[¶42-356] APPLICATION BY ENERGEX LIMITED (GAMMA) (NO 5)

(2011) ATPR ¶42-356
Court citation: [2011] ACompT 9
Australian Competition Tribunal
12 May 2011

Trade practices — Energy regulation — Distribution determination made by regulator — Value of ''gamma'' imputation credits — Calculating corporate income tax — Theta — Construction of database — Multicollinearity — Dividend drop-off studies — Tax statistics studies — Regulatory inertia — National Electricity Rules, r 6.5.3 — National Electricity Law, s 7A.

The applicants were granted leave to review distribution determinations made by the Australian Energy Regulator (AER). A common issue before the tribunal was the value of the assumed utilisation of imputation credits (gamma) which would be used to calculate the applicants' corporate income tax for each of the five years from 1 July 2010, due to r 6.5.3 of the National Electricity Rules (the Rules).

The value of gamma imputation credits is a product of the distribution ratio (F) and the utilisation rate (theta). Since the tribunal had earlier concluded that the value of the distribution ratio was 0.7, the remaining issue was the value of theta. Theta was defined as the value of imputation credits distributed to investors as a proportion of their face value.

A report by Strategic Finance Group: SFG Consulting in March 2011 (SFG report) proposed an estimate of 0.35 for theta. However, the AER submitted that issues concerning multicollinearity and the construction of the database meant the SFG report should be given less weight, and that the tribunal should also give some weight to a study by Beggs and Skeels.

There was also a question as to whether dividend drop-off studies were able to provide appropriate estimates for the purposes of the Rules, and whether the results of the SFG report should be considered in the light of other approaches. The AER commented on the possibility of using another analytical approach, tax statistics studies, but did not provide such material in the proceedings.

The AER also submitted that the Rules establish a regime of regulatory inertia whereby values set out in the Statement of Regulatory Intent (SORI) will govern distribution determinations made during the following five years unless it can be shown that a departure from the SORI values is justified.

***Held:* the value of gamma is 0.25.**

Theta and gamma

1. The tribunal is satisfied that the SFG report is the best dividend drop-off study currently available for the purpose of estimating gamma in terms of the Rules. Its estimate of a value of 0.35 for theta should be accepted as the best estimate using this approach.

2. Taking the values of the distribution ratio and of theta as 0.7 and 0.35, respectively, the value of gamma is 0.25.

Construction of database and multicollinearity

3. The tribunal cannot accept that either minor issues in the construction of the database or multicollinearity argue for giving the SFG study less weight and the Beggs and Skeels study some weight.

Tax statistics studies

4. On the material before it, the tribunal is unable to reach any conclusions about the further use of tax statistics studies in estimating theta.

Regulatory inertia

5. The tribunal accepts that due regard should be given to historical consistency in applying regulatory values over time. Nevertheless, the tribunal must determine an appropriate value for gamma on the basis of the material before it. It does not accept that its task is to determine a value of gamma that is appropriate and not too different from the previously determined value of gamma.

6. The objective set out in s 7A of the National Electricity Law (NEL), that a regulated DNSP should be provided with a reasonable opportunity to recover at least the efficient costs it incurs, must outweigh any presumption of regulatory inertia.

[*Headnote by the CCH COMPETITION AND CONSUMER LAW EDITORS*]

S Doyle SC with A Pomerenke for Energex Limited (instructed by Allens Arthur Robinson).

T Bradley for Ergon Energy Corporation Limited (instructed by Minter Ellison Lawyers).

CA Moore with M Borsky for ETSA Utilities (instructed by Gilbert + Tobin).

P Hanks QC with P Gray and T Clarke for the Australian Energy Regulator (instructed by Corrs Chambers Westgarth).

Before: Middleton J (Deputy President), R Davey and R Shogren

Middleton J (Deputy President), Mr R Davey And Mr R Shogren:

REASONS FOR DECISION: GAMMA

INTRODUCTION

1. In May 2010, the AER made a distribution determination regulating the charges each applicant may impose for the provision of its regulated services for a period of five years from 1 July 2010.

2. The NEL establishes a regime for what it describes as ''merits review'' of certain decisions of the AER. In July 2010, the Tribunal (Finkelstein J, President, R Davey and R Shogren) granted each applicant leave under s 71B of the NEL to review the AER's decisions on particular issues addressed in the determinations.

3. One issue in respect of which leave was granted was common to each determination and applicant. The other issues in respect of which leave was granted were peculiar to a particular applicant.

