NOTICE OF LODGMENT

AUSTRALIAN COMPETITION TRIBUNAL

This document was lodged electronically in the AUSTRALIAN COMPETITION TRIBUNAL on 21/05/2015 15.54 pm AEST and has been accepted for lodgment under the Interim Practice Direction dated 8 May 2015. Filing details follow and important additional information about these are set out below.

Lodgment and Details

Document Lodged:	Application - REDACTED
File Number:	ACT 5 of 2015
File Title:	Application under s 71B of the National Electricity Law for a review of a distribution determination made by the Australian Energy Regulator in relation to ActewAGL Distribution pursuant to clauses 6.11.1 and 11.56.4 of the National Electricity Rules
Registry:	SOUTH AUSTRALIA – AUSTRALIAN COMPETITION TRIBUNAL

Dated: 21/05/2015 15:54 pm AEST

Registrar

COMMONWEALTH OF AUSTRALIA
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Important Information

As required by the Interim Practice Direction dated 8 May 2015, this Notice has been inserted as the first page of the document which has been accepted for electronic filing. It is now taken to be part of that document for the purposes of the proceeding in the Tribunal and contains important information for all parties to that proceeding. It must be included in the document served on each of those parties.

The date and time of lodgment also shown above are the date and time that the document was received by the Tribunal. Under the Tribunal's Interim Practice Direction the date of filing of the document is the day it was lodged (if that is a business day for the Registry which accepts it and the document was received by 4:30 pm local time at that Registry) or otherwise the next working day for that Registry.

REDACTED

COMMERCIALLY CONFIDENTIAL INFORMATION INCLUDED

APPLICATION FOR LEAVE AND APPLICATION FOR REVIEW BY THE AUSTRALIAN COMPETITION TRIBUNAL

AUSTRALIAN COMPETITION TRIBUNAL

21 May 2015

FILED IN TRIBUNAL

Commonwealth of Australia

Electricity (National Scheme) Act 1997 (ACT)

In the Australian Competition Tribunal

File No. of 2015

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 ActewAGL Distribution pursuant to clauses 6.11.1 and 11.56.4 of the National Electricity Rules**
Applicant	**ActewAGL Distribution** (ABN 76 670 568 688)
Address of Applicant	**ActewAGL House, 40 Bunda Street, Canberra ACT 2601**

COMMONWEALTH OF AUSTRALIA
AUSTRALIA
AUSTRALIAN COMPETITION TRIBUNAL

Prepared by Fleur Gibbons
DLA Piper Australia
Tel (03) 9274 5000
Email fleur.gibbons@dlapiper.com
Address for service DLA Piper Australia
140 William Street
Melbourne Vic 3000

Ref FCG:LMH 0354593/8 (1209424774)

Fax (03) 9274 5111

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A INTRODUCTION

ActewAGL Distribution

1. ActewAGL Distribution (**ActewAGL**) is the owner and operator of an electricity distribution network located in the Australian Capital Territory (**ACT**) (**ActewAGL Distribution Network**).

2. ActewAGL is registered as a distribution network service provider (**DNSP**) under section 12(1) of the National Electricity Law (**NEL**) and clause 2.5.1 of the National Electricity Rules (**NER**) and provides distribution services to retailers by means of the ActewAGL Distribution Network. The NEL and the NER regulate the revenue that ActewAGL is permitted to derive from the provision of distribution services.

AER distribution determination process

3. The Australian Energy Regulator (**AER**) is responsible for the economic regulation of electricity distribution services in the ACT under the NEL. The AER is required to make distribution determinations for DNSPs, including ActewAGL under the NER.

4. In 2012, significant amendments were made to the NER governing the economic regulation of DNSPs through the Australian Energy Market Commission's (**AEMC's**) Rule Determination, *National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012* (**2012 Rule Determination**). As a result of those changes the AEMC deferred the full regulatory determination process for the 2014/15 to 2018/19 regulatory control period.

