spreadsheets which constituted the data and calculations in the JGN model. These submissions were complemented by detailed written submissions describing the spreadsheets and how the various data input was used to estimate JGN’s proposed ME capex forecast.

151 It appears to the Tribunal that, once properly understood, JGN’s revised model contained an adequate level of detail to comprehensively assess the validity of the JGN model. However, in forming this view the Tribunal has had the benefit of detailed written and oral submissions. While the submissions and material now before the Tribunal may allow a detailed assessment to be made of the JGN model and the underlying data by an experienced regulator, those explanations were not available to the AER when the AER made the ME Capex Decision, without further engagement by the AER with JGN.

152 In the absence of appropriate explanatory material, the Tribunal accepts that the JGN model was not in a form reasonably accessible to the AER. Consequently, in the Tribunal’s view the AER, as an experienced regulator, being conscientious, was unable comprehensively to assess JGN’s proposed ME capex and therefore was unable to assess the extent to which it was arrived at on a reasonable basis or represented the best forecast or estimate possible in the circumstances.

153 Further, in the absence of additional explanatory material, in the Tribunal’s view the AER’s concerns with the JGN model were legitimate.

## The AER’s obligation to consult or engage with a service providers

154 This raises the issues of whether the AER was entitled to base its decision on the comprehensive, but somewhat inaccessible, material provided by JGN or whether, having certain concerns and difficulties in understanding the JGN model, it was required to enquire further.

155 JGN says that the proposition that the AER was not required to give JGN an opportunity to respond to material issues that the AER had about the JGN unit rate derivation model is erroneous at law under s 28(1)(b)(i)(A), (D) and (E) of the NGL, which formalises the hearing rule of natural justice, as well as being poor practice and policy, and far from being conducive to the advancement of efficient outcomes and the NGO.

156 JGN further submits that there is no impediment in Part 8, Division 8 of the NGR to further consultations occurring after the submission of a revised access arrangement proposal.

157 The alleged consequences of the AER’s failure to raise its criticisms with JGN in advance of the Final Decision are that:

(a) the AER’s failure to raise these matters with JGN is a key aspect of “all the circumstances” against which the Tribunal must determine whether the AER’s rejections of the model was the result of an incorrect exercise of discretion (s 246(1)(d));

(b) the AER’s failure to raise these issues earlier explains what might otherwise appear to be deficiencies in the review related material (RRM); and

(c) it was not possible for the AER to reach a proper conclusion as to whether r 74 was met or was not met in the circumstances where it had not ventilated the questions and assumptions it ultimately relied upon.

158 In contrast, the AER submits that, while the NGR did not prohibit the AER from further engagement, it did not require the AER to give JGN an opportunity to explain a model that it only provided at the point of submitting its Revised Proposal and that the absence of any additional material which may have been provided by JGN does not amount to deficiencies in the RRM. Consequently, the AER says that it was not an incorrect exercise of discretion not to consult JGN further, particularly given the AER’s obligations and the time constraints specified in NGR.

159 Section 28(1)(b) of the NGL specifies that in making a designated reviewable regulatory decision JGN had to be informed and given a reasonable opportunity to make submissions in accordance with the Rules. Accordingly, the AER observes that Part 8 of the NGR prescribes a procedure which has an absolute overall time limit of 13 months between the date on which JGN makes a proposal to the AER and the date the AER makes a final decision on the proposal which cannot be extended: r 13. The NGR also contains a series of detailed steps which must be undertaken by the AER within this timeframe, including the provision by the service provider of an access arrangement proposal: r 42; the making of an access arrangement draft decision: r 59; and the provision of additions or other amendments to the access arrangement proposal: r 60.

160 The AER says that, while it has the power to obtain additional information, the restricted timeframe and detailed legislative obligations placed on the AER under the NGR indicate that there were no further legislative requirements obliging the AER to consult with JGN further than it did.

161 In the Tribunal’s view, the NGR specifies the procedure which the AER must follow in making its decision including the consultative steps which it must take to engage with service providers. The NGR is structured to allow service providers to provide an initial proposal and then get feedback on that proposal in the form of a draft decision. This process enables service providers to respond to any concerns the regulator may have with their initial proposal. JGN was provided with this opportunity. The Rules do not require the AER to engage with service providers indefinitely. There must be a point at which the consultation process ends and a decision is made. The requisite consultation and decision-making processes are specified in the NGR. The fact that the JGN model did not ultimately satisfy the AER that the ME capex forecast or estimate made by JGN in its Revised Proposal represented the best forecast or estimate in the circumstances does not demonstrate error on the part of the AER. It was entitled to rely on the material provided by JGN. The responsibility of the regulator is to consider the material put to it and to make a decision on the basis of that material. Procedural fairness does not require the AER to take further steps than it did.