4. The expressions used in these reasons are those employed by the Tribunal in its earlier reasons relating to these applications, which describe the nature of the applicants' respective businesses and the role of the AER in the economic regulation of those businesses.

THE COMMON ISSUE — GAMMA

5. The common issue in each determination in respect of which leave was granted was the AER's decision on the value of ''γ'' (or ''gamma'', the assumed utilisation of imputation credits) a component of the formula which r 6.5.3 of the Rules mandates must be applied in calculating the cost of each applicant's corporate income tax for each of the five years from 1 July 2010.

6. The approach adopted by the AER, and accepted by the applicants, was to define the value of gamma imputation credits as a product of the imputation credit ''distribution ratio'' (F) and the ''utilisation rate'' (theta or θ) ($\gamma = F \times \theta$) where:

(a) F is defined as the value of imputation credits distributed by a firm as a proportion of the value of imputation credits generated by it in the period (the distribution ratio); and

(b) theta or θ is defined as the value of imputation credits distributed to investors as a proportion of their face value (the ''utilisation rate'').

7. In October 2010, the Tribunal gave its reasons (*Application by Energex Limited (No 2)* [2010] ACompT 7) for finding error by the AER in its treatment of ''distribution ratio'' (F) and the ''utilisation rate'' (theta or θ). Those reasons foreshadowed directions:

(a) allowing a submission to be filed by the AER whether the distribution ratio (F) should be 70% (see para [57]);

(b) in respect of the utilisation rate (theta or θ), calling for a report that:

- correctly used tax statistics studies and dividend drop-off studies to arrive at the utilisation rate;
- reviewed dividend drop-off studies from as many sources as possible to see whether confident use may be made of any of them; and
- provided results from a newly-commissioned dividend drop-off study that is ''state of the art''.

(see para [146]); and

(c) concerning the provision to the Tribunal of extrinsic material relating to:

- the rationale for including the gamma component in the formula for calculating the estimated cost of corporate income tax; and
- how it relates to the rest of the building blocks, especially the rate of return (cl 6.4.3(a) and cl 6.5.2(b) of the Rules) (see para [150]).

8. Relevant directions were made on 5 November 2010 and, pursuant to those directions, the Tribunal has since had the benefit of:

(a) relevant extrinsic material;

(b) submissions from the AER accepting that on the material before the Tribunal:

(i) there was no empirical data that was capable of supporting an estimated distribution ratio higher than 0.7; and

(ii) it was open for the Tribunal to adopt a substitute distribution ratio of 0.7.

While the applicants challenged the AER's prognosis of what the ratio might be in the future, each applicant otherwise agreed with the AER' submissions.

(c) a report by Strategic Finance Group: SFG Consulting (''SFG'') entitled: *Dividend drop-off estimate of theta*, 21 March 2011 (''SFG's March 2011 report'');

(d) a report by The Securities Industry Research Centre of Asia-Pacific (SIRCA) Limited (''SIRCA'') entitled *Report to the AER – Response to questions related to the estimation and theory of theta*, 7 March 2011 (''SIRCA's March 2011 report'');

(e) a report by the AER to the Tribunal entitled: *The value of imputation credits*, April 2011 (''the AER's report'');

(f) the applicants' submissions, dated 19 April 2011, in reply to the AER's report together with the following reports to be read in conjunction with those submissions:

- *Expert Report prepared in respect of certain matters arising from the AER's Merit Review - Determination of Gamma – Prepared for ETSA Utilities, Energex and Ergon Energy by R R Officer*, 18 April 2011 (''Officer's April 2011 report'');
- *A review of SFG's 2011 Dividend Drop-off Study – Dr Neil Diamond and Professor Rob Brooks*, 19 April 2011 (''the Diamond & Brooks' report''); and
- *Dividend drop-off estimate of theta – Notes on AER Report* by SFG, 18 April 2011 (''SFG's April 2011 report'').

(g) a further supplementary report from SFG entitled: *Dividend drop-off estimate of theta – Additional estimates based on comments in the AER report*, 21 April 2011 (''SFG's further supplementary report'').

9. At a hearing on 29 April 2011, the Tribunal also had the benefit of oral submissions from the AER on the gamma issue.

10. The Tribunal concluded on 24 December 2010 (see *Application by Energex Limited (Distribution Ratio (Gamma)) (No 3)* [2010] ACompT 9) that the distribution ratio was 0.7 for the calculation of gamma.

11. As discussed above, there are two issues to be decided in determining the value of gamma: the value of *F*, the distribution ratio; and the value of theta, the utilisation ratio.