5. To allow for a transition to the new rules, the Savings and Transitional Rules in Division 2 of Part ZW of Chapter 11 of the NER provided for a two stage process for the regulation of ACT and NSW DNSPs over the five year period commencing on 1 July 2014 (the **2014-19 period**), comprising:

    5.1 the transitional regulatory control period from 2014/15 to 2015/16 (**transitional regulatory control period**); and

    5.2 the subsequent regulatory control period from 2015/16 to 2018/19 (**subsequent regulatory control period**).

6. Under the transitional arrangements, the AER was required to make placeholder distribution determinations for the ACT and NSW DNSPs for the transitional regulatory control period which would only apply for one year, from 2014/15 to 2015/16. The AER was then required to carry out a full regulatory determination process and make distribution determinations for the ACT and NSW DNSPs for the subsequent regulatory control period, from 2015/16 to 2018/19.

7. On 31 January 2014, ActewAGL submitted to the AER a regulatory proposal for the transitional regulatory control period for the distribution services it provides by means of, or in connection with, the ActewAGL Distribution Network.

8. On 16 April 2014, the AER determined a placeholder distribution determination for the transitional regulatory control period (**Transitional Determination**).

9. On 2 June 2014, ActewAGL submitted to the AER a regulatory proposal for the subsequent regulatory control period for the distribution services it provides by means of, or in connection with, the ActewAGL Distribution Network. On 17 June 2014, the AER notified ActewAGL under clause 6.9.1(a) of the NER that it required ActewAGL to resubmit its regulatory proposal on the basis that the AER did not consider the proposal to be compliant with the NER. On 10 July 2014, ActewAGL resubmitted its regulatory proposal (**Regulatory Proposal**) and in doing so addressed the matters identified in the notice in so far as those matters related to non-compliance with the NER.

10. On 27 November 2014, the AER published its *Draft decision ActewAGL distribution determination 2015/16 to 2018/19*, Overview and Attachments 1 to 19 (together, **Draft**

Decision), setting out its draft distribution determination for ActewAGL for the subsequent regulatory control period together with its reasons for decision.

11. On 20 January 2015, ActewAGL submitted to the AER a revised regulatory proposal for the subsequent regulatory control period (**Revised Regulatory Proposal**).

12. The AER invited submissions on the Draft Decision and Revised Regulatory Proposal by 13 February 2015. On 13 February 2015, ActewAGL made a submission on the Draft Decision and Revised Regulatory Proposal to the AER.

13. On 30 April 2015, the AER published its *Final Decision ActewAGL distribution determination 2015/16 to 2018/19* (**Final Determination**), encompassing its reasons together with the distribution determination.

B REGULATORY REGIME

14. Section 5 of the *Electricity (National Scheme) Act 1997* (ACT) applies the NEL, set out in the Schedule to the *National Electricity (South Australia) Act 1996* (SA), as a law of the ACT.

15. Section 7 of the NEL sets out the national electricity objective (**NEO**) which is to:

> promote the efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to-
>
> (a) price, quality, safety, reliability and security of supply of electricity; and
>
> (b) the reliability, safety and security of the national electricity system.

16. Section 9 of the NEL gives the NER the force of law in the ACT.

Economic regulation of distribution services under the NEL and the NER

Relevant NEL provisions

17. Section 15 of the NEL prescribes the functions and powers of the AER. Those functions and powers include the 'AER economic regulatory functions or powers' (section 15(1)(f)) and ‘any other functions and powers conferred on it under the [NEL] and the [NER]’ (section 15(1)(g)). The 'AER economic regulatory functions or powers' are defined in section 2 of the NEL to include a function or power performed or exercised by the AER under the NEL or the NER that relates to:

    17.1 the economic regulation of services provided by a regulated distribution system, or in connection with, a distribution system (sub-section 2(a)); or

    17.2 the making of a distribution determination (sub-section 2(c)).

