AUSTRALIAN COMPETITION TRIBUNAL

Application by Envestra Limited (No 2) [2012] ACompT 4

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| Citation: | Application by Envestra Limited (No 2) [2012] ACompT 4 |
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| Review from: | Australian Energy Regulator |
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| Parties: | **ENVESTRA LIMITED****(ABN 19 078 551 685)** |
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| File number: | ACT 6 of 2011 |
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| Tribunal: | **MANSFIELD J (PRESIDENT)****MR R DAVEY****PROFESSOR D ROUND** |
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| Date of decision: | 11 January 2012  |
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| Catchwords | **APPLICATION UNDER S 245 NATIONAL GAS LAW** – review of full access arrangement decision of Australian Energy Regulator – whether building blocks of allowable revenue correctly determined(1) Debt risk premium – reliability of fair value curve – whether regulator tested fair value curve appropriately – whether all relevant material considered – where fair value curve estimate averaged with single bond – whether averaging process erroneous(2) Market risk premium – variation from previously used value – whether arithmetic or geometric mean of historical excess returns is accurate – whether any reviewable error made out |
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| IN THE AUSTRALIAN COMPETITION TRIBUNAL |  |
|  | ACT 6 OF 2011 |

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| RE: | APPLICATION UNDER SECTION 245 OF THE NATIONAL GAS LAW FOR A REVIEW OF AN ACCESS ARRANGEMENT DECISION MADE BY THE AUSTRALIAN ENERGY REGULATOR IN RELATION TO ENVESTRA LIMITED PURSUANT TO RULE 64 OF PART 8 OF THE NATIONAL GAS RULES |
| BY: | ENVESTRA LIMITED(ABN 19 078 551 685)Applicant |

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| tribunal: | mansfield j (president)mr r daveyprofessor d round |
| DATE OF ORDER: | 11 January 2012  |
| WHERE MADE: | ADELAIDE (VIA VIDEO LINK WITH MELBOURNE AND BRISBANE) |

THE TRIBUNAL DETERMINES AND ORDERS PURSUANT TO S 259(2) OF THE NATIONAL GAS LAW:

1. That the decision of the Australian Energy Regulator entitled *Decision Access Arrangement Envestra Ltd’s Queensland gas distribution network 8 July 2011 – 30 June 2016* and dated 20 July 2011 and reflecting the reasons for decision in the *Final Decision Envestra Ltd Access arrangement proposal for the Qld gas network 1 July 2011 – 30 June 2016* be varied by replacing the figure 3.81% for the debt risk premium therein for the purposes of calculating the cost of debt with the figure 4.67%.
2. That, in relation to the market risk premium for the purposes of calculating the cost of equity, as determined in the said decision, the said decision be affirmed.

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| IN australian competition tribunal |  |
|  | act 6 of 2011 |

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| RE: | APPLICATION UNDER SECTION 245 OF THE NATIONAL GAS LAW FOR A REVIEW OF AN ACCESS ARRANGEMENT DECISION MADE BY THE AUSTRALIAN ENERGY REGULATOR IN RELATION TO ENVESTRA LIMITED PURSUANT TO RULE 64 OF PART 8 OF THE NATIONAL GAS RULES |
| BY: | ENVESTRA LIMITED(ABN 19 078 551 685)Applicant |

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| tribunal: | mansfield j (president)mr r daveyprofessor d round |
| DATE: | 11 JANUARY 2012 |
| PLACE: | ADELAIDE (VIA VIDEO LINK WITH MELBOURNE AND BRISBANE) |

**REASONS FOR DECISION**

# background

1. This matter was heard together with a review application by APT Allgas Energy Limited concerning a reviewable regulatory decision by the AER about the terms of access to its Queensland gas distribution network. It was also heard together with a review application by Envestra Limited concerning a reviewable regulatory decision by the AER about the terms of access to its South Australian gas distribution network. The Tribunal has published decisions on each of those review applications at the same time as this decision: *Application by Envestra Ltd (No 2)* [2012] ACompT 3; *Application by APT Allgas Energy Pty Limited (No 2)* [2012] ACompT 5.
2. These reasons for decision largely mirror the reasons for decision in the other matters, so far as they concern the Debt Risk Premium (DRP) issue and the Market Risk Premium (MRP) issue because, in essence, the issues and arguments were much the same. As the applications concerned different gas distribution networks and, in one case, a different applicant, the Tribunal considered it appropriate to adopt the course of delivering separate reasons for decision as well as, of course, making separate orders in each matter.
3. Envestra Limited (Envestra) owns approximately 21,000 kilometres of natural gas distribution networks, serving over one million consumers in South Australia, Victoria, Queensland, New South Wales and the Northern Territory. Envestra’s Queensland natural gas distribution network, to which this application for review relates, comprises 2,375 kilometres of pipeline delivering gas to approximately 84,000 customers in Brisbane, Ipswich, Gladstone and Rockhampton.
4. On 8 July 2011, Envestra made an application under section 245 of the *National Gas (Queensland) Law* (NGL) for leave to apply to the Australian Competition Tribunal (Tribunal) for review of an applicable access arrangement decision made by the Australian Energy Regulator (AER) entitled *Decision Access Arrangement Envestra Ltd’s Queensland gas distribution network 8 July 2011 – 30 June 2016* and dated July 2011 (Access Arrangement Decision), being a reviewable regulatory decision. That decision was in respect of its Queensland gas distribution network (Application for Review).
5. The reasons for the Access Arrangement Decision were set out in the access arrangement final decision entitled *Final decision Envestra Ltd Access arrangement proposal for the Qld gas network 1 July 2011 – 30 June 2016*, June 2011(Final Decision).
6. Envestra applied for leave to apply to the Tribunal for a review of the Final Decision to the extent the Final Decision is considered to be the reviewable regulatory decision. On 12 October 2011, in *Application by Envestra Limited* [2011] ACompT 12, the Tribunal granted Envestra leave to apply to the Tribunal for a review of the Access Arrangement Decision (read together with the reasons for the Access Arrangement Decision contained in the Final Decision) in respect of the following matters:
7. the decision by the AER, in determining the rate of return pursuant to Rule 87 of the National Gas Rules, to apply a value for the DRP of 3.81%; and
8. the decision by the AER, in determining the rate of return pursuant to Rule 87 of the National Gas Rules, to apply a value for the MRP of 6%.

# statutory scheme

1. Section 7 of the *National Gas (Queensland) Act 2008* (Qld) (Act) applies the NGL, set out in the Schedule to the Act, as a law of Queensland.
2. Section 26 of the NGL gives the National Gas Rules (NGR) the force of law in Queensland.
3. Envestra is a “service provider” within the meaning of section 8 of the NGL, in that it owns, controls or operates a scheme pipeline. The NGL defines “scheme pipeline” to include a “covered pipeline”. Envestra’s Queensland gas distribution network is a “covered pipeline” within the meaning of the NGL.
4. The AER is responsible for the economic regulation of pipeline services provided by service providers, including Envestra, by means of or in connection with a scheme pipeline. In particular, under Part 9 of the NGR, the AER is responsible for determining the total revenue for Envestra for each regulatory year of an access arrangement period for the provision by Envestra of reference services in Queensland.
5. Under Rule 52 of the NGR, Envestra was required to submit and, on 1 October 2010, did submit an access arrangement revision proposal for the access arrangement period from 1 July 2011 to 30 June 2016 to the AER for consideration in accordance with the NGR (Envestra’s Access Arrangement Proposal).
6. Under Rule 59 of the NGR, the AER was required to make, and did make, an access arrangement draft decision in relation to Envestra’s Access Arrangement Proposal entitled *Draft Decision Envestra Ltd Access arrangement proposal for the Qld gas network 1 July 2011 – 30 June 2016,* February 2011 (Draft Decision).
7. Rule 60 of the NGR entitled Envestra to submit additions or other amendments to Envestra’s Access Arrangement Proposal to address the matters raised in the Draft Decision. The amendments which Envestra was permitted to make were limited to those amendments necessary to address matters raised by the AER in the Draft Decision, unless the AER approved further amendments: NGR r 60(2).
8. On 24 March 2011, Envestra submitted a revised access arrangement proposal to the AER (Envestra’s Revised Access Arrangement Proposal).
9. Pursuant to Rule 62 of the NGR, the AER was required to make an access arrangement final decision in relation to Envestra’s Revised Access Arrangement Proposal. Rule 62 of the NGR provides that an access arrangement final decision is a decision to approve, or refuse to approve an access arrangement proposal.
10. On 17 June 2011, the AER published the Final Decision. In the Final Decision, the AER refused to approve Envestra’s Revised Access Arrangement Proposal and indicated it would publish its own revised access arrangement and access arrangement information.
11. Pursuant to Rule 64(4) of the NGR the AER decided to approve the access arrangement (including the access arrangement information) drafted by it for Envestra’s Qld gas distribution network. That decision is set out in the Access Arrangement Decision.
12. Under section 245 of the NGL, an affected or interested person or body, with the leave of the Tribunal, may apply to the Tribunal for a review of a reviewable regulatory decision.
13. An “affected or interested person or body” (as defined in section 244 of the NGL) includes a service provider to whom a reviewable regulatory decision applies. Envestra is the service provider to whom the reviewable regulatory decision, namely, the Access Arrangement Decision, applies and is therefore an “affected or interested person or body” within the meaning of section 244.
14. The NGL provides that a reviewable regulatory decision includes an applicable access arrangement decision, subject to the exception that a full access arrangement decision that does not approve a full access arrangement is not a reviewable regulatory decision: NGL s 244.
15. An applicable access arrangement decision includes a full access arrangement decision. A full access arrangement decision includes a decision of the AER under the NGR that:
16. approves or does not approve a full access arrangement proposal or revisions to an applicable access arrangement submitted to the AER under section 132 of the NGL or the NGR; or
17. makes a full access arrangement in place of a full access arrangement proposal which the AER does not approve in that decision.
18. The Access Arrangement Decision is a reviewable regulatory decision within the meaning of section 244 of the NGL because the Access Arrangement Decision is a full access arrangement decision in which the AER made a full access arrangement in place of a full access arrangement proposal which the AER did not approve in that decision.