12. Therefore, the only outstanding issue with respect to gamma is the value to be determined for theta. That value, multiplied by the value 0.7 for the distribution ratio, produces the value for gamma.

13. SFG's March 2011 report proposes an estimate of 0.35 for theta. This estimate is paired with an estimate, produced in the same statistical procedure, of the value of cash dividends in the range of 0.85 to 0.90.

14. The AER's report, responding to the Tribunal's earlier reasons, sets out its view on

the correct approach to the use of tax statistics and dividend drop-off studies. In doing so the AER draws upon SIRCA's March 2011 report. It also reviews a number of dividend drop-off studies, and assesses SFG's March 2011 report. The Tribunal finds it convenient to discuss these issues in the reverse order.

SFG's March 2011 Report

15. The terms of reference for this report were settled between the parties, with intervention by the Tribunal, on 22 November 2010. The parties had the opportunity to comment on a draft of the report, and SFG's responses to those comments are incorporated in the final report.

16. The AER's report raises what it calls major compliance issues – eight in number – with the terms of reference. These all relate to the treatment of the data. The AER also makes comments on SFG's analysis: the model specification and estimation procedures. The AER's overall conclusion is that the SFG report should be considered ''together with the results of other relevant and reliable studies''.

17. In SFG's April 2011 report and its further supplementary report, SFG responded to the AER's report in considerable detail.

18. It is not necessary to set out the details of the eight issues, since they raise no important or significant questions of principle. Rather they involve detailed decisions made in the course of constructing a database and analysing it. Having considered the reports, including Officer's April 2011 report, the Tribunal has concluded that any departures from the agreed terms of reference were justified, even necessary. Calling them ''major compliance issues'' is unnecessarily pejorative. Whether or not the terms of reference have been departed from, what is important is whether the concerns raised by the AER with the construction of the database cast doubt on the value of SFG's analysis, requiring the Tribunal to give it less weight than it otherwise would.

19. In the Tribunal's view, they do not. The Tribunal is satisfied that the procedures used to select and filter the data were appropriate and do not give rise to any significant bias in the results obtained from the analysis. Nor was that suggested by the AER.

20. The AER's further comments concern the inherent problem of multicollinearity, the model specification and the estimation procedure.

21. Little more can be usefully said about multicollinearity than was included in the Tribunal's earlier reasons subject to some brief comments below. It is an unavoidable problem in the estimation of the utilisation of franking credits, since franking credits are very highly correlated with cash dividends. What can be done is to conduct a study as carefully as possible with as large a data set as is available.

22. In respect of the model specification and estimation procedure, the Tribunal is persuaded by SFG's reasoning in reaching its conclusions. Indeed, the careful scrutiny to which SFG's report has been subjected, and SFG's comprehensive response, gives the Tribunal confidence in those conclusions. In that context, the Tribunal notes that in commissioning such a study, it hoped that the results would provide the best possible estimates of theta and gamma from a dividend drop-off study. The terms of reference were developed with the intention of redressing the shortcomings and limitations of earlier studies as far as possible.

SFG's study in the context of other dividend drop-off studies

23. The AER's report reviews ten dividend drop-off studies. The context for this was that in the hearings leading up to the commissioning of the SFG study, significant concerns were expressed regarding all of the studies that were before the Tribunal. The main contenders were a 2010 study by SFG and a 2006 study by Beggs and Skeels. Those concerns are set out in the Tribunal's earlier reasons for decision.

24. The Tribunal wanted to know whether other studies existed that did not exhibit the shortcomings of those before it.

25. The AER's report concludes that the Beggs and Skeels post-July 2000 estimate from their 2006 study is the only one that should be considered along with SFG's March 2011 study. In doing so, the AER relies in part on advice given in McKenzie and Partington (2010), a report referred to in the Tribunal's earlier reasons, which stated that where multiple studies of the same type are available,

the results from all these studies should be considered.

26. Several remarks are necessary. First, considering a range of studies does not imply that they should be given equal weight. Indeed, the AER's report proposes that only two of the ten studies it reviewed be given any weight.

27. Secondly, the Tribunal has already made clear its difficulty in accepting the results of the Beggs and Skeels study.

28. Thirdly, as the Tribunal noted in its earlier reasons, in January 2010 Associate Professor Skeels endorsed the then SFG study estimate over that of his own earlier study.