18. A 'distribution determination' is defined in section 2 of the NEL to mean a determination of the AER under the NER that regulates:

18.1 the terms and conditions for the provision of electricity network services that are the subject of economic regulation under the NER including the prices that may be charged for those services; and/or

18.2 the revenue that may be earned from the provision of electricity network services that are the subject of economic regulation under the NER.

19. The AER must perform or exercise an economic regulatory function or power in a manner that will or is likely to contribute to the achievement of the NEO (section 16(1)(a)). In performing or exercising an economic regulatory function or power in relation to making a reviewable regulatory decision, the AER must specify (section 16(1)(c)):

19.1 the manner in which the constituent components of the decision relate to each other; and

19.2 the manner in which that interrelationship has been taken into account in the making of the reviewable regulatory decision.

20. If the AER is making a reviewable regulatory decision and there are two or more possible reviewable regulatory decisions that will or are likely to contribute to the achievement of the NEO, the AER must (section 16(1)(d)):

20.1 make the decision that it is satisfied will or is likely to contribute to the achievement of the NEO to the greatest degree (**the NEO preferable reviewable regulatory decision**); and

20.2 specify reasons as to the basis on which the AER is satisfied that the decision is the NEO preferable reviewable regulatory decision.

21. In addition, the AER must take into account the revenue and pricing principles set out in section 7A of the NEL when exercising a discretion in making those parts of a distribution determination relating to direct control services (section 16(2)(a) of the NEL).

22. The AER may also take into account the revenue and pricing principles set out in section 7A of the NEL when performing or exercising any other AER economic function or power if the AER considers it appropriate to do so (section 16(2)(b) of the NEL).

23. The revenue and pricing principles are defined in section 7A of the NEL. They include:

23.1 under section 7A(2), that a regulated network service provider should be provided with a reasonable opportunity to recover at least the efficient costs the operator incurs in:

23.1.1 providing direct control network services; and

23.1.2 complying with a regulatory obligation or requirement or making a regulatory payment;

23.2 under section 7A(3), that a regulated network service provider should be provided with effective incentives in order to promote economic efficiency with respect to direct control network services the operator provides, including the promotion of efficient investment in and the efficient use of the distribution system with which the operator provides those services;

23.3 under section 7A(4), that regard should be had to the regulatory asset base (**RAB**) with respect to the distribution system adopted:

23.3.1 in any previous -

(a) distribution determination; or

(b) determination or decision under the National Electricity Code or jurisdictional electricity legislation regulating the revenue earned, or prices charged, by a person providing services by means of that distribution system or transmission system; or

23.3.2 in the NER;

23.4 under section 7A(5), that a price or charge for the provision of a direct control network service should allow for a return commensurate with the regulatory and commercial risks involved in providing the direct control network service to which that price or charge relates; and

23.5 under section 7A(6), that regard should be had to the economic costs and risks of the potential for under and over investment by a regulated network service provider in a distribution system with which a regulated network service provider provides direct control network services.

24. Section 16(1)(b) of the NEL also provides that, if the function or power performed or exercised by the AER relates to a distribution determination, the AER must ensure that the DNSP to whom the determination will apply is, in accordance with the NER:

24.1 informed of material issues under consideration by the AER; and

24.2 given a reasonable opportunity to make submissions in respect of that determination before it is made.

Chapter 6 of the NER and Transitional Rules

25. Chapter 6 of the NER governs the economic regulation by the AER of distribution services provided by means of, or in connection with, distribution systems. The Chapter requires, and sets out the procedures for, the making of a distribution determination.

26. As a result of the amendments made to the NER by the AEMC's 2012 Rule Determination, the Savings and Transitional Rules in Division 2 of Part ZW in Chapter 11 of the NER varied, to some extent, the operation of Chapter 6 with respect to the making of ActewAGL's distribution determination. Further, the Savings and Transitional Rules in Chapter 11 of the

NER specify the version of Chapter 6 which applied to the making of the Distribution Determination.

