AUSTRALIAN COMPETITION TRIBUNAL

Application by Ergon Energy Corporation Limited

(Labour Cost Escalators) (No 3) [2010] ACompT 11

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| Parties: | | **ERGON ENERGY CORPORATION LIMITED**  **(ACN 087 646 062)** |
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| Members: | | **(DEPUTY PRESIDENT),**  **MR R DAVEY AND MR R SHOGREN** |
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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: LABOUR COST ESCALATORS**

# INTRODUCTION

1. These reasons deal with the labour cost escalators. The expressions used in these reasons are those employed in earlier decisions the subject of the current review.
2. The issue to determine is whether the AER’s decision to reject Ergon Energy’s proposal to base its labour cost escalators on rates specified in a 2008-2011 Union Collective Agreement (‘UCA’) gives rise to a ground of review in terms of s 71C of the NEL.

# BACKGROUND TO THE LABOUR COST ESCALATORS

## The regulatory framework

1. Ergon Energy’s June 2009 regulatory proposal was required to include a forecast of Ergon Energy’s operating expenses (‘opex’) for the 2010-2015 regulatory control period (cl 6.5.6(a) of the Rules).
2. Clause 6.5.6(c) of the Rules provides that the AER must accept the opex forecast if it is satisfied that the total of the forecast reasonably reflects the following operating expenditure criteria (‘the opex criteria’):
3. the efficient costs of achieving the operating expenditure objectives set out in cl 6.5.6(a) (‘the opex objectives’); and
4. the costs that a prudent operator in the circumstances of Ergon Energy would require to achieve the opex objectives; and
5. a realistic expectation of the demand forecast and cost inputs required to achieve the opex objectives.

If the AER is not satisfied as required by cl 6.5.6(c), it must not accept the forecast (cl 6.5.6(d)) and it must set out its reasons for its decision and an estimate of the opex that the AER is satisfied reasonably reflects the opex criteria, taking into account the opex factors set out in cl 6.5.6(e). While the cl 6.5.6(a) opex objectives and the cl 6.5.6(e) opex factors are, no doubt, relevant to the Tribunal’s consideration of the issue and its ultimate decision, the parties focused on what was required of the AER by cl 6.5.6(c). Accordingly, the detail of the opex objectives and factors may be conveniently put to one side, as may cl 6.5.7 which mandates provisions in respect forecast capital expenditure (‘capex’) similar to those appearing in cl 6.5.6.

## The AER’s general approach

1. The AER’s draft determination provides a useful explanation of the methodology used by it for estimating each escalator used in its decision. The following paragraphs draw on that explanation to facilitate an understanding of the AER’s application of real cost escalators and the consumer price index (‘CPI’) necessary for consideration of the labour cost escalators.
2. In recent regulatory determinations for electricity network service providers, (‘providers’) the AER has adopted an approach of permitting capex and opex allowances to be escalated in real terms for expected input cost increases. This approach, which is not challenged by Ergon Energy, involves the disaggregation of expenditure allowances into specific inputs (for example labour, land and materials) which are priced in terms of a base year. These base year costs are increased or decreased for each year of the regulatory control period relative to changes in the real price level. The nominal price level (that is the real price plus inflation) is taken into account when prices and revenues are adjusted at the aggregated level under the CPI-X control mechanism.
3. The methodology employed to determine the real cost escalators generally combines forecast movements in the price of input components with weightings for the relative contribution of each of the components to final equipment or project costs. This in turn generates real capex and opex forecasts for the regulatory control period. The weightings are typically specific to each regulated business, given differences in composition of their respective expenditure forecasts.
4. As explained by the AER in its draft determination, historically the objective of introducing real cost escalation is to take account of the impact of the commodities boom and skills shortages in the engineering field in Australia in recent years. In light of these external factors, the AER has considered that cost escalation at CPI did not reasonably reflect a realistic expectation of the movement in some of the input costs faced by providers. The draft determination expressed the view that the real cost escalation regime should be applied symmetrically to also reflect real cost decreases. This approach, it said, provides the opportunity for providers to recover the efficient costs of real increases, while ensuring that end users receive the benefit of real cost reductions.
5. Also as explained in the AER’s Draft Determination, given that there is no futures market for the procurement and installation of electrical equipment (for example transformers and switchgear), in previous AER decisions cost escalation rates have been estimated with reference to the expected growth in key input cost factors such as the cost of copper and aluminium, electricity gas and water (‘EGW’) sector labour costs and general labour costs. All other inputs are typically escalated in line with CPI only.
6. Finally, as explained in the Draft Determination, the AER has a preference for updating real cost escalation factors with the most up to date forecasts at the time of its final decision. This preference is a result of the requirement in the Rules, that the capex and opex forecasts should reasonably reflect a realistic expectation of cost inputs required to achieve the capex and opex objectives. The AER considers that using the most recently available data to update cost escalation forecasts, where appropriate, satisfies this requirement.
7. Counsel for the parties also explained the AER’s use of different CPI figures in making its determination. Relevantly for present purposes, there are two main figures.
8. First, for the purposes of the roll forward model used in the pre-regulatory control period of 2009-2010 to establish Ergon Energy’s opening regulatory asset base (‘RAB’) at the start of the regulatory period commencing in July 2010. Ergon Energy’s RAB will increase to some extent in the 2009-2010 financial year due to:
9. the CPI indexation of the existing RAB determined by the regulator at the start of the previous 2005-2010 regulatory period; and
10. an inflation adjustment of Ergon Energy’s 2009-2010 financial year capital expenditure, determined by the AER in 2010.