Conclusions regarding SFG's March 2011 report

29. The Tribunal is satisfied that SFG's March 2011 report is the best dividend drop-off study currently available for the purpose of estimating gamma in terms of the Rules. Its estimate of a value of 0.35 for theta should be accepted as the best estimate using this approach. In particular, the Tribunal cannot accept the submission of the AER that either minor issues in the construction of the database or multicollinearity argue for giving the SFG study less weight and the Beggs and Skeels study some weight. The Beggs and Skeels study, despite not being subjected to anything like the same level scrutiny, is known to suffer by comparison with the SFG study on those and other grounds.

30. Moreover, the fact that in its earlier reasons the Tribunal found no error in the AER having relied on the Beggs and Skeels study is not to the point. The proceedings since then have been largely designed to render that study, along with the earlier SFG study, obsolete for the purpose of setting a value for gamma – and have done so.

Dividend drop-off studies in the context of other approaches

31. A question remains whether dividend drop-off studies are able to provide appropriate estimates for the purposes of the Rules; and whether the results of SFG's March 2011 report should be considered in the light of other approaches. This issue is addressed in the AER's report and in SIRCA's March 2011 report.

32. SIRCA's March 2011 report provided responses to a number of specific questions asked by the AER. Some of these responses raise serious issues regarding the use of dividend drop-off studies and the Tribunal's earlier reasons. For example, SIRCA's March 2011 report suggests that:

- estimates from dividend drop-off studies are very imprecise and of questionable reliability;
- such studies are likely to produce downwardly-biased estimates of theta; and
- taxation studies do not give an upper bound to theta.

33. By way of background, the Tribunal in earlier reasons noted that the AER accepted that tax statistics studies provide an upper bound on possible values of theta. The AER in its report, while being less unequivocal than SIRCA, adopts SIRCA's suggestion that the results of tax statistics studies (now called the redemption rate) could be discounted for factors such as the time between the distribution and the redemption of imputation credits. These adjustments ''would need to be made on an economically justifiable basis''. The AER referred to a 2004 study by Hathaway and Officer as being an example of such a use of an estimate of the utilisation rate.

34. Beyond these observations, the AER does not seek to adduce material from SIRCA's March 2011 report to advance its submissions. On the material before it, the Tribunal is unable to reach any conclusions about the further use of tax statistics studies in estimating the utilisation ratio, theta. No doubt the AER will in the future have opportunity, and perhaps cause, to investigate further. It has not sought to do so in these proceedings.

The argument for regulatory inertia

35. In its submission, the AER re-agitated one of its earlier arguments: that the Rules establish a regime of regulatory inertia whereby values of the WACC parameter set in the Statement of Regulatory Intent (''SORI'') will govern the distribution determinations that are made during the following five years unless, and to the extent that, it is shown that a departure from the SORI values is justified.

36. The Tribunal accepts that due regard should be given to historical consistency in applying regulatory values over time. Nevertheless, the Tribunal, standing in the AER's shoes, is inescapably required to exercise regulatory judgment in determining the appropriate value of theta.

37. The Tribunal must determine an appropriate value for gamma on the basis of the material before it. It does not accept that its task is to determine a value of gamma that is appropriate and not too different from the previously determined value of gamma. That gives too little policy weight to the objective set out in s 7A of the NEL that a regulated DNSP should be provided with a reasonable opportunity to recover at least the efficient costs it incurs. That objective must outweigh any presumption of regulatory inertia. In any event, within the SORI framework by which the AER argues for the principle of regulatory inertia, the Tribunal has persuasive evidence justifying a departure from previously determined values of gamma.

CONCLUSION

38. The Tribunal finds itself in a position where it has one estimate of theta before it (the SFG's March 2011 report value of 0.35) in which it has confidence, given the dividend drop-off methodology. No other dividend drop-off study estimate has any claims to be given weight vis-à-vis the SFG report value.

39. Although the AER has ventured some general comments about the possibility of using another analytical approach, viz, tax statistics studies, the AER has provided no such material in these proceedings.

40. The AER has tendered, largely without comment, material that casts some doubt on the use of dividend drop-off studies in estimating gamma for regulatory purposes. In responding to questions from the AER, SIRCA's March 2011 report raises questions about the theoretical basis for dividend drop-off studies. In doing so, it touches on issues raised in the Tribunal's earlier reasons regarding the arbitrage model underlying dividend drop-off studies.

41. However, SIRCA's March 2011 report does not resolve these issues and the AER has provided no conclusions of its own.

42. Taking the values of the distribution ratio and of theta that the Tribunal has concluded should be used, viz 0.7 and 0.35, respectively, the Tribunal determines that the value of gamma is 0.25.