27. Clause 11.56.4 in Chapter 11 of the NER provides that except as specified in that clause 'current Chapter 6' governs the making of a distribution determination for the subsequent regulatory control period for ACT and NSW DNSPs. Clause 11.65.2(a) of the NER provides that references to 'current Chapter 6' are to be read as Chapter 6 of the NER as in force immediately after the *National Electricity Amendment (Network Service Provider Expenditure Objectives) Rule 2013* came into force. That Rule came into force on 26 September 2013 and version 58 of the NER was the version of the NER in force from 26 September 2013. Accordingly, the NER provides that, except as otherwise specified in clause 11.56.4 of the NER, Chapter 6 in version 58 of the NER applied to the making of ActewAGL's distribution determination.[1]

28. Further, except as provided for in clause 11.55.2, Chapter 6 in version 58 of the NER applied to the making of the Transitional Determination for ActewAGL. Under clause 11.56.1 the distribution determination for the transitional regulatory control period must be made by the AER in accordance with transitional Chapter 6 and Division 2 of Part ZW in Chapter 11 of the NER. Clause 11.55.2 provides that for the purposes of Division 2 of Part ZW in Chapter 11 'transitional Chapter 6' means 'current Chapter 6', except for the modifications set out in that clause. The reference to 'current Chapter 6' in clause 11.55.2 takes the meaning in clause 11.65.2(a) of the NER set out in the preceding paragraph of this Application.

29. Accordingly, unless otherwise indicated, references to Chapter 6 of the NER in this Application are references to Chapter 6 in version 58 of the NER.

30. Clause 6.8.2(a) of the NER, as varied by clause 11.55.2(b), required ActewAGL to submit a transitional regulatory proposal to the AER at least 5 months before the expiry of the regulatory control period that immediately preceded the transitional regulatory control period.

31. The AER was required to make a distribution determination for the transitional regulatory control period under clause 11.56.1 of the NER.

---

1 Clause 11.55.3 of the NER provides that clause 11.56 prevails to the extent of any inconsistency over any other clause of the NER. Clause 11.56.4(a) of the NER provides that 'current Chapter 6' governs the making of a distribution determination for NSW and ACT DNSPs for the subsequent regulatory control period. 'Current chapter 6' is defined in clause 11.55.1 of the NER to mean Chapter 6 of the NER in force immediately after Schedules 1 and 3 of the *National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012* came into force. However, clause 11.65.2 of the NER provides that **despite clause 11.55.3**, from the commencement date of the *National Electricity Amendment (Network Service Provider Expenditure Objectives) Rule 2013*, references in clauses 11.55 to 11.60 of the NER to 'current Chapter 6' are to be read as Chapter 6 of the NER as in force immediately after the *National Electricity Amendment (Network Service Provider Expenditure Objectives) Rule 2013* comes into force. That Rule came into force on 26 September 2013 and version 58 of the NER was the version of the NER in force from 26 September 2013. ActewAGL notes that clause 11.73.1(a) of the NER provides that former Chapter 6 governs the making of a distribution determination (not including a tariff structure statement) for the initial regulatory control period of an affected DNSP. The term 'affected DNSP' is defined in clause 11.72.1 to include NSW and ACT DNSPs and the term 'initial regulatory control period' is defined in that clause to mean the regulatory control period commencing on 1 July 2015 (i.e. the subsequent regulatory control period). The term 'former Chapter 6' is defined in clause 11.70.1 of the NER to mean Chapter 6 as in force immediately before Schedules 1, 3 and 4 of the *National Electricity Amendment (Distribution Network Pricing Arrangements) Rule 2014* came into force. Those Schedules came into force on 1 December 2014 and the version of the NER in force immediately before the commencement of those Schedules was version 65. However, unlike clause 11.65.2 of the NER, clause 11.73.1(a) is not effective in modifying the version of Chapter 6 that governs the making of the ACT and NSW distribution determinations because it makes no mention of, and does not express any intent to contradict, clause 11.55.3. Nonetheless, ActewAGL observes that, for all practical purposes, there is no difference between versions 58 and 65 of the NER.