For the purposes of (b), to establish the opening RAB for the 2010-2015 regulatory period, the AER used a figure of 2.89% derived from the most up-to-date forecast of inflation for the year ending 30 June 2010, namely, the ABS’s March 2010 CPI forecast, being a March quarter 2010 to March quarter 2009 comparison. It was the subject of formal decision-making structures, including the obtaining of authority from the Ministerial Council on Energy for an extension of time so that a March quarter on March quarter figure might be used.

1. Secondly, ultimately the annual revenue requirement to be derived from the post tax revenue model which is in real terms must be expressed in nominal terms. For that purpose, a figure of 3% was used as the main inflator, that CPI figure being calculated as the geometric mean of the next 10 years of the Reserve Bank of Australia’s outlook for inflation.

## Ergon Energy’s Union Collective Agreement

1. Ergon Energy’s 2008 UCA provides for an annual guaranteed compounding nominal salary increase of 4.5% for all Ergon Energy employees covered by it from each of the first full pay periods commencing on or after 22 September 2008, 22 September 2009 and 22 September 2010. The UCA terminates in 2011.

## Ergon Energy’s regulatory proposal

1. Ergon Energy’s June 2009 regulatory proposal (the ‘Proposal’) asserted that it considered its escalators efficient because it used its UCA nominal salary increases of 4.5% as the basis for escalating all opex and capex labour costs (including contractors). It submitted that its UCA rate is the most realistic expectation of actual labour cost growth in the next regulatory period. While noting that the AER had rejected the use of rates determined on such a basis because it would move a distribution network service provider (‘DNSP’) from an incentive based framework to a cost of service recovery framework, the Proposal stated that it was unclear how the AER’s approach reconciled with the requirement in cl 6.5.6(c)(3) of the Rules to provide a realistic expectation of cost inputs required to achieve the opex objectives. It went on to state that the most realistic expectation of future labour cost growth is the labour cost growth prescribed in the UCA and that cost of service regulation requires the recovery of costs actually incurred.

## The AER’s draft determination

1. As a result of the AER’s analysis of Ergon Energy’s Proposal, forecasts by its consultant, Access Economics, and other supporting information, the AER was not satisfied that Ergon Energy’s labour cost escalation forecasts reasonably reflected the capex and opex criteria, including the capex and opex objectives. The AER considered it appropriate to apply forecasts based on the latest available data and applied Access Economics’ September 2009 labour cost growth forecasts. The Draft Determination signalled the AER’s intention to further update these forecasts for the purposes of its Final Determination.

## Ergon Energy’s revised regulatory proposal

1. Ergon Energy’s January 2010 revised regulatory proposal (the ‘Revised Regulatory Proposal’) asserted that:

• its UCA, upon which its proposed labour costs escalators were based, reflects an efficient outcome, negotiated through a prudent process, and is comparable with other recent wage negotiation outcomes;

• Ergon Energy must pay wages in accordance with the UCA regardless of the AER’s decision;

• its labour cost escalators reflect the circumstances in which it operates, namely, a forecast skills’ shortage with the recovery from the global financial crisis (‘GFC’) expected to put upward pressure on wages when it negotiates its next UCA in 2011;

• the difference between internal and contractor labour cost escalators is immaterial and does not warrant separation; and

• under the Rules, the AER cannot reject proposed labour cost escalators on the basis of incentive for future enterprise bargaining outcomes, nor can it reject escalators that reasonably reflect the opex and capex criteria.

