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## **TRIBUNAL DECISION CAUSES MAJOR RETHINK OF OPEX BUDGETING**

In a case that has ramifications across other regulated industries, the Australian Competition Tribunal has set aside the Australian Energy Regulator's (AER) approach to determining an operating expenses or OPEX budget. Gone is the ability to use simple benchmarking – and in its place is a broader range of modeling and benchmarking inputs. However, the most significant change is in the Tribunal's impetus to also include a 'bottom up' review.

While much commentary has centred around the possible impact on consumer prices, little has been made of this last point. The "bottom up" approach advocated by the Tribunal requires the Regulator to consider how an OPEX should be developed cognizant of the asset base, the stakeholder requirements, together with its operating and physical context. As opposed to benchmarking, this view examines what is required to operate that *particular network* safely and reliably to meet customer needs.

This came after a number of the electricity network businesses successfully challenged the Regulator's approach. Those operators use a Failure Mode, Effects and Criticality Analysis/Reliability Centred Maintenance (FMECA/RCM) or "bottom up process" as the basis of their OPEX budget.

Founder of Capability Partners Asset Management, Peter Kohler, has seen an increasing awareness of the need to undertake such "bottom up" analyses, both within and outside regulated industries, to provide a transparent approach to the determination of an OPEX budget.

"The Tribunal's decision highlights that the FMECA/RCM process has now become a key tool in the management of physical assets," Kohler said. "The fact that a number of operators were able to provide a defensible asset management plan went a long way to validating their claim, being that the regulator's determination on OPEX would not provide sufficient revenue to meet safety and reliability obligations."

Further, this FMECA/RCM tool also assists organisations meet the newly-launched ISO55000 requirement to "implement risk-based, information- and data-driven planning and decision-making processes" in relation to physical assets, Peter noted.

The release of the global ISO55000 standard has brought enormous focus to this area, with Kohler's team of consultants being engaged to not only create asset management plans but also provide training to asset managers (both technical and financial) in organisations across Australasia. Here and abroad, companies are scrambling to get up to speed with the

new best practice approach.

The outcome they are looking for is what Capability Partners call a “Defensible Budget”, i.e. one that enables an organisation to identify and demonstrate the effect of any change, whether that be a budgetary change, an asset performance change, or a change in acceptable risk. This obviously has applications for any organisation managing physical assets, irrespective of whether or not they operate in a regulated industry.

The high-profile nature of the Tribunal’s decision is set to ensure even more organisations increase their focus on developing defensible maintenance budgets, whether they are being defended internally, to shareholders, or to regulators.

**Attached:**

Appendix A: Australian Competition Tribunal, Summary of Australian Energy Regulator Review – Background and summary information behind determination discussed.  
(PDF format)

**About Capability Partners:**

Capability Partners provides asset management and safety-related engineering services to clients with complex, high energy physical assets in defence, oil and gas, utilities and rail industries. Its core competency is the holistic understanding of risk and its application to asset management and safety within a business framework. Capability Partners helps organisations achieve a demonstrable balance between cost, risk and asset performance – a cornerstone of the ISO 55000 Asset Management Standard.

See more at:

[www.capabilitypartners.com.au](http://www.capabilitypartners.com.au)

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# AUSTRALIAN COMPETITION TRIBUNAL

## IN THE MATTER OF APPLICATIONS BY PIAC, AUSGRID AND OTHERS

### SUMMARY

Applications by Public Interest Advocacy Service Ltd and Ausgrid Distribution  
[2016] ACompT 1

Applications by Public Interest Advocacy Service Ltd and Endeavour Energy [2016]  
ACompT 2

Applications by Public Interest Advocacy Service Ltd and Essential Energy  
[2016] ACompT 3

Application by ActewAGL Distribution [2016] ACompT 4

**This background to, and summary of, the reasons of the Tribunal (Mansfield J, Mr R C Davey and Dr D R Abraham) in determining these matters is not a complete statement of those reasons or its conclusions, nor does it comprise part of the reasons for the Tribunal's determination. The only authoritative statement of the Tribunal's reasons is that contained in the published Reasons for Determination available at [www.competitiontribunal.gov.au](http://www.competitiontribunal.gov.au).**

### **In brief**

The Tribunal's PIAC-Ausgrid determination is the 'lead' case in its consideration of the five matters listed below under the heading "Parties".