32. Clause 6.8.2 of the NER, as varied by clause 11.56.4(o), required ActewAGL to submit a regulatory proposal to the AER for the subsequent regulatory control period for the distribution services provided by means of, or in connection with, the ActewAGL Distribution Network, at least 13 months before the expiry of the Transitional Determination.

33. Under clause 11.56.4(b) of the NER, except as provided for in clause 11.56.4(d), ActewAGL was required to prepare and submit its regulatory proposal for the subsequent regulatory control period, together with all the information that was required to accompany that regulatory proposal, in accordance with Chapter 6, and as if:

    33.1 the subsequent regulatory control period comprised the transitional regulatory control period (as the first regulatory year of the subsequent regulatory control period) and all of the regulatory years of the subsequent regulatory control period (as the remaining regulatory years of the subsequent regulatory control period); and

    33.2 the transitional regulatory control period were not a separate regulatory control period.

34. Under clause 6.8.2(c)(2) of the NER, a DNSP's regulatory proposal must include, among other things, a 'building block proposal' for direct control services classified under the proposal as standard control services.

35. The 'building block proposal' must be prepared in accordance with (among other things) the requirements of Part C of Chapter 6 of the NER (clause 6.3.1(c)(1)). In particular, the 'building block' proposal must be prepared in accordance with clause 6.4.3 of the NER, which specifies the building blocks by which the 'annual revenue requirement' for a DNSP for each year of a regulatory control period is to be determined.

36. The 'building blocks' specified in clause 6.4.3 of the NER exhaustively prescribe the elements of a DNSP's annual revenue requirement for each regulatory year of the regulatory control period. The phrase 'must be determined' in clause 6.4.3 means that the AER does not have the power to make a determination about a DNSP's revenue requirements for each regulatory year other than by applying the 'building blocks' specified in that clause.

37. Clause 6.10.1 of the NER required the AER to make a draft distribution determination for the subsequent regulatory control period in relation to ActewAGL.

38. Clause 6.10.3 of the NER, as varied by clause 11.56.4(o), entitled ActewAGL to submit a revised regulatory proposal to the AER after publication of the draft distribution determination.

39. The AER was required make a distribution determination in relation to ActewAGL for the subsequent regulatory control period pursuant to clauses 6.11.1 and 11.56.4 of the NER.

40. A distribution determination is predicated on the constituent decisions by the AER described in clause 6.12.1 of the NER. For the purposes of ActewAGL's review grounds, the relevant constituent decisions described in clause 6.12.1 of the NER are as follows:

(1) a decision on the classification of the services to be provided by the *Distribution Network Service Provider* during the course of the *regulatory control period*;

(2) a decision on the *Distribution Network Service Provider's* current *building block proposal* in which the *AER* either approves or refuses to approve:

(i) the *annual revenue requirement* for the *Distribution Network Service Provider*, as set out in the *building block proposal*, for each *regulatory year* of the *regulatory control period*; and

(ii) the commencement and length of the *regulatory control period* as proposed in the *building block proposal*;

…

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

(i) acting in accordance with clause 6.5.6(c), accepts the total of the forecast operating expenditure for the *regulatory control period* that is included in the current *building block proposal*; or

(ii) acting in accordance with clause 6.5.6(d), does not accept the total of the forecast operating expenditure for the *regulatory control period* that is included in the current *building block proposal*, in which case the *AER* must set out its reasons for that decision and an estimate of the total of the *Distribution Network Service Provider's* required operating expenditure for the *regulatory control period* that the *AER* is satisfied reasonably reflects the *operating expenditure criteria*, taking into account the *operating expenditure factors*;

…

(5) a decision on the *allowed rate of return* for each *regulatory year* of the *regulatory control period* in accordance with clause 6.5.2;

(5A) a decision on whether the return on debt is to be estimated using a methodology referred to in clause 6.5.2(i)(2) and, if that is the case, the formula that is to be applied in accordance with clause 6.5.2(l);

(5B) a decision on the value of imputation credits as referred to in clause 6.5.3;