1. Expanding upon that last point in its Revised Regulatory Proposal, Ergon Energy submitted that there was not a single value, or set of values, that would reasonably reflect a prudent and efficient labour cost escalation rate in order to satisfy the requirements of cl 6.5.6(c) of the Rules. Rather, it said, there will be a range of values that reasonably reflect prudent and efficient outcomes. On this basis, if Ergon Energy’s forecasts for the growth in labour costs fall within a reasonable range then the AER must accept them. It noted that the AER had not addressed this issue in its Draft Determination.
2. Ergon Energy’s Revised Regulatory Proposal also noted that the key reason that the AER gave in its Draft Determination for rejecting Ergon Energy’s labour cost escalator (that it would eliminate the incentive for Ergon Energy to actively pursue efficient and competitive wage outcomes during negotiations with its staff and their unions) was not supported by the Rules. It claimed, in terms of cl 6.5.6(c), that its proposed labour cost escalators were consistent with the labour costs that would be faced by an efficient and prudent DNSP in its position and a realistic expectation of the labour costs that will be faced by it.
3. The Revised Regulatory Proposal concluded on this point by submitting that if its labour costs reasonably reflect the opex criteria, the Rules require the AER to accept them, notwithstanding the fact that the AER considers that:

• a lower labour cost escalator would better reflect the operating and capital expenditure criteria; or

• accepting Ergon Energy’s labour cost escalators might affect incentives relating to future enterprise bargaining.

## The AER’s final determination

1. The AER’s May 2010 Final Determination confirmed its Draft Decision that it was not appropriate to uncritically apply Ergon Energy’s current UCA rates into the next regulatory control period. To do so, it said, would reduce the incentives to negotiate efficient labour outcomes and would represent a shift from an incentive based regulation framework to cost of service regulation.
2. The AER went on to note that Ergon Energy considered that the real wage increases implied by the UCA was prudent and efficient for a range of reasons, including those set out in par [17] above.
3. The AER did not, however, consider that those points demonstrated that Ergon Energy’s UCA rates represent an efficient level of labour cost escalation, for the following reasons. First, the UCA came into effect prior to the GFC and therefore did not reflect the impact and uncertainty of GFC-associated economic conditions on labour growth. Secondly, the AER rejected Ergon Energy’s claim that the UCA is a reliable predictor of labour costs to the end of the next regulatory period. In this regard, the AER noted comments by its consultant, Access Economics, which indicated that Queensland’s underperformance in response to the economic downturn has begun to feed through to movements into utilities sector wages, with further weaknesses occurring in the first half of 2010 and data indicating reversion back to the norm may not occur until 2011. The AER also noted Access Economics’ view that while institution-based approaches (including UCAs) may assist in short-term forecasting they are not necessarily appropriate for the longer-term. The AER therefore considered that updated data provided a better basis for forecasting Ergon Energy’s future labour costs than its UCA rates established prior to the GFC.
4. Thirdly, the AER said that the outcomes from any specific wage negotiation do not necessarily reflect efficient labour costs for the industry as a whole. In this regard the AER noted comments by a consultant (PricewaterhouseCoopers (‘PwC’)) to another DNSP the subject of its determination, pertaining to ‘the market power enjoyed by unions and their ability to influence the demand for and supply of labour’. The AER expressed disagreement with PwC’s view that it has over emphasised the incentive issue discussed in the draft decision and that wage increases in the UCA should be considered a strong indicator of market conditions. The AER considered this point gave credibility to the argument that unions are in a position to inappropriately influence labour cost expectations within the electricity sector, as power lies with these unions to determine these costs which have no reflection on actual market conditions or state or territory economic performance.
5. Finally, the AER observed that state and territory specific labour cost escalators, based on the relevant industry classifications, better reflect the market conditions and economic performance of that particular state or territory than do national measures of wage growth which Ergon Energy had submitted in support of its position.
6. The AER’s Final Determination did not directly address Ergon Energy’s submission to the effect that if its forecasts for the growth in labour costs fall within a reasonable range, the AER must accept them.
7. A table in the Final Determination set out the AER’s conclusion on Ergon Energy’s internal labour real cost percentage escalators as follows:

|  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- |
|  | **2008-09** | **2009-10** | **2010-11** | **2011-12** | **2012-13** | **2013-14** | **2014-15** |
| Internal labour | 0.18 | 1.83 | 0.21 | 0.75 | 1.19 | 1.50 | 1.60 |

# CONSIDERATION OF THE LABOUR COST ESCALATORS

1. The Tribunal’s consideration of the labour cost escalators reflects the focus in the parties’ submissions on the following three discrete periods:
2. the first being the pre-regulatory control period of 2009-2010 during which the UCA applied;
3. the second being the first year of the regulatory control period, 2010-2011 during which the UCA continues to apply; and
4. the third being the remainder of the regulatory period, 2011-2015 when the UCA no longer applies.