While the Tribunal determined that it is in the long term interests of consumers of electricity and gas to set aside the AER's decisions and have the AER make them again, the impact on the suppliers' revenues, and hence the prices they may charge, will not be known until the AER remakes its decisions.

The Tribunal found in favour of the regulated suppliers on some issues and in favour of the AER on others. The most significant finding for the suppliers is that when the AER decides the suppliers' operating expenses (opex) allowances again, it is to use a broader range of modelling and benchmarking against Australian businesses and include a "bottom up" review of their forecast opex. The suppliers' challenges to the AER's allowances for their returns on debt, the value it set for gamma and ActewAGL's Service Target Performance Incentive Schemes allowance were also upheld.

The suppliers' challenges to the AER's decision on their returns on equity, Efficiency Benefit Sharing Schemes and metering issues raised by Ausgrid and Jemena were not upheld.

The Tribunal's opex finding meant that it did not need to decide the suppliers' challenges to the AER's decisions on some interrelated matters (the X factor and some metering issues) but it has provided some guidance to the AER on how it may approach those matters when it comes to remake its decisions.

## **The parties**

The hearing of PIAC and Ausgrid's challenges also involved the Tribunal's consideration applications by:

- the three NSW government owned regulated electricity suppliers: Ausgrid, Endeavour Energy and Essential Energy (Networks NSW) and by PIAC to review the AER's April 2015 determination of Networks NSW's revenues for 2014-19 (ACT Nos 1, 2 and 3);
- the regulated electricity supplier, ActewAGL Distribution, to review the AER's April 2015 determination of its revenues for 2014-19 (ACT No 4); and
- the regulated gas supplier, Jemena Gas Networks (NSW) Limited (JGN), to review the AER's June 2015 determination of its revenues for 2015-20 (ACT No 5).

The following companies, which opposed the AER's methodology because it might be applied to them, intervened in the proceeding in support of the regulated suppliers: AusNet Services (Distribution) Pty Ltd, AusNet Services (Transmission) Ltd, Australian Gas Networks Ltd, Citipower Pty Ltd, Powercor Australia Ltd, SA Power Networks and United Energy Distribution Pty Ltd (Vic/SA Network Interveners) and the Queensland government owned Ergon Energy Corporation Ltd (Ergon).

The Commonwealth Minister for Energy and Science / Minister for Resources, Energy and Northern Australia also intervened. The Minister's submissions were confined to the proper construction and application of the relevant legislation: the National Electricity Law (NEL), the National Gas Law (NGL) and associated Rules (the National Electricity Rules and the National Gas Rules). As these matters involved the first application by the AER (and, on review, by the Tribunal) of significant 2012 changes to the Rules and 2013 changes to the Laws, the Tribunal was most appreciative of the Minister's submissions.

## **The Tribunal's task**

The challenges to the AER's decisions raised complex legal and economic issues. The decisions, being made under new, untested legislation, meant that the AER's task (and the Tribunal's on review) of resolving those issues was more demanding than it might have otherwise been.

### ***Consumer consultations and prices***

Prior to hearing the applications the Tribunal engaged in two days of consultation with individual consumers and representatives of consumer and user groups. This consultation process was a 'first' for the Tribunal under the new legislation.

As PIAC was a party to the proceedings, it did not participate in the consumer consultations. However, by participating in the hearing, PIAC played a particularly helpful role by advancing the consumers' and users' perspective.