# GROUNDS for REVIEW

1. Subsection 246(1) of the NGL provides that applications for review under section 245(1) may only be made on the following grounds:
2. 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;
3. the original decision maker made more than one 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;
4. the exercise of the original decision maker’s discretion was incorrect, having regard to all the circumstances;
5. the original decision maker’s decision was unreasonable, having regard to all the circumstances.
6. Senior counsel for the AER made extensive submissions about the circumstances in which one or more of the grounds of review may be made out. The onus of making out a ground of review rests upon Envestra.
7. As the Tribunal has previously recognised, the Tribunal’s task is not simply to substitute for a decision of the AER a decision which the Tribunal may prefer to make on the material before the AER, that is, on the review related material as determined in accordance with s 261: see *Application by ElectraNet Pty Limited (No 3)* [2008] ACompT 3 (*ElectraNet (No 3)*) at [64] and [69]; *Application by Energy Australia* [2009] ACompT 8 (*Energy Australia*) at [70]. So much follows from the terms of s 246(2) as explained in *Australian Competition and Consumer Commission v Australian Competition Tribunal* (2006) 152 FCR 33 (*ACCC v ACT*) per French, Goldberg and Finkelstein JJ at [176], a decision concerning the grounds of review under s 39(2)(a) of the Gas Pipelines Access Law established under the *Gas Pipeline Access (South Australia) Act 1997* (SA). Those grounds of review are not materially different from those expressed in s 246(1) of the NGL.
8. The Tribunal in this matter remains mindful of its role as explained in *ACCC v ACT*. It is also mindful that Envestra is not permitted to raise any matter not raised before the AER: s 258 of the NGL.
9. The lengthy and helpful oral and written submissions of the AER on the scope of the available grounds of review, at least initially, were made on a general level. The Tribunal’s observations that follow in relation to those submissions made below must also be seen in that context. They are made to acknowledge these submissions and to add some comments of the Tribunal. However, they must not be taken as the Tribunal’s concluded views on matters concerning the scope or application of s 246(1) remote from the particular circumstances of this application. Each application for review must be considered on its own merits. Ultimately, it is for the Tribunal to identify any particular matter in respect of which Envestra has asserted reviewable error, and the Tribunal must be persuaded that the error is one which is reviewable in terms of s 246(1). That is the Tribunal’s task in this matter, as in like matters where the grounds of review are so confined.
10. However, as indicated, before embarking on that task, the Tribunal makes the following comments on the AER’s more general submissions.

### Error of fact

1. It is clear that findings of fact may concern the existence of a present or historical fact, being an event or circumstance. There is also some support for the proposition that an opinion about the existence of a future fact or circumstance, as well as opinions formed by the AER based upon approaches to the assessment of facts or methodologies which it has chosen to apply may also constitute findings of fact: *ACCC v ACT* at [171]; *ElectraNet No 3* at [67].
2. The inclusion of opinions about the existence of future facts within the meaning of “fact” is the subject of some controversy between the parties. In Application by ActewAGL Distribution [2010] ACompT 4 (ActewAGL) the Tribunal said that the inclusion of opinions in the meaning of “fact” was a radical meaning to be given to the word and that it was generally accepted “that an opinion is an inference which is drawn from facts”: ActewAGL at [33].
3. The nature of the AER’s task under the NGL and NGR necessarily involves an assessment as to likely future occurrences and states of affairs, formed on the basis of expert opinion and evidence of current and historic facts. The phrase “finding of fact” should not be given a meaning that would render its applicability to the AER’s functions minor and largely superficial. That is, “the term ‘findings of fact’ should be interpreted broadly enough to be meaningful in relation to the function of the” AER under review: ACCC v ACT at [171].
4. It is clear, however, that the term “findings of fact” does not include the making of choices between permitted methodologies. Nor will a finding of fact be in error because it was based on the use of one methodology rather than another. Further, the weight to be given to competing regulatory considerations is not a finding of fact: ACCC v ACT at [171].
5. Even if an expression of opinion could be a finding of fact under sections 246(1)(a) and (b), this ground of review is established only if the expression of opinion was erroneous, as revealed only by the review-related material.
6. In order to make out this ground for review, the applicant must not only establish an error of fact. It must also establish that the error (or the errors in combination) was (or were) ‘material’. This requirement was not present in *ACCC v ACT*. In this context, an error of fact is ‘material’ if the relevant decision of the AER depends on or is based on the error: *Ibrahim v Minister for Immigration and Citizenship* [2009] FCA 1328 at [8].

### Incorrect exercise of discretion

1. In *ActewAGL* at [34], the Tribunal considered the meaning of a “discretionary decision”. It stated:

It is most commonly applied to decision making which involves essentially a weighing up of relevant facts. First the decision maker finds the facts. Then the decision maker undertakes a weighing up process which involves taking into account considerations that are found to be relevant, assessing the weight to be given to those considerations so assessed and determining what, as a result of that process, is the right result.

1. This ground for review is not available merely because the Tribunal would exercise the discretion in a different way. In *ElectraNet (No 3)*, the Tribunal stated at [72]:

the concept of incorrectness extends beyond “Wednesbury unreasonableness”, but on the other hand does not extend simply to where the Tribunal would have exercised the discretion in a different way.

1. In *East Australian Pipeline Pty Ltd v Australian Competition and Consumer Commission* (2007) 233 CLR 229 at [79] Gummow and Hayne JJ, (Gleeson CJ, Heydon and Crennan JJ agreeing at [13]) compared this ground of review with that of unreasonableness, and their Honours said that the two separate grounds could be understood by the explanation in *House v The King* (1936) 55 CLR 499 at 505.
2. The Full Court of the Federal Court in *ACCC v ACT* at [174] stated that the discretion of the regulator may be incorrectly exercised in the following ways:
3. an exercise of discretion based upon a misconstruction or misapplication of the relevant principles or methodologies or factors required to be considered by the statutory scheme;
4. an exercise of discretion affected by a failure to have regard to a mandatory relevant factor as prescribed by the statutory scheme; and
5. an exercise of discretion affected by the regulator taking into account a factor extraneous to those relevant by reason of the statutory scheme.
6. In *ElectraNet (No 3)* at [66], the Tribunal applied this statement albeit in the context of the *National Electricity Law* and Rules.
7. The Full Federal Court in *ACCC v ACT* noted at [175] that each of these matters is a traditional ground of judicial review. Where such a ground is made out in the context of an administrative review (as opposed to judicial review), it is appropriate to describe the exercise of the discretion based upon such an error as ‘incorrect’.
8. The AER must also have regard to the matters required by the NGL and NGR to be included in an access arrangement: see, for example, NGR r 48. The AER must have regard to the service provider’s “access arrangement proposal”, being the terms and conditions about access to pipeline services proposed by the service provider.
9. The AER must have regard to its own reasons for refusing to approve the service provider’s proposal. Rule 64(2) must be read in conjunction with obligations on the AER imposed by the NGL, such as the obligation to exercise its economic regulatory functions in a manner that will or is likely to contribute to the achievement of the national gas objective (NGO) and the obligation to take into account the revenue and pricing principles when performing certain economic regulatory functions: NGL s 28.
10. The AER submitted to the Tribunal that the various obligations imposed upon service providers when making access arrangement proposals and/or when generating and providing access arrangement information do not fall upon the AER as binding constraints upon its power. Applying this reasoning, the requirements expressed in Rules 74, 87 and 91 of the NGRdo not bind the AER when it is proposing or making revisions to an access arrangement under rule 64(2).
11. Rule 64(2) of the NGR sets out the matters that the AER must have regard to in making its proposal for an access arrangement if it has refused an access arrangement proposal. These are:
12. the matters that the NGL and NGR require an access arrangement to include;
13. the service provider’s access arrangement proposal; and
14. the AER’s reasons for refusing to approve that proposal.
15. The AER need only have regard to the requirements of rules 74, 84 and 91 of the NGR, and others like them, to the extent that such consideration is necessary to have regard to the service provider’s access arrangement proposal and the AER’s reasons for refusing to approve it.
16. If the AER exercised its discretion on correct principles and if the particular exercise of the discretion was open to it within the framework of the legislation, the Tribunal is not empowered to set aside that decision simply because it thinks another decision would have been preferable: *ACCC v ACT* at [175].
17. A decision which is not determined by reference to the applicable criteria in the NGL or the NGR is likely to have involved an incorrect exercise of discretion: *Energy Australia* at [68]. An incorrect exercise of discretion may occur where the exercise of the discretion is based upon a misconstruction or misapplication of relevant principles, methodologies or factors required to be considered by the NGL or NGR: *ElectraNet* *(No 3)* at [66]; see also *ACCC v ACT* at [174].
18. Further, a decision affected by failure to have regard to a mandatory relevant factor prescribed by the NGL or the NGR, or affected by the regulator taking into account factors which are extraneous to those relevant under the NGL or NGR may well involve an incorrect exercise of discretion: *ElectraNet* *(No 3)* at [66]; see also *ACCC v ACT* at [174].
19. If the reasons for a decision contain a logical error or an unexplained discretionary choice made in reaching a conclusion, then the decision is likely to have involved an incorrect exercise of discretion, as well as also being unreasonable: *Energy Australia* at [67]. If factual error is made out and the exercise of discretion is based upon it, the exercise of discretion is incorrect *ElectraNet (No 3)* at [66]; see also *ACCC v ACT* at [175].