(7) a decision on the estimated cost of corporate income tax to the *Distribution Network Service Provider* for each *regulatory year* of the *regulatory control period* in accordance with clause 6.5.3;

…

(9) a decision on how any applicable … *service target performance incentive scheme* … is to apply to the *Distribution Network Service Provider;*

(10) a decision in which the *AER* decides other appropriate amounts, values or inputs;

(11) a decision on the form of the control mechanisms (including the X factor) for *standard control services* (to be in accordance with the relevant *framework and approach paper*) and on the formulae that give effect to those control mechanisms;

(12) a decision on the form of the control mechanisms for *alternative control services* (to be in accordance with the relevant *framework and approach paper*) and on the formulae that give effect to those control mechanisms[.]

41. Clause 11.56.4(c) of the NER provides that, for the purpose of making a distribution determination for ActewAGL for the subsequent regulatory control period, the AER must determine (amongst other things) the annual revenue requirement for ActewAGL for each regulatory year of the subsequent regulatory control period and its total revenue requirement for the subsequent regulatory control period, as if the subsequent regulatory control period comprised the transitional regulatory control period and all of the regulatory years of the subsequent regulatory control period and the transitional regulatory control period were not a separate regulatory control period. That clause further provides, for the avoidance of doubt, that the AER was required to determine a notional annual revenue requirement for the regulatory year that comprised the transitional regulatory control period.

42. Under clause 11.56.4(h) and (i) of the NER, the AER is required to adjust ActewAGL's total revenue requirement for the subsequent regulatory control period by increasing or decreasing the annual revenue allowance(s) for one or more of the regulatory years of the subsequent regulatory control period. The amount of that adjustment is calculated as the amount of the annual revenue allowance approved for the transitional regulatory control period in its placeholder determination less the amount of the 'notional' annual revenue allowance for the transitional regulatory control period determined in the distribution determination for the subsequent regulatory control period (subject to modifications as set out in the AER's Stage 1 Framework and Approach Paper ActewAGL, March 2013 (Stage 1 **Framework and Approach Paper**). There were no modifications to the calculation of the adjustment amount referred to in clauses 11.56.4(h) and 11.56.4(i) of the NER in the Stage 1 Framework and Approach Paper.

43. Under clause 6.11.2 of the NER, the AER must, not later than 2 months before the commencement of the relevant regulatory control period (in this case the subsequent regulatory control period), publish notice of the making of the distribution determination, the distribution determination itself and the AER's reasons for making the distribution determination, including the constituent decisions on which it is predicated, in its final form.

44. Clause 6.12.2 of the NER provides that the reasons given by the AER for a draft distribution determination under clause 6.10 or a final distribution determination under clause 6.11 of the NER must set out the basis and rationale of the determination, including:

44.1 details of the qualitative and quantitative methods applied in any calculations and formulae made or used by the AER;

44.2 the values adopted by the AER for each of the input variables in any calculations and formulae, including:

44.2.1 whether those values have been taken or derived from the DNSP's current building block proposal; and

44.2.2 if not, the rationale for the adoption of those values;

44.3 details of any assumptions made by the AER in undertaking any material qualitative and quantitative analyses; and

44.4 reasons for the making of any decisions, the giving or withholding of any approvals, and the exercise of any discretions, as referred to in this Chapter 6, for the purposes of the determination.

45. The exercise of the AER's discretion in making a distribution determination is governed by clause 6.12.3 of the NER, which relevantly provides:

> (a) Subject to this clause and other provisions of this Chapter 6 explicitly negating or limiting the *AER's* discretion, the *AER* has discretion to accept or approve, or to refuse to accept or approve, any element of a *regulatory proposal*.
>
> …
>
> (d) The *AER* must approve the *total revenue requirement* for a *Distribution Network Service Provider* for a *regulatory control period*, and the *annual revenue requirement* for each *regulatory year* of the *regulatory control period*, as set out in the *Distribution Network Service Provider*'s current *building block proposal*, if the *AER* is satisfied that those amounts have been properly calculated using the *post-tax revenue model* on the basis of amounts calculated, determined or forecast in accordance with the requirements of Part C of this Chapter 6.

