AUSTRALIAN COMPETITION TRIBUNAL

Application by Ergon Energy Corporation Limited

(Non-system property capital expenditure) (No 4) [2010] ACompT 12

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| Citation: | | Application by Ergon Energy Corporation Limited  (Non-system property capital expenditure) (No 4)  [2010] ACompT 12 |
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| Appeal from: | | Australian Energy Regulator |
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| Parties: | | **Ergon Energy Corporation Limited (ACN 087 646 062)** |
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| File number: | |  |
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| Members: | | **(DEPUTY PRESIDENT),**  **MR R DAVEY AND MR R SHOGREN** |
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| Date of decision: | | 24 December 2010 |
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| Counsel for Australian Energy Regulator: | Mr P Hanks QC with Mr Gray, Mr T Clarke and  Mr L Merrick | |
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| IN THE AUSTRALIAN COMPETITION TRIBUNAL |  |
|  | FILE NO |

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| RE: | APPLICATION UNDER SECTION 71B OF THE NATIONAL ELECTRICITY LAW FOR A REVIEW OF A DISTRIBUTION DETERMINATION MADE BY THE AUSTRALIAN ENERGY REGULATOR IN RELATION TO ERGON ENERGY CORPORATION LIMITED PURSUANT TO RULE 6.11.1 OF THE NATIONAL ELECTRICITY RULES |
| BY: | ERGON ENERGY CORPORATION LIMITED  (ACN 087 646 062) |

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| MEMBERS: | MIDDLETON J (DEPUTY PRESIDENT),  MR R DAVEY AND MR R SHOGREN |
| DATE: | 24 DECEMBER 2010 |
| PLACE: |  |

**REASONS FOR DECISION:**

**NON-SYSTEM PROPERTY CAPITAL EXPENDITURE**

# INTRODUCTION

1. These reasons deal with the non-system property capital expenditure (‘capex’). The expressions employed in these reasons are the same as employed in earlier decisions the subject of the current review.
2. In its Regulatory Proposal, Ergon Energy proposed a total forecast of $266 million for non-system property capex for the next regulatory control period.
3. In the Draft Decision, the AER noted that Ergon Energy had not provided business case documentation or other supporting documentation for the major construction projects included in its proposed non-system property capex. The AER concluded that Ergon Energy had not adequately demonstrated the prudence and efficiency of the program of proposed building works – for example, through a clear exposition of the consideration of options, prioritisation of projects or cost–benefit analysis underpinning the proposed program. The AER proposed to allow Ergon Energy an amount of non-system property capex which reflected a “business as usual” approach, based on the removal from the capex proposal of costs associated with the major building projects.
4. In its Revised Regulatory Proposal, Ergon Energy proposed a revised forecast of $263.8 million for non-system property capex. Together with its Revised Regulatory Proposal, Ergon Energy submitted assessment reports and business cases to the AER in relation to non-system property capex proposals for sites at Townsville, Cairns, Hervey Bay, Maryborough, Rockhampton and Mackay.
5. In the Final Decision, the AER concluded that Ergon Energy had demonstrated that its proposed capex for the Cairns, Hervey Bay, Maryborough and Mackay projects was prudent and efficient, but that it had not demonstrated that the proposed capex for the Townsville and Rockhampton projects was prudent and efficient. The AER therefore removed the proposed cost of the Townsville and Rockhampton projects from Ergon Energy’s proposed non-system capex forecast.
6. The grounds of review advanced by Ergon Energy relate to the AER’s refusal to accept Ergon Energy’s capex proposals for the Townsville and Rockhampton projects.
7. The AER acknowledged that it erred in exercising its discretion under cl 6.12.3 of the Rules by not allowing any capex in respect of the Townsville and Rockhampton projects.
8. The AER accepted that, to fulfil the requirements of cl 6.12.3(f)(1) and (2) of the Rules, it should have arrived at a substitute value for Ergon Energy’s non-system property capex requirement by allowing the cost of the “business-as-usual” proposal advanced in Ergon Energy’s business case analyses for those two sites.
9. Accordingly, the AER submitted that the appropriate order for the Tribunal to make was to vary the amount of Ergon Energy’s capex requirement in the Final Decision by including the value of Ergon Energy’s “business-as-usual” proposals for those two sites.
10. The AER maintained that its decision not to accept the full amount of Ergon Energy’s forecast non-system property capex requirements for the Townsville and Rockhampton sites was not affected by error.