### Unreasonableness

1. The ground for review in subsection 246(1)(d) of the NGL requires that the decision under review is itself unreasonable. Guidance as to the ambit of this ground was provided by the Tribunal in *ElectraNet (No 3)*, where it said at [74]:

The unreasonableness must be of the AER’s decision itself, not of a step in its factual findings or its reasoning. It is important to recognise that it is the AER’s decision which must be unreasonable having regard to all the circumstances before that ground is enlivened.

1. The concept of unreasonableness goes beyond *Wednesbury* unreasonableness but is still limited. There must be logical error or irrationality in the decision. To make out this ground, the AER’s decision must not be justified by reference to its stated reasons. In *ACCC v ACT,* the Full Court stated at [178]:

The concept of ‘unreasonableness’ imports want of reason. That is to say the particular discretion exercised by the [regulator] is not justified by reference to its stated reasons. There may be an error in logic or some discontinuity or non sequitur in the reasoning. It may be that the decision has an element of arbitrariness about it because there is an absence of reason to explain the discretionary choices made by the [regulator] in arriving at its conclusion.

1. The Tribunal repeated and applied this statement in *ElectraNet (No 3)* at [65] and in *EnergyAustralia* at [66]-[67].
2. In *ActewAGL*, the Tribunal said that a decision will be unreasonable if it is arbitrary or capricious. It said at [35]:

It is, we think, neither possible nor necessary to give an exhaustive definition of what is an unreasonable decision. At one extreme a decision that is arbitrary or capricious will plainly be unreasonable. At the other extreme, it will not be sufficient merely to reach a different decision to the first instance decision maker; in many areas reasonable persons can perfectly reasonably come to opposite conclusions.

1. A decision which is not determined by reference to the applicable criteria in the NGL or the NGR is likely to be unreasonable in all the circumstances: *Energy Australia* at [68]. A failure to take into account a matter which is required to be considered or consideration of a matter which is irrelevant may also give rise to a decision which is unreasonable: *ActewAGL* at [35].
2. The unreasonableness ground in subsection 246(1)(d) and the incorrect exercise of discretion ground in subsection 246(1)(c) overlap to a certain extent: *Energy Australia* at [67] and [68]. For example, if the reasons for a decision contain logical error or an unexplained discretionary choice made in reaching a conclusion, then the decision may well be unreasonable: *Energy Australia* at [67]; see also *ACCC v ACT* at [178].

## If a Ground of Review is Established

1. If the Tribunal is satisfied that a ground of review is established, the first matter that the Tribunal may consider is whether to allow new information or material to be submitted: NGL s 261(3). The Tribunal may allow new information to be submitted if the new information would assist the Tribunal and was not unreasonably withheld from the AER when it was making its decision.
2. Once the Tribunal has had an opportunity to consider any new material and the parties’ submissions with respect to that material, the Tribunal must make a determination. Section 259(2) of the NGL provides the Tribunal with four options – it may:
3. affirm the AER’s decision;
4. set aside the AER’s decision;
5. vary the AER’s decision; or
6. remit the matter to the AER to reconsider the matter in accordance with any direction or recommendation the Tribunal considers appropriate.

# Debt Risk Premium

1. The first issue in this matter is the appropriate rate of return on debt to be used in determining Envestra’s allowable revenue. Rule 72(1)(g) of the NGR provides that one of the items of information that must be provided to the AER by the service provider is the proposed rate of return, the assumptions on which the rate of return is calculated and a demonstration of how it is calculated.
2. The rate of return on capital is to be commensurate with the prevailing conditions in the market for funds and the risks involved in providing reference services: NGR r 87(1). In determining the rate of return on capital it is to be assumed that the service provider meets benchmark levels of efficiency and uses a financial structure that meets benchmark standards as to gearing and other financial parameters for a going concern and reflects in other respects commercial best practice: NGR r 87(2)(a). Further, a well-accepted approach that incorporates the cost of equity and debt, such as the Weighted Average Cost of Capital (WACC) and a well accepted financial model, such as the Capital Asset Pricing Model (CAPM), are to be used: NGR r 87(2)(b).
3. There was no disagreement between the parties as to the appropriate formula or model to be used in calculating the return on capital. Both Envestra and the AER accepted that the appropriate model for determining the return on capital was a nominal vanilla WACC, a weighted average of the pre-tax cost of debt and the post-tax cost of equity, calculated as follows:

where:

1. is the value of debt as a proportion of the value of equity and debt;

1. is the nominal risk-free rate;

1. *DRP is* the debt risk premium;

1. is the equity beta; and

1. *MRP* is the market risk premium.
2. The DRP is the margin above the nominal risk free rate that a debt holder would require for it to invest in a benchmark efficient service provider. This is determined by subtracting the yield on ten year Commonwealth Government bonds (the nominal risk free rate) from the yield payable on a reference bond. It is accepted by both parties that the relevant reference bond is an Australian issued a BBB+ bond with a ten year maturity, issued by an Australian company.
3. Financial services provider Bloomberg publishes what is known as a fair value curve. A fair value curve plots estimates of bond yields against terms to maturity for a given credit rating. Relevantly, Bloomberg publishes a BBB fair value curve (taking into account BBB+, BBB and BBB- rated corporate bonds) for periods up to seven years (the Bloomberg curve). The Bloomberg curve is derived using proprietary methodology from a sample of Australian corporate bonds. As at 16 March 2011, the sample comprised 18 bonds with maturities of less than six years.
4. As the benchmark bond in this context is a ten year bond, the Bloomberg curve must be extrapolated from seven years to ten. This was done by incorporating the change in spread between Bloomberg’s AAA rated estimates from seven to ten years into the Bloomberg BBB fair value curve, averaged over the 20 trading days ending 22 June 2010. The result of this methodology, Is referred to by the Tribunal as the extrapolated Bloomberg value (EBV).
5. Envestra proposed placing sole reliance on the EBV. That is, Envestra submitted that the point estimate of the Bloomberg curve extrapolated to 10 years should be the sole determinant of the DRP.
6. The AER did not agree, however, and stated that only a 50% weighing should be given to the EBV, with the other 50% weight being placed on the yield observed on a single BBB rated bond issued by APA Group with a 10 year term maturing in July 2020 (the APA bond).
7. In simple terms, Envestra submits that the DRP should be determined solely by reference to the EBV of 18 bonds with maturities up to six years, whereas the AER submits that it should be determined by reference to an average of a single ten year bond selected by it and the EBV. The AER’s averaging resulted in it adopting a value for the DRP of 3.81%. Envestra’s proposed sole reliance on the EBV resulted in a value for the DRP of 4.67%.