## The pre-regulatory control period, 2009-2010

1. As observed, the labour escalator in the pre-regulatory control period, 2009-2010, is relevant to establishing Ergon Energy’s RAB at the start of the regulatory period commencing in July 2010. For that purpose, the AER’s Final Determination adopted Ergon Energy’s actual UCA labour rates for the period 2009-2010 and, in calculating the real internal labour cost increment for that period, applied the real UCA-based increment in respect of Ergon Energy’s specialist employees (weighted as to 73%) but applied an increment derived from its consultant Access Economics’ Queensland general labour series – without adjustment on account of the UCA – for Ergon Energy’s non-specialist employees (weighted as to 27%).
2. For the 2010-2015 regulatory control period, the final decision applied updated forecasts of EGW labour rates and Queensland general labour rates to determine Ergon Energy’s weighted average internal labour costs.
3. It was submitted on behalf of the AER that:
4. for consistency with its reasoning, it should have applied the UCA-based real escalator for the whole of Ergon Energy’s internal workforce for 2009-2010 and only applied a weighted average based on the two different Access Economics labour cost series from 2010-2011; and
5. its application of the UCA-based real escalator on a weighted basis for 2009-10 is capable of being characterised as a material error of fact or an incorrect exercise of discretion within the meaning of s 71C(1) of the NEL .
6. While Ergon Energy adopted the AER’s submissions as outlined in par [31] and there was agreement on the nominal rate escalator of 4.5% used in the UCA, the parties joined issue on the CPI figure to be used to arrive at the real escalator for the 2009-2010 period.
7. The AER submitted that for consistency with a CPI increase of 3% for 2009-2010 applied by it in the Final Determination to determine Ergon Energy’s (and another Queensland DNSP’s) opex and capex escalation, 3% should now be applied to determine the real equivalent of the nominal 4.5% UCA increase, rather than the 1.83% it used in its Final Determination to determine Ergon Energy’s 2009-2010 internal labour rate escalator. In support of this submission, the AER noted that its proposed 3% figure closely approximates the actual annual 3.1% CPI increase for the year to June 2010 derived from the ABS’s Consumer Price Index, June quarter 2010. The AER also submitted by incorporating a 3% adjustment, the appropriate real internal labour cost increment for 2009-2010 would be 1.46%.
8. Ergon Energy contended for a CPI figure of 2.3%, being a figure also derived from the ABS’s Consumer Price Index, June quarter 2010.
9. The difference between the parties turns on their selection of the appropriate CPI figure from the ABS’s Consumer Price Index, June quarter 2010. The AER figure of 3% is based on the ABS’s comparison of the June 2009 quarter figure with the June quarter 2010 figure. The 2.3% figure for which Ergon Energy contends is derived from the ABS’s calculation of the percentage change from the previous financial year.
10. Ergon Energy supported its contention for the 2.3% figure by submitting that the method by which it was derived was consistent with the model the AER otherwise used to derive the labour cost increments it applied in its Final Determination, namely, a comparison of the annual average of the four quarterly increments for a given financial year against the annual average of the quarterly increments for the previous financial year.
11. The Tribunal accepts the AER’s submission that its application of the UCA-based real escalator on a weighted basis for 2009-2010 should be characterised as an error in terms of s 71C(1) of the NEL and is of the view that a ground of review has been established.
12. In so far as the 2009-2010 pre-regulatory control period is concerned, there was no issue between the parties that a ground of review having been established, the Tribunal may, pursuant to s 71R(3) of the NEL, allow new information or material to be submitted if the new information or material would assist it on any aspect of the determination to be made. Consistent with the view expressed by the AER in its Draft Determination that it is appropriate to apply forecasts based on the latest available data, the Tribunal is of the opinion that the ABS’s Consumer Price Index, June quarter 2010 figures referenced by the parties would assist it in its consideration of the determination of Ergon Energy’s internal labour escalator for the 2009-2010 pre-regulatory control period. Not surprisingly, the figure to be derived from the new material results in a more favourable outcome for Ergon Energy than the figure submitted by the AER. That outcome does occasion a concern whether new material would be advanced by an applicant pursuant to s 71R(3) of the NEL if the figure to be derived from it were unfavourable. No doubt, the AER’s preference to apply the latest data, favourable or unfavourable, will address the concern.
13. Because it is derived in accordance with the model the AER otherwise used to derive the labour cost increments it applied in its Final Determination, there is merit in Ergon Energy’s submission that the figure of 2.3% appearing in the most up-to-date material now available to the Tribunal (the ABS’s Consumer Price Index, June quarter 2010) should be applied. Applying the 2.3% CPI figure to Ergon Energy’s nominal 4.5% figure results in a real labour cost escalator for the 2009-2010 pre-regulatory control period of 2.15%.
14. Having regard to:
    * + 1. pars[29] to [39] above;
        2. all the material before it on the issue of labour cost escalators; and
        3. the capex and opex factors,