Merits review

46. Division 3A of Part 6 of the NEL provides for merits review by the Australian Competition Tribunal (**Tribunal**) of 'reviewable regulatory decisions'. 'Reviewable regulatory decision' is defined in section 71A to include a distribution determination, being either a network revenue or pricing determination (as defined in section 2 of the NEL), that sets a regulatory period.

47. Under section 71B of the NEL, an 'affected or interested person or body', with the leave of the Tribunal, may apply to the Tribunal for a review of a 'reviewable regulatory decision'. 'Affected or interested person or body' is defined in section 71A of the NEL to include a regulated network service provider to whom the 'reviewable regulatory decision' applies.

48. Under section 71C of the NEL, an application under section 71B may be made only on one or more of the following grounds:

48.1 the AER made an error of fact in its findings of facts, and that error of fact was material to the making of the decision;

48.2 the AER made more than one error of fact in its findings of facts, and that those errors of fact, in combination, were material to the making of the decision;

48.3 the exercise of the AER's discretion was incorrect, having regard to all the circumstances;

48.4 the AER's decision was unreasonable, having regard to all the circumstances.

49. Under section 71C(1a) of the NEL an application under section 71B must 'specify the manner in which a determination made by the Tribunal varying the reviewable regulatory decision, or setting aside the reviewable regulatory decision and a fresh decision being made by the AER following remission of the matter to the AER by the Tribunal, on the basis of one (1) or more grounds raised in the application, either separately or collectively, would, or would be likely to, result in a materially preferable NEO decision'. 'Materially preferable NEO decision' is defined in section 71P(2a(c)) of the NEL as a 'decision that is materially preferable to the reviewable regulatory decision in making a contribution to the achievement of' the NEO.

50. Section 71E of the NEL provides that the Tribunal must not grant leave to apply for review of a reviewable regulatory decision under section 71B(1) unless it appears to the Tribunal that:

    50.1 there is a serious issue to be heard and determined as to whether a ground for review set out in section 71C(1) exists; and

    50.2 the applicant has established a prima facie case that a determination made by the Tribunal varying the reviewable regulatory decision, or setting it aside and a fresh decision being made by the AER on remittal, on the basis of one or more grounds raised in the application, either separately or collectively, would, or would be likely to, result in a materially preferable NEO decision.

51. Section 71F(1) of the NEL applies where the application for leave to apply for merits review:

    51.1 relates to a reviewable regulatory decision that is a network revenue or pricing determination; and

    51.2 the ground for review relied on by the applicant relates to the amount of revenue that may be earned by a regulated network service provider that is specified in or derived from that decision.

52. Section 71F(2) of the NEL provides that, in such cases, the Tribunal must not grant leave to apply for merits review unless the amount specified in or derived from the decision exceeds the lesser of $5 million or 2 per cent of the average annual regulated revenue of the regulated network service provider.

53. Under sections 71P(1) and 71P(2) of the NEL, if the Tribunal grants leave in accordance with section 71B(1), the Tribunal must make a determination in respect of the application which:

    53.1 affirms the reviewable regulatory decision; or

    53.2 varies the reviewable regulatory decision; or

    53.3 sets aside the reviewable regulatory decision and remits the matter back to the AER to make the decision again in accordance with any direction or recommendation of the Tribunal.

54. Under section 71P(2a) of the NEL, the Tribunal can only make a determination to vary a reviewable regulatory decision under sub-section (2)(b) or to set aside the reviewable regulatory decision and remit the matter back to the AER under sub-section (2)(c) if:

54.1 the Tribunal is satisfied that to do so will, or is likely to, result in a materially preferable NEO decision (if the Tribunal is not so satisfied it must affirm the decision); and

54.2 in the case of a determination to vary the reviewable regulatory decision, the Tribunal is satisfied that to do so will not require the Tribunal to undertake an assessment of such complexity that the preferable course of action would be to set aside the reviewable regulatory decision and remit the matter to the AER to make the decision again.