## Rejection of the sole use of the extrapolated Bloomberg curve value (EBV)

1. In its original access arrangement proposal, Envestra proposed that the DRP should be calculated by taking an average of the value arrived at from the EBV and a value arrived at from a similar curve published by the Commonwealth Bank of Australia (the CBA Spectrum Curve). The CBA Spectrum Curve was last published on or about 8 September 2010. Envestra relied on an expert report by Synergies Economic Consulting Pty Ltd to support this proposal.
2. In the Draft Decision, the AER rejected this approach and instead based the estimate of the DRP on an average of the EBV and the APA bond. At the time of this decision, the AER was able to observe the yields for three long dated bonds (of up to 11 years maturity), including the APA bond. The AER believed that this sample provided a basis for rejecting the use of the EBV alone and supported the use of an average of the EBV and the single APA bond.
3. In response to the Draft Decision, Envestra submitted its Revised Access Arrangement Proposal, in which it proposed an estimate of the DRP based solely on the EBV. In support of this proposal Envestra relied on an expert report prepared by Australia Ratings.
4. After publishing the Draft Decision, the AER was able to observe yields on four additional long-dated bonds, bringing the number of bonds additional to those contained in the extrapolated Bloomberg curve to seven bonds. The AER believed that these yields supported placing greater weight on the APA bond at the expense of the EBV and wrote to Envestra on 23 May 2011 proposing to estimate the DRP on the basis of placing a 70% weight on the APA bond and a 30% weight on the EBV (the May 23 letter).
5. Envestra responded to the May 23 letter by reiterating its submissions in support of placing sole reliance on the EBV and urging the AER not to place any greater weight on the APA bond.
6. In responding to the AER’s May 23 letter, Envestra relied on an expert report prepared by Competition Economists Group (CEG) The report, authored by Dr T Hird, criticised the AER’s approach to determining the reliability of the Bloomberg curve. In particular, the report suggested that the AER’s analysis was flawed in that it excluded several long-dated bonds that were relevant to establishing the reliability of the EBV. The yields on these bonds, in CEG’s analysis, supported sole reliance on the EBV. The Final Decision rejected sole reliance on the EBV and instead estimated the DRP on the basis of a simple average of the EBV and the APA bond.
7. It was accepted by both Envestra and the AER, and is clearly correct, that it is appropriate for the AER to investigate the reliability and accuracy of any index that is advanced as the preferred method for determining the DRP. Indeed, such an investigation should be undertaken with respect to any method put forward as the basis for calculating a critical value in determining the WACC or any other component of regulated revenue.
8. The issue in this matter, then, is not whether the AER erred in not accepting sole reliance on the EBV, but whether it strayed into reviewable error in the process of the review it undertook or the conclusions it came to.

### The Bloomberg curve’s historic performance

1. In the Final Decision, the AER placed significant emphasis on the behaviour of the Bloomberg curve since the onset of the global financial crisis (GFC). The AER claimed that this behaviour was “somewhat counterintuitive” because the current yields implied by the Bloomberg curve were higher at the time of the Final Decision than during much of the GFC, suggesting an increased perception of risk. The AER viewed this as counterintuitive on the basis of “substantial evidence” that indicated that debt market conditions had improved significantly since the GFC.
2. In submissions before the Tribunal, Envestra responded by pointing out that this analysis assumes that risk was appropriately priced and estimated prior to and during the GFC. Further, as Dr Hird pointed out in CEG’s response to the May 23 letter, the world’s debt markets were significantly restricted following September 2008, leading to a paucity of information on corporate bond yields in the year or so following. Once trading information again became available towards the end of 2009 it was not surprising to see bond yields increase. Dr Hird argued that the Bloomberg fair value estimates have been relatively stable from that time until the date of his report.
3. It is also submitted for Envestra that the evidence before the AER illustrated that investors’ views about the appropriate level of compensation for exposure to risk have changed and the financial regulatory environment has also changed. In addition, Envestra submits that it is notorious that one of the causes of the GFC was a failure to correctly evaluate risk.
4. The AER submitted that its conclusion that the Bloomberg curve’s performance was counterintuitive was not material to its decision to reject sole reliance being placed on the EBV curve, as its decision was based primarily on the basis of a comparison of the Bloomberg curve with long dated bonds. In addition, the AER maintained that there was significant evidence that market risk was at its peak during the GFC and has subsided since.
5. It is clear from the Final Decision that the AER did not rely on its conclusion about counterintuitive behaviour in deciding to reject the sole use of the EBV. For this reason, it does not constitute a material error of fact and Envestra has not made out a ground of review on that respect. It does appear, however, as noted in [81] below that the AER paid insufficient regard to the reasons behind the Bloomberg curve’s performance during the GFC. Little regard was had to the question of whether this performance was likely to provide an accurate assessment of the Bloomberg curve’s current reliability: see *Application by Jemena Gas Works (NSW) Ltd (No 5)* [2011] ACompT 10 (*Jemena No 5)* at [66].
6. If the Bloomberg curve were to display poor performance during market conditions that can be regarded as ‘normal’ or likely to be repeated, then there will be strong evidence for questioning its usefulness. The reasons for poor performance are crucial to an understanding of whether such performance should be taken as indicative of the Bloomberg curve’s general accuracy. The AER did not, in either the Final Decision or the Draft Decision undertake the analysis necessary to form a proper understanding of this question. It intuitively considered that, for the purposes of its Access Arrangement Decision, the Bloomberg curve was not a directly reliable source of information. It is necessary to consider carefully where the AER went from that step.
7. At this point, it is sufficient for the Tribunal to express the view that the performance of the Bloomberg curve during and after the GFC alone would not necessarily have warranted its rejection. The unusual circumstances and market conditions, in particular the restriction of the debt market, that prevailed during the GFC are unlikely to persist for extended periods and might not therefore be viewed as indicative of the likely market conditions that would prevail during the majority of the ten year reference period. At most, the so-called “counterintuitive” performance would warrant further investigation of the reliability of the Bloomberg curve.

### Comparison of the Bloomberg curve with long-dated bonds

1. The AER placed great emphasis on the fact that, in determining the implied fair value yield at 10 years using Bloomberg data, an extrapolated curve was being used. That is, the information was not published by Bloomberg as part of the BBB fair value curve. The method of extrapolation was not, however, in contention between the parties.
2. The AER’s submissions suggest that, because the EBV is an extrapolation at the 10 year point, greater scrutiny should be applied to its reliability. This is no doubt correct. Envestra agreed with the proposition that it is appropriate for the AER to investigate the reliability of any measure it is using to determine the DRP.
3. The AER’s analysis of the reliability of the Bloomberg curve in the Final Decision rested on a comparison of an estimated yield derived from the Bloomberg curve with a sample of long-dated bonds. In particular, the AER relied on the following figure which depicts an extrapolation from 31 May 2018 to 31 May 2021:

Figure : Australian corporate bonds with maturities greater than five years and credit ratings from BBB
to A- (Final Decision: Figure A.6)

1. What becomes immediately obvious on viewing the AER’s preferred depiction of the data is that a significant proportion of the plotted bonds lie beneath the Bloomberg curve and, in particular, below its extrapolated portion. At first blush this may suggest that the Bloomberg curve, at least the extrapolated portion, overstates true yields.
2. The problem with this view, however, is that it ignores the generally held proposition that yield curves slope upwards, a view accepted by both parties. For the Bloomberg curve to accurately reflect the yields displayed by the sample of long-dated bonds preferred by the AER it would be required to slope downward from the point at which extrapolation commences. The required change in direction becomes even more apparent when Envestra’s preferred figure is inspected, but ignoring the additional bond sample:

Figure : Bloomberg BBB Fair Value Curve extrapolated to 15 years and reported yields (CEG's response to the May 23 letter).