162 It is also the Tribunal’s view that it is not an incorrect exercise of discretion for the AER to raise each of it concerns with a service providers’ Revised Proposal, nor does the absence of any material which may have been provided by JGN in response to those concerns amount to a deficiency in the RRM.

## The AER’s discretion to make a substitute decision

163 The AER’s discretion to withhold its approval to JGN’s proposal in relation to ME capex is only enlivened if it is not satisfied that JGN’s proposed ME capex forecast or estimate was arrived at on a reasonable basis and represents the best forecast or estimate possible in the circumstances: r 74(2).

164 Thus, in the Tribunal’s view, the concerns outlined by the AER in relation to the JGN model clearly show that the AER was not, in fact, satisfied that JGN’s ME capex was conforming capex. It was not unreasonable for the AER to exercise its discretion to make a substitute decision on the basis of legitimate concerns raised by the material provided by JGN to the AER.

165 Consequently, there is no reviewable error in the AER’s decision not to approve the ME capex forecast produced through the use of the JGN model.

## The AER’s ME capex forecast

### The AER’s obligations

166 JGN says that there are two key problems with the AER’s ME Capex Decision, its adoption of historical average unit rates and its exclusion of certain categories of costs. These will be considered in turn.

167 It is convenient to note at this point the dispute between JGN on the one hand, and the AER as to whether r 74 of the NGR applies when the AER comes to determine its own capex forecast. In the event, the Tribunal does not need to resolve the issue. That is simply because, in other respects, the Tribunal is satisfied that grounds of review have been made out in relation to the AER’s determination of the appropriate ME capex forecast.

168 Rule 74 of the NGR provides that a forecast or estimate must be supported by a statement of the basis of the forecast or estimate, and that the forecast or estimate must be arrived at on a reasonable basis, and must represent the best forecast or estimate possible in the circumstances.

169 The AER said that, as it was not satisfied that JGN’s forecast met the requirements of r 74, it therefore had to do its best to undertake the forecasting process: see *Application by United Energy Distribution Ltd* [2012] ACompT 1 at [196]. JGN contends that it, in undertaking that task, the AER itself was required to comply with r 74 of the NGR, and that it did not do so.

170 In *Application by Envestra* [2012] ACompT 3 at [43] the Tribunal observed that the AER, in formulating an alternative access arrangement for itself, and in particular in producing the forecast of ME capex for that purpose, the AER did not specifically have to apply the requirements of r 74. JGN submitted that that observation by the Tribunal was incorrect, and should not be followed. It says that the correct position is that either r 74 applies to the AER’s forecast of ME capex, or at least that the same principles as are expressed in r 74 apply by necessary implication. Reference is made to r 64(2)(a) and (b) which prescribes that, in formulating an access arrangement, the AER must have regard to the matters that the NGL requires an access arrangement to include as well as to the service providers access arrangement proposal. Alternatively, it says, *Minister for Aboriginal Affairs v Peko-Wallsend Ltd* (1986) 162 CLR 24 at pp 41-43 per Mason J supports the proposition that, as a matter of implication, the estimation functions and forecasting functions required of the AER by rr 64, 78(b) and 79 should not be done “in a statutory vacuum” (to use the words in the JGN Reply Submission) but in the context of r 74.

171 As noted, the Tribunal does not need to resolve that issue. However, it should not be taken as accepting the proposition that the AER, in making its ME capex forecast, did not at least in principle endeavour to give effect to the requirements of arriving at a forecast or estimate on a reasonable basis, or represent the best forecast or estimate possible in the circumstances.

### AER adoption of historical average unit rates

172 The AER determined total unit rates for each connection type by multiplying the number of new connections by the five year actual average unit rates for mains, services and meters and the mains/services/meter per connection volumes.