The consumer consultation process enabled the Tribunal to better understand and appreciate consumers' and users' concerns – price being the most significant. There was material showing the number of disconnections over time and consumers raised the issue of the less well-off in the community being either unable to afford access to the services at all, or at least to do so only at considerable personal cost.

It is, however, to be noted in that context that the national electricity / gas objectives (NEO / NGO) that speaks of efficiency in the long term interests of consumers, do not extend to broader social and environmental objectives better dealt with in other legislative instruments and policies which sit outside the NEL / NGL (see Legislative Council, South Australia, 16 October 2007, Hansard at p 886).

The issue of price was not only raised by consumers in a lower socio-economic context, but also by some smaller commercial enterprises, primary producers and others – all noted, and generally supported, the price reductions that the AER predicted should follow from its decisions. Those predictions will, however, have to be revisited once the AER has made its decisions again in accordance with the Tribunal's determination.

### ***The hearing***

The available grounds for review are, briefly, that the AER made material error of facts, its exercise of discretion was incorrect or its decisions were unreasonable in all the circumstances.

The hearing involved what is known as a limited merits review – 'limited' because it is a review 'on the papers' in which the Tribunal is restricted in the material it may consider. The material that the Tribunal may consider is material which was before the AER when it made its decision (eg the suppliers' proposals and their experts' reports in support of those proposals), submissions made in the course of the Tribunal's consumer consultations, the applications for review and written and oral submissions by the parties appearing before the Tribunal. Neither the AER nor the Tribunal has the benefit of the experts' reports being tested by oral examination before them.

The hearing of oral submissions by those opposing the AER's decisions and from the AER occupied three weeks. The review-related material which the parties drew on in making their submissions was said to extend to more than one million pages. Lengthy written submissions were presented to the Tribunal – on but one issue (the AER's opex allowances) the parties' written submissions were over 460 pages and their oral submissions occupied three and a half days filling over 250 pages of transcript.

The length of the Tribunal's reasons (over 300 pages), and the time taken to release them, reflects the size of its task and that of the AER in reaching its decisions – just one of the AER's five decisions under challenge (the Ausgrid decision) comprised an overview of 66 pages and 20 attachments totalling 1,470 pages, with the other four decisions being of similar size.

## **The legislation**

### ***The AER's obligations***

The Laws and Rules empower the AER to decide the revenue a regulated electricity or gas supplier may earn over a regulatory period of 5 years.

In making a decision the Laws require the AER to, amongst other things:

- have regard to, as appropriate, the NEO / NGO and to the Laws' revenue and pricing principles (the RPP);

- give users or consumers a reasonable opportunity to make a submission before the decision is made; and
- if there are two or more possible decisions that will or are likely to contribute to the achievement of the NEO / NGO make the decision that the AER is satisfied will or is likely to contribute to the achievement of those objectives to the greatest degree (the preferable reviewable regulatory decision).

While the requirement to have regard to the NEO / NGO and to the RPP have existed for some time, this was the first time that the AER has been obliged to give consumers the opportunity to be heard and to make a preferable reviewable regulatory decision.

### ***The Tribunal's obligations***

When reviewing an AER decision, the Tribunal may only determine to vary it, or set it aside and remit it to the AER to make the decision again, if the Tribunal is satisfied that to do so will, or is likely to, result in a materially preferable NEO / NGO decision (ie a decision that is materially preferable to the AER's decision in making a contribution to the achievement of the NEO / NGO).

In a context where for every competing argument there is a supporting expert or experts, the use of the phrase "materially preferable" requires the Tribunal to look through the inevitable conflict and difference of views between experts, all advocating positions which they regard as being preferable, and to determine whether an advocated materially preferable NEO / NGO decision is, indeed, materially preferable: ie a decision which, notwithstanding that divergence of views, is sufficiently compelling to be seen by the Tribunal as being "materially preferable" to the AER's (cf: *Wellington International Airport Limited & Ors v Commerce Commission* [2013] NZHC 3289 at [164]).