1. The additional bond sample comprises the three bonds labelled “SUNCORP”, the bond labelled “DBCT” at the far right of the figure, the two bonds labelled “VERO”, the two bonds labelled “BKQLD” and the bond labelled “AMP”. These bonds were not included in the AER’s preferred figure, being Figure 1 above.
2. Rather than casting doubt on the reliability of the extrapolation, the AER’s analysis, if accepted, would cast doubt on the overall reliability of the Bloomberg curve at all, as a reflection of Australian corporate bond yields, at all. Perhaps a more plausible explanation for the apparent incongruity between the Bloomberg curve and the reported yields on the AER’s sample of long-dated bonds is that the sample of bonds used by the AER is not complete or representative. The AER’s view that the Bloomberg curve overstated relevant bond yields may have been one that was open to it had the only available evidence been the sample it selected. This was not, however, the case.
3. As observed in [72] above, in responding to the May 23 letter, Envestra commissioned an expert report from CEG which identified additional bonds that, in CEG’s analysis, should be included in the comparison sample. The AER claimed that it did not have sufficient time to fully analyse CEG’s response to the May 23 letter before publication of the Final Decision.
4. If these additional bonds are included in the sample, the extrapolated Bloomberg curve over the entire 15 year period appears to be much more reliable in terms of being representative of the whole sample of bonds. In particular, several of the new bonds lie substantially above the Bloomberg curve, at periods to maturity greater than 10 years.
5. The new sample of bonds arose, in large part, because Dr Hird, the CEG Report’s author, changed the methodology he used to determine the maturity date of callable bonds. Previously he had used the first call date as the appropriate date of maturity. For the later report, Dr Hird instead used the final call, or final maturity, date in circumstances in which the call option is unlikely to be exercised. The AER in submissions through counsel on the review accepted the correctness of this approach, but had several criticisms of the inclusion of these bonds in the sample, at least in their current form.
6. In *ActewAGL* at [39] the Tribunal said that, when using a sample of bonds to check the reliability of a fair value curve, the sample should be as large as possible.. In *ActewAGL*, the Tribunal was considering the basis on which the AER attempted to decide which of three fair value curves was most representative. In that case, the Tribunal stated that a sample of five bonds was insufficient, particularly when these bonds only covered half of the relevant term to maturity: *ActewAGL* at [39]. In the present matter the AER used a sample of seven bonds to reach its conclusion in the Final Decision. These bonds were, however, bunched tightly across time, however. Little consideration was given to the relevance of shorter or longer dated bonds in testing the overall validity of the Bloomberg curve or the representativeness of the APA bond. While it may be accepted that bonds with a maturity of approximately 10 years may be particularly relevant, they should not be considered to the exclusion of all others in deriving a representative estimate of the DRP.
7. The inclusion or otherwise of the additional bonds put forward by the CEG report may be of crucial importance in determining whether the Bloomberg curve provides a reliable estimate of 10 year BBB+ corporate bond yields. It was not an appropriate response by the AER to publish the Final Decision without considering, and if appropriate, taking into account the suggestions made by CEG.
8. A detailed analysis whether inclusion of the bonds proposed by CEG should have been undertaken. If, as the AER submitted, there are anomalies with the yields used, suitable adjustments might be required to be made. Likewise, any adjustments to remove the value of the call options might also be necessary.
9. In the Final Decision the AER said:

In the limited timeframe available to assess CEG’s proposal, the AER has been unable to adequately verify the reasonableness of CEG’s changed methodology. Regardless, the AER considers that the additional bonds noted by CEG are immaterial for this final decision.

1. The AER did not therefore investigate or methodically analyse the validity of CEG’s proposal. The AER’s analysis only extended to noting that bonds issued by financial institutions often have higher yields than those issued by infrastructure service providers and that several of the bonds in CEG’s proposed sample were subordinated debt.
2. The AER did not therefore investigate or methodically analyse the validity of CEG’s proposal. The AER’s analysis only extended to noting that bonds issued by financial institutions often have higher yields than those issued by infrastructure service providers and that several of the bonds in CEG’s proposed sample were subordinated debt.
3. As Envestra correctly submitted, the nature of the debt, that is subordinated or unsubordinated, and the industry of the issuer should be taken into account in the determination of the bond’s credit rating. Similarly, the industry of the issuer is not relevant within the current structure of the AER’s process. If the AER is to continue to use BBB+ rated corporate debt as its benchmark for determining the DRP, it is not reasonable for it to pick and choose which of the BBB+ bonds it deems to be appropriate without considering the significance of the other potentially relevant bonds. The analysis of all potentially relevant bonds as assessed by Bloomberg produces the EBV. If the AER were to decide that the EBV was an unreliable indicator for the purposes of deciding that DRP, it would be desirable in the longer term to develop an alternative coherent and consistent methodology, in consultation with the relevant regulated entities and other interested parties. Although the DRP must be determined at a particular point in time, the use of a consistent and acceptable methodology would ensure regulatory consistency, and in relation to particular matters would also facilitate efficient decision making and in turn reduce the number of reviews of the DRP decisions by the AER brought to the Tribunal. While such a task would be a complex and lengthy one, it is one the Tribunal commends to the AER.
4. However, given the time constraints upon its decision making, that was not an option available to the AER in this matter. It is necessary to determine whether the AER committed reviewable error in the manner of selection of the DRP on the material available to it, and upon which it was obliged to make its decision.
5. Focusing on the industry of the issuer and being selective in choosing which BBB+ rated corporate debt to use for determining the DRP is a novel technique by the AER. This would require a different approach from the AER and different submissions from service providers.
6. Rule 62(1) of the NGR requires the AER to consider all submissions made in response to the Draft Decision before making the Final Decision, as well as any other matters it thinks relevant. While, strictly, the May 23 letter did not form part of the Draft Decision, it was a significant course of action for the AER to propose a substantial variation to its approach from the Draft Decision without giving Envestra an opportunity to respond and, having received the response in a timely manner, in the circumstances explained by the AER, fail to give Envestra’s response thorough consideration.
7. The Tribunal appreciates the constraints of the timetable to be observed by the AER and the risk that a regulated entity may ‘game’ the timetable. But here, the timing issue was one of the AER’s own making. Indeed, this was an issue that could have been raised and addressed by the AER so that it did have sufficient time to fully analyse CEG’s response to the May 23 letter.
8. The AER appears to have reached a hybrid position. It properly decided to review the reliability of the EBV. However, in doing so, it selectively relied on the APA bond. For the reasons given, the Tribunal considers that that was not appropriate. There had been identified to the AER a range of other bonds, some of which lay below the EBV and some above the EBV. Had the AER considered them, its caution about the limited use of the EBV may have been resolved. The hybrid position emerges from the fact that the AER nevertheless decided to rely on the EBV as one of the two significant inputs into its weighting process. It must therefore have regarded the EBV as relevant and meaningful.
9. The AER, having rejected placing sole reliance on the EBV, decided to use the APA bond as a component of an averaging process. After first considering placing a 70% weight on the APA bond it decided to determine the DRP based on an average of the APA bond and the EBV, giving a 50% weight to each.
10. The choice of the APA bond and the weighting applied to it are attended by the same error as the decision to reject the sole use of the EBV, namely the failure to have sufficient regard to the expert report of CEG. As noted, this report was prepared in response to the AER’s proposal to place a 70% weight on the APA bond. No consideration appears to have been given to the question of whether the APA bond has been used by the market, broadly defined, as a reference for determining acceptable yields for bonds with similar credit ratings and terms to maturity. Indeed, no consideration has been given to the question of whether it is accepted practice in the market to estimate reference yields on the basis of a single bond. The lack of consideration of this issue runs counter to the emphasis placed on market use of, and reliance on, evaluative techniques in *ActewAGL* at [78] and reiterated in *Jemena (No 5)* at [64].
11. The manner in which the weightings in the averaging process were assigned was also in error. As was said in *ActewAGL* and *Jemena (No 5)*, the process of averaging needs to be given significant consideration and the allocation of weights should be done on a scientific basis. The Tribunal noted, in discussing the processing of averaging two fair value curves in *Jemena (No 5)* that:

An average is a blunt instrument unless careful thought is given to the individual components and whether each should be given the same consideration, or weight, in the calculation of the average. A simple unweighted average gives each component the same weight. This will not always be appropriate, especially where (as here) the two fair value curves differ considerably over the relevant periods to maturity.

1. This point is apposite in the current matter. There is a substantial difference between the DRP implied by the EBV and that implied by the APA bond. To take a simple average of these, without consideration of the methodology behind the Bloomberg curve, or the relevance of selecting just the APA bond from the whole sample of bonds (including longer and shorter dated bonds) is to use a very heavy “blunt instrument” when a more nuanced, rigorous and sophisticated method is required.
2. The sole basis for the assignment of weights in this matter was the AER’s opinion that the APA bond and the EBV (based as it is on the yields of 18 bonds) were each equally reliable as indicators of the benchmark DRP. No explicit consideration appears to have been given to the fact that the APA bond was being used as a quasi-proxy for the other bonds the AER deemed as appropriate comparators, nor is there any consideration given to the nature of the Bloomberg curve, which is derived from a sample of 18 bonds.
3. The placing of equal weight on the APA bond and the EBV estimate effectively assigns a 50% weight to one bond, the APA bond, and a 2.8% weight to each of the 18 bonds comprising the Bloomberg curve sample. The AER has not provided any analysis, or demonstrated any consideration, of whether this division of weights is correct.
4. The choice of weights in the averaging process is of vital importance. It should not be undertaken in an arbitrary manner. Any decision on weighting must have a sound and reasoned logic.
5. In the view of the Tribunal, the decision to reject the adoption of the EBV on the basis of the APA bond and the weighting chosen amounts to reviewable error on the part of the AER. The reviewable grounds invoked by Envestra are primarily under s 246(1)(c) and (d), although it also asserts material errors of fact so as to enliven s 246(1)(a) and (b). In the view of the Tribunal, the AER in the circumstances made a decision which was unreasonable by adopting a rate of return for the DRP based upon the simple averaging of the EBV and the APA bond. There may be reasons why some or all of the bonds referred to in Envestra’s response to the May 23 letter are inappropriate to be considered. However, the AER regarded those bonds as “immaterial” without sufficient grounds for doing so. Given the common understanding of both Envestra and the AER as to the nature of the bonds considered in the formulation of the Bloomberg curve (that is, before its extrapolation), there was no apparent reason to exclude those bonds because they were issued by financial institutions. That is not how the AER had proceeded in the past, when averaging the EBV and the extrapolated CBA Spectrum value. That step on the part of the AER, in the Tribunal’s view, rendered its reviewable decision unreasonable because the consequences of its error were obviously of significant magnitude. The significance of the different approach is addressed in the reasons for decision of the Tribunal giving leave to Envestra to apply to review the AER reviewable decision: *Application by Envestra Limited* [2010] ACompT 13. It is also an error capable of being expressed within the terms of s 246(1)(c), that is as an incorrect exercise of the AER’s discretion in selecting the rate of return for the DRP as it did without considering the increased bond sample proposed by Envestra, particularly as the AER by the 23 May letter invited comment on a variation of the weighting proposed in the Draft Decision.
6. Thus, Envestra has successfully made out a ground of review: NGL s246(1)(c) and (d). Accordingly, the Tribunal must decide whether to vary the AER’s decision, affirm the AER’s decision or remit the matter back to the AER for further consideration: NGL s 259(2). Before doing so, there are a couple of other matters to be mentioned.