# THE STATUTORY BACKGROUND

1. Clause 6.5.7(a) of the Rules requires a distribution network service provider (‘DNSP’) to include in its building block proposal a forecast of its total capex for the forthcoming regulatory control period:

*A* building block proposal *must include the total forecast capital expenditure for the relevant* regulatory control period *which the* Distribution Network Service Provider *considers is required in order to achieve each of the following (the* capital expenditure objectives*):*

*(1) meet or manage the expected demand for* standard control services *over that period;*

*(2) comply with all applicable* regulatory obligations or requirements *associated with the provision of* standard control services*;*

*(3) maintain the quality, reliability and security of supply of* standard control services*;*

*(4) maintain the reliability, safety and security of the* distribution system *through the supply of* standard control services*.*

1. Clause 6.12.1(3) of the Rules provides that a distribution determination shall include a constituent decision in relation to the forecast capex included in a building block proposal (‘the capex constituent decision’):

*A distribution determination is predicated on the following decisions by the* AER *(*constituent decisions*):*

*…*

*(3) a decision in which the* AER *either:*

*(i) acting in accordance with clause 6.5.7(c), accepts the total of the forecast capital expenditure for the* regulatory control period *that is included in the current* building block proposal*; or*

*(ii) acting in accordance with clause 6.5.7(d), does not accept the total of the forecast capital expenditure for the* regulatory control period *that is included in the current* building block proposal*, in which case the* AER *must set out its reasons for that decision and an estimate of the total of the* Distribution Network Service Provider’s *required capital expenditure for the* regulatory control period *that the* AER *is satisfied reasonably reflects the* capital expenditure criteria*, taking into account the* capital expenditure factors*;*

1. In the event that the AER decides not to accept the forecast capex amount proposed by a DNSP, the capex constituent decision comprises two limbs, namely:
2. the AER’s decision not to accept the amount proposed by the DNSP; and
3. the AER’s decision as to the appropriate substitute value.
4. Clause 6.5.7(c)-(e) of the Rules governs the first limb of the capex constituent decision (identified above):

*(c) The* AER *must accept the forecast of required capital expenditure of a* Distribution Network Service Provider *that is included in a* building block proposal *if the* AER *is satisfied that the total of the forecast capital expenditure for the* regulatory control period *reasonably reflects:*

*(1) the efficient costs of achieving the* capital expenditure objectives*; and*

*(2) the costs that a prudent operator in the circumstances of the relevant* Distribution Network Service Provider *would require to achieve the* capital expenditure objectives*; and*

*(3) a realistic expectation of the demand forecast and cost inputs required to achieve the* capital expenditure objectives*.*

*(the capital expenditure criteria)*

*(d) If the* AER *is not satisfied as referred to in paragraph (c), it must not accept the forecast of required capital expenditure of a* Distribution Network Service Provider*.*

*(e) In deciding whether or not the* AER *is satisfied as referred to in paragraph (c), the* AER *must have regard to the following (‘the* capital expenditure factors*’):*

*(1) the information included in or accompanying the* building block proposal*;*

*(2) submissions received in the course of consulting on the* building block proposal*;*

*(3) analysis undertaken by or for the* AER *and* published *before the distribution determination is made in its final form;*

*…*

*(5) the actual and expected capital expenditure of the* Distribution Network Service Provider *during any preceding* regulatory control periods*;*

*…*

1. In the event that the AER refuses to approve the amount of capex proposed by a DNSP, in relation to the second limb of the capex constituent decision (identified above) cl 6.12.3(f) of the Rules provides:

*If the* AER *refuses to approve an amount or value referred to in clause 6.12.1, the substitute amount or value on which the distribution determination is based must be:*

*(1) determined on the basis of the current* regulatory proposal*; and*

*(2) amended from that basis only to the extent necessary to enable it to be approved in accordance with the* Rules*.*

1. The grounds advanced by Ergon Energy focused attention on the capex criteria under cl 6.5.7(c) of the Rules.
2. The Tribunal accepts that there is no one correct answer to the question of what are the “efficient”, “prudent” and “realistic” costs of achieving a DNSP’s capex objectives, since there is no single objective question. Rather, the terms used in cl 6.5.7(c) of the Rules call for evaluation of the particular situation. Moreover, what are “efficient costs” and what is “prudent” are abstract concepts. Making an evaluation as to what are efficient costs and what costs are prudently incurred requires the decision-maker to undertake a process of assessment by reference to relevant considerations, factors or criteria.

# PROPOSED CAPEX FOR TOWNSVILLE AND ROCKHAMPTON

1. The AER concluded that Ergon Energy had not demonstrated that the proposed capex for the Townsville and Rockhampton projects was prudent and efficient, because:
2. the dollars per weighted ‘key result areas’ (‘KRAs’) point scores for Townsville and Rockhampton were significantly higher than the scores for the other four sites, which was taken to indicate that there was a substantially higher cost of achieving non-financial benefits at the Townsville and Rockhampton sites;
3. the results of Ergon Energy’s business case analyses for Townsville and Rockhampton were sensitive to the assumed weighting between financial and non-financial criteria; and
4. Ergon Energy had not considered any alternative development proposals for those two sites, other than “Scenario 2” and the business-as-usual scenario referred to in the business cases.
5. To justify its proposed capex for each of the six major projects, Ergon Energy prepared case studies that compared a “business-as-usual” or “incremental development” proposal (referred to as ‘Scenario 1’) with a “transformational development” proposal (referred to as ‘Scenario 2’) for each site. Ergon Energy attributed a score for the “comparative commercial performance” for each scenario assessed on a discounted cash flow basis. The case studies also attributed a score for the non-financial performance for each scenario. This score was broken down among various KRAs. Based on the scores given to each scenario for each site by Ergon Energy, and the relative weightings for the commercial and non-financial KRAs that Ergon Energy applied (40% for commercial performance and 60% for non-financial performance), the outcome of each case study was that Scenario 2 achieved a higher overall score.
6. One of the criticisms that Ergon Energy advanced is that the AER’s approach of comparing the implied dollar value of non-financial benefits across the six major projects was irrational because the non-financial benefits differed significantly from project to project, and the scores given by the business case analyses for each site were not comparable between sites.
7. The AER noted that Ergon Energy applied different quantitative scales for the commercial performance parameter in each business case.
8. The AER accepted that, because Ergon Energy has derived an overall KRA score by adding the financial and non-financial KRA score, it must therefore follow that the implied scale that Ergon Energy applied to the non-financial criteria must also have differed from one business case study to the next.
9. The AER therefore accepted that the KRA scores (for both commercial performance and non-financial criteria) produced by Ergon Energy’s business cases were not objectively comparable across the six projects. Accordingly, the dollars per weighted non-financial KRA point comparison that the AER referred to in its Final Determination did not provide an objectively consistent comparison of relative cost-efficiency across the six projects.
10. The AER noted that Ergon Energy purported to rely on the business case analyses for the purpose of its own prioritisation of the six major non-system property projects. In light of the idiosyncratic scaling that Ergon Energy adopted for each of its business cases, the AER did not understand how the business cases could meaningfully have been used for that purpose.
11. Accepting that Ergon Energy’s business cases only enable a comparison to be made between the business-as-usual scenario and Scenario 2 for each site, the AER therefore sought to assess the relative cost-efficiency of the alternative proposals for each site by calculating the implied cost (on the dollars per non-financial weighted KRA point measure) of obtaining the non-financial benefits assessed by Ergon Energy for each scenario individually. That analysis produced the following results:

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|  | **Dollars ($m) per weighted non-financial KRA point** | |
|  | **Business-as-usual** | **Scenario 2** |
| Townsville | 0.21 | 4.45 |
| Cairns | -3.32 | -0.80 |
| Hervey Bay | -1.36 | 1.13 |
| Maryborough | 1.24 | 2.90 |
| Rockhampton | 1.03 | 6.45 |
| Mackay | 13.77 | 1.94 |

1. The AER noted that, for both the Townsville and Rockhampton sites, the implied cost of obtaining an additional KRA point was very significantly higher for Scenario 2 than for the business-as-usual scenario. Accordingly, the above results were said to confirm the conclusion that the AER arrived at in the Final Determination, namely, that Ergon Energy had not demonstrated that its capex proposals for Townsville and Rockhampton were efficient.
2. Therefore, it was submitted by the AER that even though Ergon Energy’s business cases did not provide a proper basis for the dollars per weighted KRA point comparison between projects that the AER relied on in the Final Determination, the AER was nonetheless correct in determining that the capex proposed by Ergon Energy for the Townsville and Rockhampton sites was not efficient, and did not therefore reasonably reflect the capex criteria.
3. The AER did note that the analysis above indicated that Ergon Energy’s preferred redevelopment proposals for Cairns, Hervey Bay and Maryborough were also less cost-efficient than the business-as-usual scenarios for those sites.
4. The table referred to above was relied upon by the AER because of the divergence between business-as-usual and Scenario 2, in respect of Townsville and Rockhampton. It has been assumed by both Ergon Energy and the AER that the business-as-usual case and Scenario 2 both achieved capex objectives.
5. The only question left to the Tribunal to decide (accepting as it does that the AER made a reviewable error) is how to vary the determination.
6. As already indicated, cl 6.12.3(f) requires that, once the AER has refused to approve the amount of the forecast capex provided in a DNSP’s building block proposal, it must determine a substitute value for capex that is:
   * + 1. determined on the basis of the current regulatory proposal; and
       2. amended from that basis only to the extent necessary to enable it to be approved in accordance with the Rules.
7. Accordingly, the substitute value for capex determined by the AER was required to be determined on the basis of Ergon Energy’s current regulatory proposal and amended from that basis only to the extent necessary for the AER to be satisfied that the substitute amount of capex reasonably reflects the capex criteria, taking into account the capex factors.
8. The AER accepted that, having acknowledged in the Final Determination that it would be prudent for Ergon Energy to address the safety and capacity issues identified in the site assessment reports for Townsville and Rockhampton, Ergon Energy’s non-system property capex allowance would satisfy the capex criteria if that amount reasonably reflected the efficient costs of addressing the safety and capacity issues for those sites.
9. The business case analyses for the Townsville and Rockhampton sites that Ergon Energy submitted with its Revised Regulatory Proposal did consider a business-as-usual scenario as an alternative means of “address[ing] the identified problem” at each site.
10. The AER submitted that it would have exercised its discretion correctly in the Final Determination if it had allowed the capex associated with Ergon Energy’s business-as-usual proposals for the Townsville and Rockhampton sites. This was then the approach pressed upon the Tribunal.
11. However, it is now for the Tribunal to determine the appropriate non-system property capex. If necessary the Tribunal can consider new information and material – see s 71R(3) of the NEL.
12. Whilst the Tribunal is confined by the NEL and the Rules in making its determination, this is subject to the role the Tribunal has under the NEL.
13. Under the NEL, the Tribunal may perform all the functions and exercise all the powers of the AER under the NEL or the Rules - see s 71P(3) of the NEL. However, in addition, the Tribunal has its own functions to perform and powers to exercise – eg see s 71P(1), (2) and s 71R(3) of the NEL.
14. The materials before the Tribunal in the form of the business case analyses and property strategy, in addition to indicating future proposals for development, show substantial differences and staff levels between each site. The Tribunal is satisfied that such material explains the divergence in the analysis of figures relied upon by the AER and referred to in [25] above.