173 JGN submits that reliance by the AER on an average of the volume mix unit costs across five years of historical data, where only the last of those years (2013-14) was subject to the new outsourcing arrangements that apply to JGN, was unreasonable having regard to all of the circumstances and involves the incorrect exercise of discretion, in that it is overwhelmingly weighted with out-of-date cost information that is materially lower than the true costs JGN faces in the forthcoming access arrangement period. In short, JGN says that for this reason, the unit rates are skewed on a ratio of 4:1 in favour or out-of-date, inaccurate (too low) cost information.

174 Further, JGN says that the AER made an error or errors of fact because no forecast or estimate which gives the newly contracted rates only 1:5 weight could be regarded as compliant with r 74. As outlined above, r 74 requires that a forecast or estimate must be arrived at on a reasonable basis and must represent the best forecast or estimate possible in the circumstances.

175 The AER says that in the circumstances, particularly where the JGN model had the problems outlined above, the AER considered it to be appropriate to calculate the unit rates using actual data between 2009-10 and 2013-14, the source and reliability of which it was able to identify. Relevantly, the AER contends that the difficulties associated with comparing the position under the contracts before 1 July 2013 and the position thereafter, in light of compositional differences between the contracts, supports its approach to ME capex.

176 Consequently, the AER says that its approach did not involve an incorrect exercise of its discretion in all the circumstances and did not involve a decision which was unreasonable in all the circumstances. It says that, in its view, it was provided by JGN with insufficient data to enable it to understand and audit the JGN AA Proposal or the data provided in response to its requests. As indicated above, the Tribunal has accepted the matters referred to in the immediately preceding sentence.

177 However, whilst accepting then that the AER was required itself to make an ME capex forecast, doing the best it could on the material available, it does not accept that the AER was entitled, in effect, to give no real weight to the acknowledged change in contractual arrangements after 1 July 2013, or that by doing so it would necessarily be obliged to accept the validity of the JGN model.

178 The RRP (s 24 of the NGL) require that:

(2) A service provider should be provided with a reasonable opportunity to recover at least the efficient costs the service provider incurs in –

(a) providing reference services; and

(b) complying with a regulatory obligation or requirement or making a regulatory payment.

[Emphasis added].

179 While there may be circumstances in which there may be one or more appropriate decisions concerning the efficiency of contract rates, in the present matter there are no competing economic efficiencies because the efficiency of the contract rates was, and had been, accepted by the AER as efficient. The inability of the AER to fully understand and audit JGN’s model, including the complementary or supplementary information provided, does not, in the Tribunal’s view, justify the use of a five year historical average where it was known (and accepted as prudent and efficient) that the contractual rates from 1 July 2013 were significantly higher. As noted above, the Tribunal does not accept that, in drawing that conclusion, it is a necessary consequence that the Tribunal has accepted that the JGN model, in all respects, is a materially preferable model. It is simply to say that, in the Tribunal’s view, the AER’s conclusion based upon historical average unit rates involves an error of fact, or alternatively an error in the exercise of a discretion which was both material and inappropriate, that the historical average unit rates were those likely to be incurred by JGN going forward into the next regulatory period.

180 In these circumstances, there was no basis for substituting a historical five-year average of contract rates. Consequently, the AER’s decision reveals unreasonableness.

181 The AER says that the consequence of accepting JGN’s claims is that it requires the Tribunal to accept the validity of the JGN model. We do not accept that position. In our view, it is not a necessary corollary that the JGN model is, in all respects, a materially preferable model.

182 It is appropriate to record at this stage that JGN submitted that the AER modified the JGN unit rates model in ways that JGN claimed introduced errors of logic and construction. If so, the model would potentially be unreasonable independently of the problems with the historical forecast of unit costs (although probably to an immaterial degree). On the basis of our findings in relation to the historical forecast of unit costs, it is not necessary to consider this matter further.

### Exclusion of certain categories of costs

183 In making the ME Capex Decision, the AER “corrected” JGN’s proposed ME capex forecast which included certain categories of costs by excluding them from its model on the basis that the additional costs associated with certain cost categories were already included in other cost components. JGN submits that the exclusion of each cost category constituted an error or errors of fact by the AER, and that the AER’s overall approach was unreasonable.