the Tribunal is satisfied that a real labour cost escalator for the 2009-2010 pre-regulatory control period of 2.15% reasonably reflects the capex and opex criteria including the capex and opex objectives.

1. Accordingly, the Tribunal determines that the decision of the AER to apply a real cost escalator of 1.83% to Ergon Energy’s internal labour costs for the pre-regulatory control period, 2009-2010, is varied pursuant to s 71P(2)(a) of the NEL by substituting the figure 2.15% on the grounds that:
   * + 1. the AER made an error of fact and the error was material to the making of the decision (s 71C(1)(a) of the NEL); and
       2. the exercise of the AER’s discretion was incorrect having regard to all the circumstances (s 71C(1)(c) of the NEL).

## The first year of the regulatory control period, 2010-2011

1. As observed, Ergon Energy’s 2008 UCA carries through the first year of the regulatory control period, 2010-2011, providing for an annual nominal salary increase of 4.5% for Ergon Energy’s employees.
2. Relying on cl 6.5.6(c)(3) of the Rules (a realistic expectation of the demand forecast and cost inputs required to achieve the opex objectives), Ergon Energy submitted that the figure of 4.5% should be accepted as the basis for calculating its real internal labour rate escalator for the first year of the regulatory period. The thrust of its case being that is what it would have to pay and that is what should be allowed.
3. Ergon Energy pointed to the UCA being negotiated in circumstances of, amongst other things:

• a skills shortage exacerbated by competition with the mining sector leading to a rapid increase in wages and salaries;

• a framework approved by the Queensland Government; and

• the difficulty of attracting and retaining the personnel to regional Queensland.

1. Ergon Energy submitted that in the circumstances in which the agreement had been negotiated an efficient outcome had been achieved. It noted that the AER had undertaken no critical analysis of the circumstances and submitted that for the AER to advance an argument that the ‘transitional’ risk issue it identified as being a matter, in terms of cl 6.5.6(c), leading to the importance of a DNSP’s efficient costs outweighing a realistic expectation of its cost inputs, was a failure by the AER to properly satisfy itself in terms of cl 6.5.6(c)(1) and (3).
2. Before addressing the substance of Ergon Energy’s submissions, the AER raised an issue whether Ergon Energy’s attack on the AER’s decision to use a different nominal rate to arrive at its real internal labour rate in the first year of the regulatory control period was a ground of review raised by Ergon Energy’s May 2010 Application for Leave and Application for Review (‘Application’) or the Statement of Grounds for Review (‘Statement of Grounds’) which accompanied it.
3. Relevantly, Ergon Energy’s Application was in the following terms:

*On the grounds stated below, the applicant seeks leave to apply for review of the AER Determination, pursuant to section 71B(1) of the NEL, and, if leave is granted, applies for review of the AER Determination in the respects identified in the grounds stated below.*

*The grounds for review are that in the circumstances set out in the accompanying Statement of Grounds for Review:*

*...*

*11. The decision of the respondent not to accept the applicant’s proposed labour cost escalators for the regulatory period.*

1. The relevant paragraphs in its Statement of Grounds were expressed in the following terms:

*14.2 In the AER Determination, the AER rejected Ergon’s proposed labour cost escalators.*

*14.3 The AER decided to do so on the basis that the rates in the UCA should not be applied in the years following the expiry of the UCA.*