15. The Townsville and Rockhampton projects involve transformational development, including large scale redevelopment of core property assets to enable a rationalisation of locations, building assets and workplace interfaces. For instance:
    * + 1. the Townsville project involves commencing development of the Ingham Rd site, a greenfield site which will house 550 staff once the development is complete; and
        2. the Rockhampton project involves progressive redevelopment of 10.3 hectares of the Glenmore Rd depot site which will grow from 170 to 370 staff over the regulatory control period.
16. This may be contrasted with the Cairns project which only involves construction of a warehouse and associated external works at Swallow Rd during this regulatory period.
17. There are other reasons why the cost of achieving non-financial benefits for some projects will necessarily exceed the average cost of achieving those benefits over all projects. The cost of building a staff amenity in the Brisbane CBD may be higher than building an identical staff amenity in Rockhampton. In both cases, the non-financial benefits may be identical, but the Brisbane project will have a higher cost per weighted KRA index point. It does not follow that the Brisbane project is inefficient simply because its benefits are more costly to realise.
18. It is also not correct to assume that a project is less cost efficient because it has a higher cost of generating a weighted KRA index point. For a network such as Ergon Energy's, this is not a logical or reasonable conclusion. Ergon Energy was created in 1999 through the merger of six separate Queensland electricity corporations. Its network coverage extends over 1,698,100 square kilometres and includes such geographically disparate regions as Far North Queensland, North Queensland, Mackay, Capricornia, Wide Bay and South West. In such a network, it is not logical to compare a proposal to build a warehouse in rural Queensland with a proposal to build an identical warehouse in an urban area. A project in the rural area may be less costly than one in an urban area in all circumstances. This does not mean that the proposal in the urban area is not efficient.
19. Therefore, the Tribunal does not accept that the AER’s approach necessarily indicates that the estimates put forward by Ergon Energy in relation to Townsville and Rockhampton are inappropriate. It is to be recalled that the AER regarded Ergon Energy’s approach in considering other sites or projects as reasonable and accepted that Ergon Energy had demonstrated that its proposed capex was prudent and efficient. Based upon the methodology (including the reliance on the KRAs) accepted by all parties, the Tribunal sees no justification for taking a different approach between Townsville and Rockhampton on the one hand and the other major sites or projects on the other.
20. The Tribunal makes a further observation. The parties have accepted the KRA methodology for the purposes of this review. The Tribunal is prepared to adopt this methodology in this review. However, the Tribunal should not be seen as necessarily endorsing this methodology as being appropriate to demonstrate a proposed capex for a particular site or project is prudent and efficient.

# CONCLUSION

1. Therefore, the Tribunal will not vary the decision as suggested by the AER in allowing the amount of expenditure required for the “business as usual” proposal for each of the Townsville and Rockhampton sites.
2. However, it is not yet satisfied that the proper way to proceed is to make the variation suggested by Ergon Energy by increasing the non-system property component of capex by Ergon Energy’s estimate of the cost of projects planned in Townsville and Rockhampton.
3. The Tribunal would be assisted by a short written submission by the AER on whether (in light of the above reasons and the submissions made by Ergon Energy during the hearing) the Tribunal should accept the estimate of Ergon Energy, or whether further information or material as to the estimates should be sought prior to the Tribunal making a final decision.
4. If the AER does not consider the Tribunal should accede to Ergon Energy’s estimates then a short directions hearing may need to be convened to consider the further disposition of this issue.
5. The Tribunal directs that the parties confer and notify the Tribunal as to their joint or respective positions no later than 4:00pm on Monday 31 January 2011.

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| I certify that the preceding fifty (50) numbered paragraphs are a true copy of the Reasons for Decision herein of the Honourable Justice Middleton (Deputy President), RC Davey and RF Shogren. |

Associate:

Dated: 23 December 2010