184 As indicated above, in the Final Decision the AER did not:

(1) include additional expenditure for MDLs, quoted works, “other costs”, CATS and I&C ME capex on the basis that the historical unit rates for ME capex included these costs;

(2) approve the re-classification of certain metering costs from opex to capex costs as it could not identify any offsetting negative adjustment in opex; or

(3) consider that a step increase was justified over the 5-year historical meter unit rate, as it considered that the historical average was lower and that JGN’s proposed purchase of the more expensive meter was not efficient.

185 In addition, in the Final Decision the AER did not include additional expenditure for non-routine connections on the basis that any additional capex costs for non-routine connections should be recovered from customers through capital contributions.

186 Due to the potentially limited evidence presented by JGN in support of its model and the focus by the parties on the AER’s ME capex forecast, the Tribunal is not currently in a position to consider the relative merits of the AER model and the JGN model.

# APPROPRIATE RELIEF

187 For reasons appearing elsewhere in this decision, the Tribunal proposes to set aside the JGN Final Decision. As addressed in the *PIAC-Ausgrid Decision*, and as discussed also later in these reasons for decision, the Tribunal does not consider it appropriate for the Tribunal to substitute a determination varying the determination of the AER in the JGN Final Decision on this topic. However, having regard to the obligation of the AER in reconsidering its Final Decision as imposed by s 28(1)(b)(iii) of the NGL, the Tribunal considers that it is appropriate for the AER to have the opportunity to reconsider its ME Capex Decision. It is likely that there will be further information available to it. It will also have to consider the interrelationships of the ME capex element of its revised reconsideration, as well as determining what decision will be the preferable designated reviewable regulatory decision.

188 The Tribunal notes that the intervener Ergon raised a discrete issue as to capex, related also to opex, and concerning the appropriate transition path. That was not a matter raised by JGN, In the view of the Tribunal, that is a matter which it is more appropriate for Ergon to raise when, and if, it is necessary to do so in relation to a Final Determination of the AER in relation to Ergon’s regulatory entitlements in respect of the current regulatory review period.

# CONCLUSION

189 JGN adopted the leave submissions of Networks NSW in relation to the legal principles applicable to the scope and application of grounds for review, noting that s 246 of the NGL provides substantially similar grounds for review as s 71C of the NEL.

190 It also provided additional submissions in reply to the AER in relation to departures from the NGR necessarily leading away from the achievement of the NEO or NGO and the AER’s regulatory discretion being significantly constrained such that non-compliance will invalidate the decision.

191 The Tribunal has discussed in the concluding section of the *PIAC-Ausgrid Decision* the way in which the AER approached its task under s 16(1)(d) of the NEL. Not surprisingly, it adopted the same approach in relation to s 28(1)(b) of the NGL. For much the same reasons as expressed in the *PIAC-Ausgrid Decision*, the Tribunal has reached the view that the JGN Final Decision should be set aside having regard to the grounds of review which have been established, and the matter remitted to the AER for reconsideration in accordance with these reasons for decision. The Tribunal’s reasons for setting aside the JGN Final Decision, in a sense, at large rather than specific to particular matters where grounds of review have been made out are, in essence, the same in this matter.

192 Section 259(4a) and (4b) are the relevant provisions of the NGL. The Tribunal may only set aside the JGN Final Decision, having found a ground or grounds of review made out, if it is satisfied that to do so will, or is likely to, result in a materially preferable designated NGO decision. The matters which the Tribunal is required to address before reaching such a conclusion are set out in s 259(4b) in terms which are materially the same as s 71P(3a) and (3b) of the NEL.

193 It is not necessary to repeat what is set out in the *PIAC-Ausgrid Decision* concerning the background to the 2013 Legislative Amendments insofar as they relate to the NGL.

194 As the other Network Applicants did, JGN first argued that the correction of the errors established by the grounds of review which have been made out would lead to a materially preferable designated NGO decision. That is because each of the identified errors may lead to JGN being allowed less than the amount of revenue required to support efficient investment in, and efficient operation and use of, natural gas services for the long term interests of consumers. In its submission, JGN did not simply assert the revenue shortfall of itself as giving rise to that conclusion, but it sought to identify a number of adverse practical consequences for consumers as a result of those errors. It is, of course, necessary to take that view because s 259(4a)(d)(i)-(iii) means that the making out of a ground of review or the demonstration that the ground of review exceeds the amount specified in s 249(2) of the NGL does not in itself resolve favourably to the Network Applicants that the correction of the error will of itself lead to a materially preferable designated NGO decision. In that context, to describe an error as a “material error” is not of itself particularly helpful.