Also, if the Tribunal's determination is to vary the AER's decision – the Tribunal must be satisfied that to do so will not require it to undertake an assessment of such complexity that the preferable course of action would be to set aside the decision and remit it to the AER to make the decision again. It is self-evident from each issue outlined below where the Tribunal's set aside the AER's decision, the task of undertaking the appropriate review and making the decision again is a complex one.

### **The issues and the Tribunal's decisions**

That the Tribunal found for the applicants on some issues is not to cast an adverse reflection on the AER. Nor is it to suggest that the AER did not conscientiously examine the submissions it received. It recognises that the AER had a large and most difficult task to perform within a limited timeframe.

The applicants, variously supported by the interveners, took issue with aspects of certain 'building blocks' that the AER is obliged to use in deciding the revenue to allow each regulated supplier for the relevant regulatory period. The building blocks, the applicants which challenged them and the Tribunal's decision on each topic follow:

#### ***The operating expenses (opex) allowance: PIAC; Networks NSW; ActewAGL.***

Networks NSW and ActewAGL argued the AER's opex allowances for them were too low. PIAC's challenge, which it limited to the AER's opex allowances for Networks NSW, asserted they were too high.

Networks NSW and ActewAGL's raised a number of issues in relation to a benchmarking model on which the AER relied to arrive at their respective opex allowances. PIAC's concerns focused on the AER's lowering of the model's efficiency target comparison point and adjustments it made to the model to account for operational environment factors peculiar to a particular supplier.

*The Tribunal's decision*

The AER is to make the opex decision again in accordance with Tribunal's reasons including using a broader range of modelling and benchmarking against Australian businesses and a "bottom up" review of the regulated suppliers' forecast opex.

***The X-factor: Networks NSW.***

The X factor for a particular year represents the real rate of change in revenues for that year that have been approved by the AER (before any annual adjustments). In effect, it operates as a "smoothing factor" for revenue over consecutive years.

Networks NSW and the AER agreed on the desirability of avoiding price volatility and the strong message from the consumer consultations was that price shocks should be avoided where possible. The immediate effect of the AER's X factor decisions would, however, be significant price decreases in 2015-16 potentially followed by nominal price increases during 2016-19.

*The Tribunal's decision*

The Tribunal's decision on the opex issue requires the AER to revisit and re-determine Networks NSW's opex allowances and then re-apply the X factor. In those circumstances while the Tribunal did not need to determine whether Networks NSW's contention was correct it did observe that the NEO and RPP are complementary and that the NEO may not give rise to a decision by the AER which in fact is inconsistent with the RPP.

***The Efficiency Benefit Sharing Scheme (EBSS): Networks NSW.***

As part of the incentive regulation underpinning the Laws, the EBSS rewards a regulated supplier by allowing it to keep any yearly gain derived from the difference between its actual opex and its forecast.

The difference between Networks NSW and the AER turned on whether the rewards were related to real efficiency gains. The AER took the view that certain reductions in Ausgrid and Endeavour's respective opex resulted from substantial changes in the assumptions underlying estimates for provisioning of future payments of employee entitlements, such as long service leave, not real business outcomes.

*The Tribunal's decision*

The Tribunal was not satisfied that any ground of review exists in relation to the AER's decisions concerning the EBSS – the view taken by the AER was open to it. A consequence of the Tribunal's opex decision does, however, mean that the AER will be required to make its EBSS decisions again.

***The Service Target Performance Incentive Scheme (STPIS): ActewAGL***

The STPIS is designed to balance incentives to reduce expenditure, with the need to maintain or improve service quality. It achieves that by providing financial incentives to a supplier to



maintain and improve performance and reliability – penalties if the supplier fails to maintain historical levels of reliability over the last five years, benefits if the levels are exceeded.

ActewAGL contended that the AER's decision to apply its then existing STPIS to ActewAGL for the subsequent regulatory period without modification of the targets to account for reductions in its opex was erroneous because the reductions meant it could not maintain its historical levels of reliability by reference to which the targets had been set.