43. The Tribunal notes that, in accordance with cl 6.5.3 of the Rules, the consequence of this decision is that the estimated cost of corporate income tax of a DNSP will be 75% of the estimated tax liability of a bench mark efficient entity determined in accordance with the post tax revenue model. Of course, this provision is based upon the receipt and utilisation of franking credits by shareholders, it being determined that 25% of tax credits created are utilised.

44. The Tribunal has been provided with extrinsic materials in an attempt to explain clearly the basis of this approach. It has not found an explanation in the clear terms that might be expected. The Tribunal remains of the view that an explanation is needed of the basis for adjusting the costs of a DNSP to take account of the tax liabilities of its shareholders. Such an explanation should be the starting point for considering how best to estimate gamma.

45. Further, the Tribunal notes that estimation of a parameter such as gamma is necessarily, and desirably, an ongoing intellectual and empirical endeavour. Its decision in these proceedings is based on the material before it.

46. It now remains for the Tribunal to make a determination in each of the applications.

47. An issue has arisen whether the Tribunal has the power to make interim or partial determinations – see eg *Application by Jemena Gas Networks (NSW) Ltd (No 4)* [2011] ACompT 8; and *Application by EnergyAustralia* [2009] ACompT 7 at [3].

48. After considering this matter and receiving submissions from the parties, this is a matter which needs no further consideration in these applications.

49. As there is doubt about the validity of earlier determinations made in these proceedings, the Tribunal will make a final determination incorporating all earlier decisions. The Tribunal is still seized of the applications and is not *functus officio*. No party opposes this course of action. No third party

(including any consumer) is adversely affected by this approach.

50. Therefore, the parties are requested to bring before the Tribunal a determination in each application reflecting the various decisions made by the Tribunal.

51. The parties are reminded that the Tribunal has given notice extending the period that the Tribunal has for determining the applications to 31 May 2011.

[¶42-357] PILBARA INFRASTRUCTURE PTY LTD v AUSTRALIAN COMPETITION TRIBUNAL

(2011) ATPR ¶42-357
Court citation: [2011] FCAFC 58
Full Federal Court of Australia
4 May 2011

Access to existing infrastructure — Whether ''uneconomical for anyone'' to develop another facility — Test of private profitability — ''Economically feasible'' v ''economically efficient'' — Whether the relevant perspective is that of the ''society as a whole'' or of participants in the marketplace — Natural monopoly test — Whether social costs and benefits are relevant to s 44H(4)(f) — Whether costs inherent in the Pt IIIA process are relevant to s 44H(4)(f) — Procedural fairness — Material provided to Tribunal after the conclusion of hearing — Competition and Consumer Act 2010 (Cth), Pt IIIA, s 44H(4)(b), 44H(4)(f).

The Pilbara Infrastructure Pty Ltd, a subsidiary of Fortescue Metals Group Ltd (collectively ''Fortescue''), sought to obtain access to four railway lines in the Pilbara region of Western Australia under Pt IIIA of the *Competition and Consumer Act 2010* (Cth) (CCA). It planned to use the existing infrastructure to provide its own rail transport services to miners in the region. Two of the lines were owned by BHP Billiton Iron Ore Pty Ltd and BHP Billiton Minerals Pty Ltd (collectively ''BHP''), and the other two lines were owned by Rio Tinto Ltd and its subsidiaries or associates (collectively ''Rio Tinto'').

Part IIIA establishes a two-step process. During the first stage, a service can be ''declared'' by the designated Minister. If a service is declared, an enforceable right to negotiate the terms of access to the service vests in any interested person. The second stage may include the arbitration of terms of access, if the parties are unable to reach agreement by negotiation. The Minister may not declare the service unless satisfied of the criteria in s 44H(4) of the CCA, including the following:

- **Criterion (b): ''that it would be uneconomical for anyone to develop another facility to provide the service''**
- **Criterion (f): ''that access (or increased access) to the service would not be contrary to the public interest''.**

Fortescue was initially successful in having three of the four lines declared by the designated Minister for a 20-year period. In June 2010, the Australian Competition Tribunal set aside the Minister's decision to declare the Hamersley line and varied the decision in relation to the Robe line so that it would expire in 10 years.

Criterion (b)

Before the Full Federal Court, Rio Tinto submitted that the Minister's declaration in relation to the Robe line should have been set aside in its entirety. Rio Tinto and BHP both submitted that criterion (b) establishes a test of private profitability, that is, criterion (b) would not be satisfied if it was privately profitable for someone to build another facility to provide the service in question. Rio Tinto argued that the tribunal erred in preferring a test of productive efficiency from the point of view of society as a whole.