## Cross checking

1. The AER undertook “cross-checks” of its estimates with actual cost of debt data. It was submitted for Envestra that this was inappropriate.
2. The regulatory regime, in determining allowable revenue, is structured on the basis of attempting to simulate a benchmark efficient service provider. Recourse to the actual cost of debt, in seeking to defend the reasonableness of the decision, is inappropriate in this context. The reasonableness or otherwise of a component of allowable revenue must be determined on the basis of the factors set out in the NGR.

## Additional matter

1. Envestra sought to put before the Tribunal information as to the identity of the issuers of the 18 bonds that comprised the sample used to derive the Bloomberg curve.
2. There was some debate during the hearing before the Tribunal about whether the AER could, at Envestra’s request, put before the Tribunal the details of the 18 corporate bonds that made up the sample on which the Bloomberg curve was based. Because the AER submitted that the Tribunal could not receive the information, even if the AER sought to provide it, the AER did not seek to do so. Thus, it was not strictly necessary for this issue to be decided.
3. Section 261(1) of the NGL states that the Tribunal must not have regard to matter other than “review related matter”, other than as provided for by that section. “[R]eview related matter” is defined in section 261(7) and includes the submissions and material before the AER as well as the Draft Decision and Final Decision. The material defined as “review related matter” can reasonably be described as evidentiary material when before the Tribunal.
4. Envestra was seeking to have the identity of the bond issuers placed before the Tribunal by the AER, exercising its power under NGL s 258(1). The language and, in particular, context of that section suggest that it does not empower the AER to put before the Tribunal material that is not "review related matter". Section 258 deals with the matters that parties may and may not raise before the Tribunal. In this context, the word matter is used as a synonym for “issue”. The section speaks of “raising” matters before the Tribunal. Section 258 is intended to restrict the issues that the Tribunal may consider and that an applicant may raise. It also allows the AER to raise an issue, or matter, where it deems it appropriate. The section does not permit the consideration by the Tribunal of non-review-related matter.
5. Envestra, in the alternative, sought to persuade the Tribunal that the identity of the bond issuers *was* "review related matter". It sought to sustain this submission on the basis that, in several documents that clearly were "review related matter", the AER or the service providers had made reference to the number of bonds in the sample. The link between the acknowledgement of the number of bonds and saying that the identity of the issuers is within the review related matter is too tenuous. The submission should not be accepted. For these reasons the Tribunal declined to receive the list of the issuers of the bonds in the Bloomberg curve sample.

## Conclusion with respect to DRP

1. The Tribunal, of course, accepts that in the first instance it is for the AER to determine whether to rely upon the Bloomberg curve, or to accept the extrapolation of that curve in the manner done in the past. It is not obliged to do so, although given the past regulatory decisions it may be expected to do so unless there were sound reasons to depart from that practice. For the future, that is a matter for the AER.
2. In the longer term, as the Tribunal has said, it is open to the AER to adopt a different methodology. Consideration of the proper composition of the comparison sample of bonds, the methodology for deciding on the appropriate sample of bonds and the relevance of these bonds to its task should be undertaken by the AER in consultation with interested parties across the spectrum of entities in the industries it regulates, consumers of their services and other interested parties.
3. In this matter, for the reasons given, the AER was obliged to do the best it could on the information available. Having determined that the AER fell into reviewable error, the Tribunal may set aside or vary the Access Arrangement Decision, or it may remit the matter to the AER to make the decision again: s 259(2). If the Tribunal sets aside or varies the decision, it may perform all of the functions and exercise all of the powers of the AER: s 259(3). If the Tribunal considers remitting the matter, it must have regard to the nature and relative complexities of the Access Arrangement Decision, and the matter the subject of the review: s 259(4).
4. The Tribunal has decided to vary the Access Arrangement Decision by substituting for the DRP value determined by the AER a DRP value of 4.67% based upon the EBV.
5. The Tribunal has taken into account that the AER, in the course of considering any proposed access arrangement or its revision, is obliged to address a multitude of issues and ultimately, it is only those few selected by the regulated entity which may come before the Tribunal; the majority of the issues resolved by the AER are resolved to the satisfaction of the regulated entity. That is the case in this matter. The Tribunal is reluctant to remit the matter to the AER to make the decision again, even constrained by any directions or recommendations of the Tribunal. In this matter, as the Tribunal has noted, there will be no real opportunity for the AER to develop a coherent alternative methodology to determine the DRP in the time available, so the AER would be forced to make the best decision it could on the material available if the matter were remitted to it. The more substantial task of developing an alternative methodology would be time consuming and complex, and necessarily be one which to a degree at least would not be specific to the parties but affect other regulated entities.
6. The Tribunal has also taken into account that the AER regarded the EBV as having sufficient reliability to give it substantial weight. In making the decision about whether to discount it in some way, the material available to the AER gave it no clear path to follow.
7. Envestra provided to the AER strong evidence in support of the EBV, in particular by its response to the May 23 letter. The view of Dr Hird of CEG was that that material did not demonstrate any basis for the substitution of an alternative estimate for the EBV. As noted, the AER itself accepted the relevance of the EBV. Whilst the Tribunal accepts that the AER properly considered the reliability of the EBV, it has reached the view on the available material that there is no reason shown from the available material why the use of the EBV should not be adopted in this particular matter. There is no viable alternative methodology at present, other than making a decision on all the material. The observations of the Tribunal in *ActewAGL* at [74]-[78] suggest also that, on the existing material, it is appropriate to vary the decision in the manner indicated.

# Market risk premium

1. Rule 87(1) of the NGR requires that the rate of return on capital is to be commensurate with prevailing conditions in the market for funds and the risk involved in providing reference services. Rule 74(2) provides 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.
2. The AER has determined that the CAPM is to be used to estimate the cost of equity for the purposes of determining the WACC referred to in Rule 87(2).
3. In the CAPM context the MRP is the expected return over the risk free rate that investors require to invest in a well diversified portfolio of risky assets. The MRP is an input into the calculation of the cost of equity for the purposes of the WACC referred to in Rule 87(2).

## Envestra’s proposal and the AER’s decision

1. In Envestra’s access arrangement proposal, it proposed an MRP in the range of 6.5‑8%. In the Draft Decision, the AER did not accept this proposal and instead adopted a MRP of 6% for the purposes of determining the cost of equity. This estimate reflected the AER’s views that, while evidence about the MRP was imprecise, the best available evidence of pre and post-GFC MRP estimates supported the rate of 6%.
2. In the Draft Decision, the AER concluded that a long term MRP of 6% was consistent with the latest long-term historical estimates of excess returns. In its May 2009 Review of electricity transmission and distribution of WACC parameters Final Decision the AER concluded that an MRP of 6.5% was warranted in the circumstances of increased uncertainty associated with the GFC. In the Draft Decision, the AER formed the view that this uncertainty had diminished and no longer warranted an MRP in excess of its historical long-term estimates. In addition, it concluded that it was unlikely that increased risk would be part of forward-looking expectation of returns over the next decade. In support of this, the AER relied on survey-based estimates that led it to the view that the GFC has not resulted in a change to the forward looking MRP which is expected to prevail in the future.
3. The AER relied on comments made by the Organisation for Economic Co-operation and Development (OECD), the International Monetary Fund (IMF) and the Reserve Bank of Australia (RBA) in support of its proposition that there is a robust outlook for the Australian economy and that investor expectations of market returns now reflect pre-GFC expectations.
4. Estimates derived from dividend growth model (DGM) analysis were discounted by the AER on the basis that they appeared to be entirely dependent on the time at which estimates are prepared on the assumptions used.
5. In its Revised Access Arrangement Proposal, Envestra maintained the range for MRP of 6.5-8%, applying a point estimate for the purposes of the WACC of 6.5%. In response to the reasoning of the AER in its Draft Decision, Envestra also submitted further expert evidence.
6. In the Final Decision, the AER rejected Envestra’s proposal and applied a MRP of 6%. The AER confirmed its Draft Decision and stated that available evidence for the value of the MRP was imprecise, but that it considered that its conclusion was supported by both pre-GFC and post-GFC evidence. The AER said that it considered historical excess return estimates for three time periods (1883-2010, 1937-2010 and 1958-2010) calculated on an arithmetic mean basis and on a geometric mean basis, on DGM based estimates of the MRP which the AER considered to incorporate reasonable assumptions; on the implied volatility derived from options of ASX200 listed companies; and on pre-GFC market practitioner surveys regarding the commonly adopted value for the MRP, together with limited survey evidence from 2009 and 2010 and recent broker reports (including a recent report from AMP Capital Investors) regarding current market practice in relation to the value adopted for the MRP.
7. The AER also concluded that investors would factor into their expectations of equity market returns the robust outlook for Australia’s economic and financial markets, which outlook had been noted by the RBA, the IMF and the OECD. In the AER’s view, the short-term MRP will vary from the long run estimates of MRP at times but that in order to maintain regulatory consistency, a long-term MRP with a notional ten year investment consistent with the term of the risk free rate ought to be considered.