1. Focusing on the words in the Statement of Grounds “ ... in the years following the expiry of the UCA” it was submitted on behalf of the AER that Ergon Energy’s submissions relating to the first year of the regulatory control period, 2010-2011, prior to the expiry of the UCA, are not the subject of the 15 July 2010 Order made granting leave “... in respect of grounds 1 and 4 to 14 of the grounds specified in the application dated 27 May 2010.”
2. Ergon Energy conceded that its precise point in relation to the first year of the regulatory control period, 2010-2011 was not set out in paragraph 14.3 of the Statement of Grounds but referred to paragraphs 14.11, 14.12 and 14.13 which referred to: “The decision of the AER not to accept Ergon Energy’s propose labour cost escalators ...” in terms of the grounds for review set out in s71C of the NEL and submitted that:
   * + 1. while the Statement of Grounds sets out the circumstances, the grounds for review are those in the Application;
       2. fairly raised the matter that is in dispute (ie, Ergon Energy is relying on its UCA and the AER had rejected it); and
       3. the May 2010 Order granting leave covers Ergon Energy’s submissions relating to the first year of the regulatory control period.
3. It was also submitted on behalf of Ergon Energy that if the AER’s objection is that Ergon Energy had disputed only the last four years of the regulatory period, leave to amend should be granted to strike the words “... in the years following the expiry of the UCA” from paragraph 14.3 of the Statement of Grounds and insert the words “... during the regulatory period.”
4. In the Statement of Grounds reference was made to the rejection of Ergon Energy’s proposal in respect of the application of the current UCA for the years following the expiry of the UCA. No specific mention was made of the position during the currency of the UCA, and the application of the rates in the UCA being applied in that period.
5. Nevertheless, the Tribunal is of the view that no amendment is necessary and that the issue has been raised in the Application.
6. The Tribunal proceeds on the assumption that the Statement of Grounds confined the ambit of the Application itself. However, the Statement of Grounds included a general reference to Ergon Energy’s reliance in its Proposal on the rate in the UCA generally, and AER’s rejection of Ergon Energy’s proposed labour cost escalators. This was sufficient to raise the issue now sought to be agitated, even though more specific attention was later articulated in the Statement of Grounds in respect of the years following the expiry of the UCA.
7. On this basis, the Tribunal need not consider in this review the question of its power to allow an amendment to an application, either generally or at a time after the expiry of the time limit prescribed in the NEL in which to bring an application.
8. Responding to the substance of Ergon Energy’s submission in respect of the first year of the regulatory regime, 2010-2011 (in which Ergon Energy was bound to apply the rates in its UCA), the AER submitted that the question whether Ergon Energy’s forecast opex reasonably reflects the opex criteria is a matter of judgment for the AER and, insofar as Ergon Energy advances its grounds of review on the basis that the AER ‘incorrectly exercised its discretion’, cl 6.5.6(c) of the Rules confers no discretion on the AER. The Rules also require that the AER must accept a forecast if it is satisfied that the forecast reasonably reflects the opex criteria. However, that requirement does not rule out the need for the AER to consider the forecasts that may be presented as alternatives reasonably reflecting the opex criteria as well as the methods by which those alternatives are arrived at. Indeed, if the requirement were to rule out this consideration on the part of the AER it would deny the AER’s argument that the ‘transitional’ risk issue it identified allowed it to weigh the importance of a DNSP’s efficient costs against a realistic expectation of its cost inputs.
9. There is substance to the concerns underpinning the AER’s submission that to automatically allow a labour cost increment negotiated under an agreement that transits two regulatory periods creates an unacceptable risk of undermining the incentives to promote economic efficiency in future negotiations for such an agreement. The concerns are not, however, sufficient to conversely and automatically reject a labour cost increment so derived. Indeed, the gravamen of Ergon Energy’s complaint, namely, that the AER had failed to satisfy itself in terms of cl 6.5.6(c) by investigating whether the circumstances in which the UCA had been negotiated resulted in efficient costs, costs that a prudent operator in Ergon Energy’s circumstance would require and costs which founded a realistic expectation of the cost inputs required to achieve the opex objectives, is well founded. The AER’s reliance on the forecasts of its consultant, Access Economics, to arrive at its real escalator for the first year of the regulatory period, is no substitute for such an investigation.
10. Having regard to:
    * + 1. pars [42] to [57] above;
        2. all the material before it on the issue of labour cost escalators, particularly the circumstances of the negotiation of Ergon Energy’s UCA; and
        3. the capex and opex factors,

the Tribunal is satisfied that not investigating the circumstances in which the UCA had been negotiated but rather relying on its consultant’s figure to arrive at its real escalator for the first year of the regulatory period was an error of material fact on the part of the AER and an incorrect exercise of the discretion available to it in satisfying itself in terms of cl 6.5.6(c) of the Rules.