195 The Tribunal does not therefore accept routinely that a “material error” will lead a regulated business to recovering less (or more) than the efficient costs of supplying regulated services, and therefore will lead – if corrected – to a materially preferable designated NGO decision. To that extent, it does not accept that the expert report of Mr Geoff Swier: *Economic Considerations for the Interpretation of the National Gas Objective*, 23 May 2014 (appended to the JGN AA Proposal), should be accepted. There is no real qualitative assessment of the consequences of the “material error” in the estimation of building blocks component which that text proposes.

196 However, having regard to the judgment which the Tribunal is required to make, it is satisfied that the consequence of the grounds of review which have been made out, if not corrected, may significantly and adversely affect the long term interests of consumers both because the consequences may well mean that the determination reflected in the JGN Final Decision by the AER will result in a level of revenue which in the immediate to longer term may impair the provision of safe, secure and efficient gas to consumers below an acceptable standard to consumers, and in this instance also because the longer term cost implications to consumers of the present AER Final Decision may well also result in significant increments in prices to consumers in the immediate to longer term future, particularly in relation to the allowance for ME capex. It considers that the tension between the price relief which consumers of gas obviously seek on the one hand, and the needs of future consumers both in relation to price and in relation to the maintenance and provision of a safe, secure, efficient and reliable network is likely to be more satisfactorily resolved, and therefore to lead to a materially preferable designated NGO decision, if the Final Decision is set aside and the matter remitted to the AER for further consideration. It is also obvious, having regard to the errors which the established grounds of review demonstrate, that the complexity of the task involved in a reconsideration is such that it is not appropriate for the Tribunal itself to vary the Final Decision.

197 It is desirable to make some additional comments explaining why, in the case of JGN, the view has been reached that it is appropriate to set aside the Final Decision and to remit the matter to the AER for reconsideration.

198 It is the composition of the grounds of review which the Tribunal has found to be established in relation to the JGN Final Decision which have satisfied the Tribunal that it is appropriate to set aside the AER Final Decision concerning JGN and to remit the matter to the AER for further consideration. JGN operates in an environment, and under a price cap, where fewer customers results in lower revenues, other things being equal, because natural gas is in competition with alternative energy sources, including electricity. An ME capex which did not enable it to effectively invest in new connections would not only result in the loss of opportunity to consumers to take up new connections at an economic level, but in the longer term may result in higher prices for the services to existing consumers. The more consumers, and therefore the more new customers to its network, the more there would be downward pressure on network prices through increased utilisation of the shared network. Consequently, in this instance, there are real potential net benefits for consumers by a revised ME capex forecast, if ultimately the AER determines that to be appropriate, quite apart from issues concerning the quality, safety and reliability of the supply of natural gas.

199 There is a real risk, therefore, that the level allowed for ME capex, subject to the AER’s reconsideration, may increase price volatility, particularly for longer term consumers as well as reducing service levels, and in turn lowering demand.

200 JGN has estimated the extent of the amount it claims to recover as a return on debt, if its transitional proposal were to be accepted, to be very significant. Both JGN and the AER in final submissions handed up tables estimating the revenue outcomes by topic, without relationships, of such adjustments. It is difficult precisely to compare those tables because the AER table identifies the consequences for JGN (if its claimed position is restored) in relation to return on debt under three alternative options which do not directly correlate with those provided by JGN. It is sufficient to observe that the amount involved is very substantial. In the case of the adjustment for gamma, although the amount is slightly different, both accept that the alteration would be in excess of $13m. In the case of the ME capex adjustment, both tables identify the amount of the adjustment as $8.4m. The amounts are sufficient, overall, to support the conclusion of the Tribunal as to the vulnerability of JGN, in respect of the grounds of review which have been made out, that the reduced level of revenue of which it complains are such as to expose the longer term interests of consumers to unacceptable risks.

201 As in other matters, it is of course for the AER upon reconsideration, and in the light of s 28(1)(b)(iii) of the NGL to determine the appropriate outcome in a reconsidered Final Decision.

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| I certify that the preceding two hundred and one (201) numbered paragraphs are a true copy of the Reasons for Decision herein of the Honourable Justice Mansfield, Mr R Davey and Dr D Abraham. |

Associate:

Dated: 3 March 2016