*The Tribunal's decision*

The Tribunal's decision on the opex issues means that one of the foundations on which the AER based its STPIS decision is flawed. In those circumstances, the Tribunal considers that the AER's STPIS decision is also flawed.

***The return on equity: PIAC; Networks NSW; ActewAGL, JGN***

An allowed rate of return objective introduced by 2012 changes to the Rules informs both the rate of return on equity and the rate of return on debt. The objective is that the rate of return for a regulated entity is to be commensurate with the efficient financing costs of a benchmark efficient entity with a similar degree of risk as that which applies to the regulated supplier in respect of the provision of its regulated services.

Applying its foundation financial model, the AER allowed an annual return on equity of 7.1 percent in lieu of Networks NSW's proposed 10.11 percent, ActewAGL's 10.71 percent and JGN's 9.83 percent. PIAC focused on one of the components of the AER's foundation financial model, the equity beta, contending that the correct equity beta should have been 0.5 and that the AER erred in selecting a value at the top of the range, 0.7, which its guidelines contemplated.

*The Tribunal's decision*

The AER's use of its foundation financial model did not involve an error of discretion. Nor was the Tribunal persuaded that the AER's selection of an equity beta of 0.7 was wrong – the Tribunal observed that it is one matter to show that the AER's analysis might have been undertaken in another way, but it is another matter to show that the other way would produce an outcome which is *the* correct outcome rather than just an alternative and rational outcome.

***The return on debt: PIAC; Networks NSW; ActewAGL, JGN***

While the AER replacement of its 'on-the-day' method of estimating a supplier's return on debt used in the previous regulatory with a 'trailing average' method was uncontentious, there was contention about it adopting a 10 year transitional period for a supplier to move to the new method.

Networks NSW proposed immediate application of the new method. Although there were some differences between them, ActewAGL joined in Networks NSW's submissions on this issue. They also asserted other errors in the AER's transitioning approach. JGN contended that the AER was wrong to apply its transition methodology to both the base rate and the DRP components of the return on debt. PIAC argued that the transition to the new method should have commenced from 2015-16 rather than 2014-15 to comply, or to better comply, with the relevant rule, especially where the on-the-day interest rates at the time of, and leading up to, the date of its decision were declining. Ergon contended that the AER made an error of fact in finding that a simple trailing average should be used to estimate the return on

debt when the use of a Post-Tax Revenue Model (PTRM) weighted average would better meet the requirements of the Rules.

*The Tribunal's decision*

The Tribunal found that a ground of review was made out and ordered the AER to make its decision on a return on debt in relation to the introduction of the trailing average approach in accordance with the Tribunal's reasons.

The Tribunal noted PIAC's contention to the effect that Network NSW's existing debt financing structures are not necessarily efficient for the purposes of any transition and that, when the AER comes to make its decision again, the requirement upon it to make the preferable regulatory decision may entitle the AER to make some adjustment if, as PIAC says, consumers may be paying "a second time" for the consequences of the spike in DRP rates following the GFC.

As the AER acknowledged that Ergon's PTRM-weighted average approach had potential advantages in some circumstances and observed it was open to future consideration by the AER, the Tribunal did not consider it desirable to address that issue.

***Imputation credits/gamma: Networks NSW; ActewAGL; JGN***

The value of imputation credits is recognised by the Rules in estimating a regulated supplier's allowed revenue. The Rules reduce the revenue that a regulated supplier requires to pay the estimated cost of its corporate tax by way of a formula in which the value of imputation credits is represented by the Greek letter 'gamma'.

Under the formula, the higher the value for gamma, the lower the estimated cost of corporate income tax for a regulated supplier. The AER adopted a gamma of 0.4 (from a possible range of 0.3 to 0.5). The Networks NSW; ActewAGL and JGN argued for a gamma of 0.25. PIAC argued that the AER should retain the value of 0.5 it adopted in its Draft Decisions.