1. Accordingly, the Tribunal determines that in deciding to apply a real cost escalator of 0.21% to Ergon Energy’s internal labour costs for the first year of the regulatory period, 2011:
   * + 1. the AER made an error of fact and the error was material to the making of the decision (s 71C(1)(a) of the NEL); and
       2. the exercise of the AER’s discretion was incorrect having regard to all the circumstances (s 71C(1)(c) of the NEL).
2. It follows that the Tribunal accepts that the nominal figure of 4.5% derived from Ergon Energy’s UCA should be accepted as the basis for calculating its real internal labour rate escalator for the first year of the regulatory period, 2011. A question then arises as to the CPI figure which should be applied to convert the nominal figure to a real equivalent. The AER submitted that in the event that the Tribunal should accept the nominal figure of 4.5% for consistency with the general approach adopted by the AER in converting nominal to real terms, an inflation rate of 2.5% should be applied to arrive at a real increment of 1.95% for 2011.
3. On the other hand, Ergon Energy advocated that, having found error, the Tribunal should, pursuant to s 71R(3) of the NEL, allow new material (an Access Economics’ September 2010 report, being an up-date of an Access Economics’ March 2010 report relied on by the AER) to be submitted that would assist the Tribunal in determining the inflation rate. Again, consistent with its earlier decision to apply the latest available data, particularly when that data is sourced from an up-date of a report relied on by the AER, the Tribunal is of opinion that the CPI figure of 2.13% to be derived from Access Economics’ September 2010 report should be applied to arrive at a real increment of 1.33% for 2011.
4. For reasons appearing above, the Tribunal determines that the decision of the AER to apply a real cost escalator of 0.21% to Ergon Energy’s internal labour costs for the first year of the regulatory control period, 2010-2011, is varied pursuant to s 71P(2)(a) of the NEL by substituting the figure 1.33%.
5. In so deciding, the Tribunal had regard to not only the capex and opex factors but also the capex and opex criteria, including the capex and opex objectives.

## The remaining four years of the regulatory control period, 2011-2015

1. Ergon Energy submitted that a figure derived by projecting forward the annual nominal salary increases of 4.5% provided for during the term of the UCA should be accepted as the basis for calculating its real internal labour rate escalator for each of the remaining four years of the regulatory control period, 2011-2015, when the UCA will have expired.
2. In answer to the AER’s finding that because the UCA came into effect prior to the GFC and therefore did not reflect the impact and uncertainty of GFC-associated economic conditions on labour growth, Ergon Energy submitted that:
   * + 1. the UCA was finalised in mid-September 2008, so that the bulk of the negotiations occurred before the effects of the GFC were fully appreciated; and it is inappropriate to assess the efficiency or prudence of the UCA against expected wage outcomes after the GFC; and
       2. by September 2011, when the UCA will have to be renegotiated (or replaced), the effects of the GFC are expected to have dissipated.

Whether the 2008 UCA outcomes reflect prudence and efficiency may be significantly relevant to whether Ergon Energy’s forecasts for a year in the regulatory period while the UCA operates and may satisfy the AER in terms of cl 6.5.6(c) of the Rules. But once the term of the agreement has expired, the relevance of what occurred three years ago is significantly diminished. Once the agreement has expired, forward-looking forecasts, such as those relied on by the AER, assume far more relevance. The AER cannot be faulted for preferring those forecasts to the outcome of three year old negotiations in deciding whether it is satisfied as required by cl 6.5.6(c) of the Rules, particularly when it is required to be so satisfied in respect of a period expiring seven years after the 2008 UCA negotiations concluded.