## Grounds of review

1. Envestra submitted that the AER’s decision on the MRP was attended by several errors. In particular, it is submitted that the AER exercised its discretion incorrectly, reached an unreasonable decision having regard to all the circumstances and that its decision involved errors of fact that, either alone or in combination, were material to its decision.

### The finding that market conditions had returned to pre-GFC levels

1. According to submissions for Envestra, a critical basis for the AER’s MRP decision was the finding that the prevailing conditions in the market for funds had returned to pre-GFC levels and accordingly, the AER’s previous estimate of MRP of 6.5% was no longer appropriate. It was submitted by Envestra that in the 2009 WACC Review Final Decision and in all subsequent decisions prior to Envestra’s Draft and Final Decisions, including its most recent Victorian Electricity Distribution Determinations, the AER applied an MRP of 6.5%. Its final decision in the Victorian determinations was made in October 2010. In Envestra’s submission, there was no basis or evidence to support a change in the AER’s estimate of MRP since that time.
2. The AER submitted that it had not made such a finding. Rather, it had concluded that “market conditions had significantly improved and reflect reduced concern about the potential ongoing impact of the GFC”. The AER acknowledged, however, that it did find that implied volatility had returned to pre-GFC levels. It also acknowledged that debt spreads and dividend yields had not returned to pre-GFC levels, though it also noted that they had substantially improved since the height of the GFC.
3. While not explicitly classed as such in its submissions, Envestra appears to proceed primarily on the basis that this alleged error is one of fact. To succeed on this ground for review Envestra must show not only that there was an error of fact, but that it was, either in isolation or in concert with other errors of fact, material to the decision made: NGL ss 246(1)(a) and (b). It is necessary also to consider whether Envestra has made out reviewable error in terms of s 246(1)(c) or (d).
4. In determining whether an error of fact was made, it is crucial to ascertain precisely what the conclusion of fact was. It appears clear from the text of the Final Decision that the AER did not conclude that appetite for risk had returned to pre-GFC levels. It did find substantial improvement in market conditions and reduced concern about the impact of the GFC in the market. When characterised in these terms, the AER’s findings are clearly open on the evidence before it. The conclusion that market conditions had improved from the height of the GFC, but not necessarily to pre-GFC levels, was supported by expert evidence, submitted in support of access arrangement proposals by regulated service providers, from Strategic Finance Group: SFG Consulting, Value Adviser Associates and NERA Economic Consulting. The issue is whether the retreat from the heights of the GFC-related market risk was sufficient to warrant a return to an MRP of 6%. This is clearly a matter of discretion, not one of fact.; it might also be said to be an unreasonable conclusion affecting the reasonableness of the decision.
5. It was said in *ACCC v ACT* that a finding of fact is not an error “because it is based upon the use of one methodology rather than another”. Here the AER has based its findings about market conditions on many different methodologies. What is in issue is the weight that is to be applied to each of these. Clearly, if the choice of methodology cannot render a finding of fact an error, neither can the choice of weight to be assigned to different methodologies. The coherent choice of weighting is a matter of discretion.
6. Moreover, it is not immediately apparent that the AER’s decision to assign an MRP of 6% relied upon the finding that market conditions had subsided from the heights of the GFC. While it is accepted that the AER did take issue with much of the evidence submitted by Envestra and concluded that market conditions had improved, the AER also had regard to substantial evidence as to what constituted the best estimate of the MRP, including evidence of historical excess returns and DGM analyses. In these circumstances any error of fact (as asserted by Envestra) that the AER may have committed in its comparison of market conditions with those during the GFC cannot be classed as “material”. The AER decision on MRP was based upon a much broader consideration of data spread.
7. Turning to the question of whether the AER exercised its discretion incorrectly in these circumstances, consideration needs to be paid to how it is said that the discretion was exercised incorrectly. Envestra alleges that the AER exercised its discretion incorrectly because it failed to give adequate weight to the expert evidence. The AER submits that it considered the experts’ reports extensively and that, “[i]n truth, Envestra’s complaint is that the AER should have adopted the conclusions expressed in its consultants’ reports.” The AER’s submission should be accepted. It is not sufficient that the Tribunal would reach a different view than the AER for it to conclude that the AER incorrectly applied its discretion: *ElectraNet (No 3)* at [72]. The bases for an incorrect exercise of discretion, as set out in *ACCC v ACT* at [74] have not been made out; it is the result that is complained of, not the process. The AER’s discretion was not applied incorrectly. Nor is the Tribunal persuaded that the decision of the AER in this regard involved the exercise of a discretion which was not, on the material, reasonably available to it.
8. The critical issue in this section of the review is whether the AER’s determination of the MRP at 6% was reasonably open to it on the evidence. As has already been mentioned, there was substantial evidence before the AER, both that submitted to it by service providers and that sourced by the AER itself. This evidence was not conclusive. It was incumbent upon the AER to exercise its judgment in deciding on an appropriate MRP.
9. As was noted in submissions, the MRP is a forward-looking estimate. There is no accepted scientific, mathematical or financial technique that can, uniquely, be deployed to ascertain an estimate of the MRP over the ten year reference period. Indeed, there is no settled view among the experts as to what is the best methodology to employ in coming to such a conclusion. Further, there are substantial debates among the experts, as well as the parties, as to how particular methodologies should be employed and the nuances and assumptions that are necessary for their effectiveness. The choice of methodologies and assumptions has the potential to significantly alter the result, as was demonstrated, particularly, by reference to the DGM analyses.
10. In circumstances such as this it is incumbent upon Envestra, if it is to show a ground of review, to demonstrate why the choice of methodology made by the AER was not reasonable in all the circumstances. While it is true that Envestra pointed to a large body of expert evidence that supported its contention that 6.5% would have been a more appropriate choice for the MRP; there was also a large body of evidence that supported the AER’s chosen rate.
11. It is not sufficient for Envestra to persuade the Tribunal that 6.5% should be preferred. It must demonstrate the unreasonableness of the decision made by the AER. Unless this can be done, the Tribunal would be merely reaching a different conclusion as to the preferable result. The mere fact that the Tribunal may prefer a different rate does not entitle it to substitute its preferred MRP for that of the AER unless a ground of review has been made out. In all the circumstances of this matter, it was reasonably open to the AER to choose an MRP of 6%.
12. While it was reasonably open to the AER to determine an MRP of 6%, regulatory consistency may have led the AER to provide a more detailed explanation of the trigger that caused the AER to choose an MRP of 6% rather than the previously adopted 6.5%. However, for the reasons given, the Tribunal is not persuaded that the AER fell into reviewable error in any of the ways contended for by Envestra.

## Other alleged errors

1. In addition to the matters already mentioned, there were several issues agitated by the parties. While it is not necessary for the Tribunal to decide these issues for the purposes of this review, some comments should be made. That is because the Tribunal is not persuaded that these issues materially influenced the AER’s decision on the MRP. They are each matters adverted to in the Final Decision, but not in such a way as to indicate that any of the grounds of review under s 246(1) would be established in relation to them by the AER’s reference to them.