*The Tribunal's decision*

The Tribunal decided that the AER set a value for gamma which was too high. It ordered the AER to make its decision on gamma in accordance with the Tribunal's reasons including by reference to an estimated cost of corporate income tax based on a gamma of 0.25.

***Metering services – opex: ActewAGL***

ActewAGL contended that the AER misconstrued data provided to it and made an error in the course of its calculation of its price cap for ActewAGL's Type 5 and 6 metering services.

The AER argued that it proceeded on a reasonable understanding of the complex data presented by ActewAGL and submitted, amongst other things, that the amount in issue (\$4.9m (\$2013-2014)) – assuming that its assessment of ActewAGL's data was incorrect – means that the contended error is not a material one and its correction would not lead to a materially preferable NEO decision.

*The Tribunal's decision*

It was not necessary to decide whether, in the circumstances, a ground of review had been made out. That is because, the Tribunal's opex decision means that the AER must revisit ActewAGL's opex and in doing so it is unlikely that the contended misconception of ActewAGL's data will recur.

***Metering classification: ActewAGL***

The AER's decision on the classification of ActewAGL's metering services was made in error.

The AER conceded the error and that it should be corrected. It proposed to do so after the Tribunal proceedings were concluded. Notwithstanding the AER's concession, ActewAGL maintained that the most appropriate course is for the error to be corrected by the Tribunal.

***The Tribunal's decision***

The Tribunal did not need to further address this issue because its opex decision means that the ActewAGL decision is being set aside and the AER will make the decision again. In those circumstances the error, which is conceded, should be corrected by the AER.

***Metering services - opex: Ausgrid***

Ausgrid challenged the AER's decision to reject its forecast metering opex and substitute its own forecast alleging errors on the part of the AER in:

- deciding that a Type 5 meter is not more expensive to operate and maintain than a Type 6 meter (it was Ausgrid's contention that a Type 5 meter is more complex than the more common Type 6 meters); and
- using an average of 2008-13 when calculating Ausgrid's metering opex allowance, rather than a single base year of 2012-13.

***Tribunal's decision***

The AER's decision that Type 5 and 6 meters do not have materially different costs was not an error of fact and did not lead to it making an unreasonable decision. Nor did the AER's use of a 5 year average to calculate Ausgrid's metering opex demonstrate a reviewable error.

***Market Expansion Capital Expenditure (ME Capex): JGN***

ME capex is expenditure for new assets that JGN requires to connect new customers to its network. JGN challenged the AER's decision not to approve JGN's ME capex forecast based on its unit rate derivation model (the JGN model) and to adopt an ME capex forecast based on its own, alternative model (the AER's ME capex decision). The AER was not satisfied that the unit rate composition JGN used in determining the cost per connection was arrived at on a reasonable basis or was the best estimate because JGN relied on only one year of data and did not adequately justify increases in its estimates of metres of certain connections

***The Tribunal's decision***

While the Tribunal formed the view that properly understood, the JGN model contained adequate detail to assess its validity, the Tribunal has had the benefit of detailed written and oral submissions not available to the AER when it made its ME Capex Decision. In the absence of appropriate explanatory material, the AER's concerns with the JGN model were legitimate. In reaching that view the Tribunal observed that the Rules do not require the AER to engage with a service provider indefinitely – there is a point at which the consultation process must cease and a decision made. The fact that the JGN model did not ultimately satisfy the AER that JGN's ME capex forecast represented the best forecast or estimate in the circumstances did not demonstrate error on the part of the AER.

The Tribunal did, however, find that the AER's rejection of JGN's one year of data and conclusion based upon historical average unit rates involved an error.

Rather than substituting or varying the AER's ME capex decision, the Tribunal concluded that when comes to re-make its JGN Final Decision on other grounds, it will have the opportunity to reconsider its ME capex decision and its interrelationships when deciding what is the preferable designated reviewable regulatory decision.

26 February 2016