1. That the AER had regard to the outcomes of the UCA is clear from its decision as summarised in pars [23] to [25] above. There is no suggestion that it automatically disregarded the outcomes, which would be wrong. The AER noted Access Economics’ advice to the effect that while such outcomes might assist in short term forecasting, they are not necessarily appropriate for the long-term and, having noted that advice, exercised its discretion to give greater weight to up-to-date data as providing a better basis than the UCA for it being satisfied whether Ergon Energy’s forecast of its future labour costs reasonably reflect the opex criteria set out in cl 6.5.6(c).
2. Ergon Energy also submitted that the nominal figure of 4.5% for which it contends falls within a reasonable range of labour costs escalators that would be faced by a prudent and efficient DNSP and put in support of that submission that:
   * + 1. the Queensland EGW sector is projected to see wage growth rates trending upwards from mid-2011; and
       2. general labour costs in Queensland are projected to be broadly aligned with the projected national average from mid-2011;
       3. the internal labour outcomes negotiated in the UCA were in keeping with the average annualised increase for the EGW sector of 4.7% (nominal); and
       4. while the UCA outcomes may be higher than the nominal forecasts produced by Access Economics, they are:
3. in the lower end of the range of 4.5% to 6.75% annual increases in other collective agreements for the electricity sector; and
4. they are sufficiently close to suggest that they fall within a reasonable range.
5. Relying on passages in re *GasNet Australia (Operations) Pty Ltd* [2003] ACompT 6, (at [29]); re *Application by ElectraNet Pty Limited (No 3)* [2008] ACompT 3 (at [203] to [209]); and re *Telstra Corporation Limited* [2006] ACompT 4 (at [63]) Ergon Energy submitted that:
   * + 1. where a figure proposed by a regulated entity falls within the range of choice reasonably open and is consistent with principles in the relevant legislation, it is beyond the power of a regulator not to approve the proposed figure simply because the regulator prefers a different figure which it believes would better achieve the regulator’s understanding of the legislation’s objective; and
       2. the AER was bound to accept the nominal 4.5% escalator figure proposed by Ergon Energy because it falls within a reasonable range.
6. It is axiomatic that there will be no one correct or best figure derived from a forecast that in terms of cl 6.5.6(c) ‘reasonably reflects’ the opex criteria – the very nature of forecasting means that there can be no one absolute or perfect figure. Different forecasting methods are more likely than not to produce different results. Simply because there is a range of forecasts and a DNSP’s forecast falls within the range does not mean it must be accepted when, as here, the AER has sound reason for rejecting the forecast.
7. First, cl 6.5.6(c) of the Rules does not require the AER to identify a range of forecasts and determine whether a DNSP’s figure falls within that range. Nor is there anything in the legislation under consideration here that requires the AER to accept a figure advanced by a DNSP simply because it may be within a range of figures the DNSP may point to as reasonable. As submitted by the AER, cl 6.5.6(c) does not require it expressly nor is such a requirement implicit in the clause.
8. Secondly, what cl 6.5.6(c) requires is the AER to accept a forecast if it is satisfied that the forecast reasonably reflects the opex criteria. The AER pointed to cl 6.1.2(3) of Sch 6.1 to the Rules which requires a DNSP to explain the method by which its forecasts have been developed, as making good its claim that the requirement of cl 6.5.6(c) extends beyond mere examination of figures to an examination of how those figures are arrived at. In this respect, the reasons advanced by the AER, outlined in pars [23] to [25] above, for rejecting a forecast based on the outcome of industrial wage negotiations are sound. In relation to the remaining four years of the regulatory control period, 2011-2015, there was no automatic, uncritical rejection of the figures advanced by Ergon Energy.
9. Thirdly, Ergon Energy’s forecast is based on wage negotiations concluded in 2008, two years prior to the commencement of the regulatory control period and seven years prior to its conclusion. On the other hand, the AER’s figure is based on forecasts in its consultant’s Access Economics’ March 2010 report, three months prior to the start of the period and two years closer to its conclusion. Also, it is a report that Ergon Energy does not otherwise challenge. Indeed, Ergon Energy relies on a figure derived from a September 2010 up-date of it to advance its case in respect of the first year of the regulatory control period.
10. Furthermore, as observed by Mr O’Shea SC, counsel for Ergon Energy: “... it is a well accepted truth that in the world of forecasting forecasts five years out can change dramatically in six months.”
11. Finally, the figures advanced by Ergon Energy as a reasonable range do not survive the AER’s uncontroverted analysis of them as values that do not fall within a ‘reasonable range’ that reflect the opex criteria.
12. Pursuant to s 71P of the NEL and for the reasons in pars [64] to [74] above, the Tribunal affirms the AER’s decision not to accept Ergon Energy’s nominal salary increases of 4.5% provided for during the term of the UCA as providing a basis for calculating its real internal labour rate escalator for each of the remaining four years of the regulatory control period, 2011-2015 after the term of the UCA has expired. In so deciding, the Tribunal had regard to the capex and opex factors, the capex and opex criteria, including the capex and opex objectives.
13. The Tribunal directs that the parties confer and provide minutes of the appropriate determination to be made in light of the above reasons no later than 4:00pm on Monday 31 January 2011.

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| I certify that the preceding seventy-six (76) 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