### Arithmetic and geometric means

1. There was considerable argument between the parties as to the appropriate method to apply in calculating average historical returns. Broadly speaking, it was submitted for Envestra that the arithmetic mean should be used, whereas the AER submitted that the arithmetic mean overstated average historic returns, while the geometric mean produced an underestimate.
2. Envestra submitted that geometric averages are not a correct basis on which to estimate the MRP, are not compatible with the CAPM and are inconsistent with standard valuation practice. According to Envestra no reliance should be placed on geometric averages and the proper basis is to estimate the MRP on the basis of the arithmetic mean. Historical data is used to estimate the MRP by taking some average of annual excess returns (the return on a broad stock market index minus the relevant risk‑free rate of interest) based on the assumption that the probability distribution of future annual excess returns is similar to that which has been observed historically. According to Envestra’s submissions, an arithmetic average of historical excess returns mathematically produces an estimate of the expected future excess return, whereas a geometric mean does not. Envestra submitted that, because the CAPM unambiguously requires an estimate of the expected return on the market, the arithmetic average is an appropriate estimate and the geometric average is not.
3. The AER took a different approach as to the preferable method. It noted that the arithmetic mean of 10 year historical excess returns would likely be an unbiased estimator of a forward looking 10 year return, the appropriate benchmark. It is the AER’s view, with which the Tribunal agrees, that the cumulative return across a period greater than one year will be less that the average of yearly returns because a negative return in later years will reduce the value of gains in previous years as well as the value of the initial portfolio. For example, imagine a portfolio that is worth 100 at the beginning of year one. Suppose that in year one the portfolio falls to 80, a -20% return, before returning to 100 in year two. The cumulative two year return is zero, whereas the average annual return is (-0.2+0.25)/2=2.5%.
4. According to the AER, historical excess returns are conventionally estimated as the arithmetic or geometric mean of 1 year returns. This convention was adopted in the historical excess return evidence available to the AER. Accordingly the AER submits that it interpreted this (one year return) data based on the strengths and weaknesses of how closely this reflected the relevant benchmark (being a ten year rate, expressed in annual terms).
5. Mathematically, if there is variability in the one year historical excess returns, the arithmetic mean of one year historical excess returns will overstate the arithmetic mean of ten year historical excess returns. This is because the process of averaging one year returns does not take account of the cumulative effect of returns over a ten year time horizon. Also mathematically, if there is variability in the one year historical excess returns, the geometric mean of one year historical excess returns will understate the arithmetic mean of ten
6. The AER concluded that the arithmetic average of the data considered is an overestimate of the relevant benchmark and the best estimate of historical excess returns over a ten year period is likely to be somewhere between the geometric mean and the arithmetic mean of annual excess returns. The imprecise nature of historical excess returns estimates, as well as other indicators of the expected MRP, means, in the AER’s submission, that the exercise of a significant degree of judgment is required when interpreting the available evidence to derive the best estimate of the expected MRP.
7. It may be accepted that an arithmetic mean of historic annual returns is an unbiased estimate of expected future one-year returns. It is not, however, an unbiased estimate of expected future returns over longer time horizons. A geometric mean of historical annual returns does not provide an unbiased estimate of expected returns over longer time horizons, either. Envestra’s submission that, because the CAPM model uses expected returns, only the arithmetic mean may be used cannot be accepted once it is understood that the arithmetic mean of annual historic returns is *not* an unbiased estimate of expected ten year returns.
8. Once it is accepted that the relevant benchmark is ten year excess returns, considerable thought and effort should be given to deriving the best estimate of expected ten year returns. The material before the Tribunal in this matter does not allow it to decide this issue. Rather, it is a matter that the AER should consider in consultation with service providers and other interested parties.

### The use of general macroeconomic forecasts

1. The AER referred to statements which had been recently published by the RBA, the OECD and the IMF that all indicated a robust economic outlook for Australia.
2. Envestra submitted that the reports relied upon by the AER from the IMF, the OECD and the RBA related to economic and investment growth rather than market risk which drives the market risk premium. The link between economic growth and market volatility expectations was made by the AER rather than by the authors of the quotes. This approach, Envestra submits, is unique and neither the AER, nor other capital market practitioners, have used such a methodology previously.
3. While there is nothing inherently incorrect about the AER having regard to statements from eminent bodies regarding current and forecast economic conditions, the use to which these reports are put must be carefully considered. It is not appropriate for the AER to infer from generally positive economic forecasts conclusions as to the likely MRP. These reports are not intended to provide forecasts of equity returns. Further, the reports do not endeavour to address the extent of correlation between economic performance and equity risk. This correlation would need to be explicitly dealt with, either by the forecasting bodies, the AER or expert evidence, before these reports could be usefully or validly employed to assist in forecasting the MRP.

### The use of surveys of market participants

1. In the Draft Decision, the AER recorded its view that survey-based estimates should be considered when estimating the MRP. In the AER’s submission, surveys of market practitioners and academics reflect the forward-looking MRP applied in practice. This technique involves asking a number of experts, including academics and market practitioners what they think the MRP is or what MRP figure they use in their work, and then collating and averaging the answers to arrive at a consensus MRP.
2. Envestra heavily criticised the improper use of these surveys. In support of these criticisms, Envestra relied principally on an expert report by NERA Consulting. NERA undertook a critique of the two post-GFC surveys relied upon by the AER.
3. NERA found that there were a very large number of non-respondents to both surveys. Of those that did respond, only a handful were Australian academics or analysts, 23 out of 1309 in one survey and 7 out of 2460 in the other. Further, NERA criticised the survey for not providing sufficient real world context to give the survey results any real meaning.
4. Surveys must be treated with great caution when being used in this context. Consideration must be given at least to the types of questions asked, the wording of those questions, the sample of respondents, the number of respondents, the number of non-respondents and the timing of the survey. Problems in any of these can lead to the survey results being largely valueless or potentially inaccurate.
5. When presented with survey evidence that contains a high number of non-respondents as well as a small number of respondents in the desired categories of expertise, it is dangerous for the AER to place any determinative weight on the results.

***Broker’s WACC estimates***

1. The parties made written submissions on this topic, submitted on 9 January 2012.
2. Envestra attacked the use to which the AER used equity broker estimates of WACC. It contended that to do so was an unreliable methodology because the risk-free rates of those estimates related to a different point in time from that used in the Final Decision, as illustrated by that decision adopting a risk-free rate different from any of the broker estimates, and because the required return on equity does not include imputation credits (if imputation credits were included the required return on equity, and so the WACC, would be higher), and thirdly because it is not clear that the broker estimates of WACC were consistently based on the nominal vanilla WACC concept as used by the AER.
3. It is fair to note that, as to those matters, the AER largely recognised the possible reasons why broker estimates might be unreliable and sought to make adjustments in that light. More importantly, the Tribunal accepts the AER submission that it did not estimate the WACC or the DRP by reference to the broker reports. It used them as a “useful reasonableness check” that its WACC estimate did not produce results which did not broadly accord with a range of market opinions concerning firms that are a reliable proxy to the benchmark firm. Its use of the broker reports was thus an “output” test of the nominal vanilla WACC rather than an input into its calculation of the WACC. In using the broker estimates in that way, it was addressing a concern of Envestra in its initial Access Arrangement Proposal that it should not focus only on input parameters.
4. In that context, in particular having regard to the limited use to which the AER applied the broker estimates as an “output” check only, the Tribunal is not persuaded that the AER fell into reviewable error by its use of broker estimates of WACC.

# conclusion

1. The AER’s decision to reject sole reliance on the EBV and to determine the DRP based on an average of the APA bond and the EBV amounts to reviewable error. For the reasons given above, the Tribunal proposes to vary the Access Arrangement Decision by substituting for the DRP rate there specified the rate of 4.67%.
2. The AER’s decision with respect to the MRP was supported by a large body of evidence. Envestra’s submissions and supporting evidence, in the Tribunal’s view, invited the Tribunal to substitute its preferred view of the evidence for that of the AER’s. Envestra has been unable to make out any of the available grounds for review and, for this reason, its challenge to the AER’s MRP decision should fail.
3. The AER’s task in assessing an access arrangement proposal is burdensome, requiring lengthy consideration and detailed analysis of many complex issues. The information asymmetry between the regulated entity and the AER add to the burden, as do time constraints. The issues before the Tribunal in these matters (*Application by Envestra Ltd (No 2)* [2012] ACompT 3; *Application by APT Allgas Energy Pty Limited (No 2)* [2012] ACompT 5) suggest that while some issues are peculiar to a particular regulated entity, others (such as the DRP and MRP) will be common to a number of regulated entities across a number of industries. As noted above, one way to relieve the AER's burden would be for it to determine, at least at a general level, an alternative methodology to determine DRP and MRP, including by appropriate consultation with the regulated entities and other interested parties. The AER may then be able to address the DRP and MRP issues in relation to particular requested entities, by reference to the issues peculiar to a particular regulated entity in consultation with that entity. This in turn might, perhaps, reduce the incidence of regulated entities “cherry picking” those issues to bring before the Tribunal for review. Of course, an aspect of an issue such as the appropriate DRP may be time-specific to a particular regulated entity and hotly debated. But if those aspects common to all regulated entities have been determined in advance as suggested above, an aspect peculiar to a particular entity may be better resolved by dialogue between the entity and the regulator because more time would be available for that dialogue.

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| I certify that the preceding one hundred and seventy-three (173) numbered paragraphs are a true copy of the Reasons for Decision herein of the Honourable Justice Mansfield (President), Mr R Davey and Professor D Round. |

Associate:

Dated: 11 January 2012