55. Section 71P(2b) of the NEL provides that in connection with the operation of section 71P(2a):

55.1 the Tribunal must consider how the constituent components of the reviewable regulatory decision interrelate with each other and with the matters raised as a ground for review;

55.2 without limiting the preceding sub-section, the Tribunal must take into account the revenue and pricing principles set out in section 7A of the NEL;

55.3 the Tribunal must, in assessing the extent of contribution to the achievement of the NEO, consider the reviewable regulatory decision as a whole; and

55.4 the following matters must not, in themselves, determine the question about whether a materially preferable NEO decision exists:

55.4.1 the establishment of a ground for review under section 71C(1);

55.4.2 consequences for, or impacts on, the average annual regulated revenue of a regulated network service provider; and

55.4.3 that the amount that is specified in or derived from the reviewable regulatory decision exceeds the amount specified in section 71F(2).

56. Section 71P(2c) provides that if the Tribunal makes a determination to vary a reviewable regulatory decision or to set aside that decision and remit the matter back to the AER to make the decision again, the Tribunal must specify in its determination:

56.1 the manner in which it has taken into account the interrelationship between the constituent components of the reviewable regulatory decision and how they relate to the matters raised as a ground for review as contemplated by sub-section (2b)(a); and

56.2 in the case of a determination to vary the reviewable regulatory decision – the reasons why it is proceeding to make the variation in view of the requirements of sub-section (2a)(d).

57. For the purposes of making a determination to affirm a reviewable regulatory decision or vary a reviewable regulatory decision, the Tribunal may perform all the functions and exercise all the powers of the AER under the NEL or the NER (section 71P(3)).

58. A decision by the Tribunal affirming, varying or setting aside the reviewable regulatory decision is, for the purposes of the NEL, to be taken to be a decision of the AER (section 71P(5)).

C APPLICATION FOR LEAVE TO APPLY AND APPLICATION FOR REVIEW OF THE DISTRIBUTION DETERMINATION

59. ActewAGL seeks the leave of the Tribunal to apply, and subject to that leave makes application, to the Tribunal for a review of the AER's Final Determination pursuant to section 71B of the NEL.

60. The Final Determination, being a distribution determination, is a 'reviewable regulatory decision' and ActewAGL, being the regulated network service provider to whom the Final Determination applies, is an 'affected or interested person or body'.

61. ActewAGL applies for review of the Final Determination in respect of the following matters:

61.1 *opex allowance*: the AER’s decision to reject ActewAGL’s proposed operating expenditure (**opex**) allowance of $371.2 million ($ 2013–14) for the 2014–19 period (excluding debt raising costs and Demand Management Incentive Allowances (**DMIA**)) in its Revised Regulatory Proposal, and to determine that ActewAGL’s opex allowance ought to be $240.6 million ($ 2013/14), and to otherwise not make any provision for ActewAGL transitioning to that level of opex by way of a 'glide path' in the control mechanism or otherwise;

61.2 *service target performance incentive scheme:* the AER's decision to apply its national service target performance incentive scheme (**STPIS**) to ActewAGL for the subsequent regulatory control period without modification to the performance targets applicable to ActewAGL, which ActewAGL contends is necessary by reason of the reduction in opex allowed in the Final Determination from the levels allowed to ActewAGL at the time when it achieved the reliability outcomes on which those performance targets were set;

61.3 *alternative control metering services annual charges (annual metering services opex):* the AER's decision to reject ActewAGL's proposed opex for annual metering services of $15.7 million ($ 2013/14) (excluding debt raising costs), and to determine an alternative opex allowance for those annual metering services of $10.8 million ($ 2013/14) (excluding debt raising costs);

61.4 *classification of metering services:* the AER has made an error in the classification of metering services pursuant to clause 6.12.1(1) of the NEL. The AER concedes that it has made the error, and that it ought to be corrected, but proposes to do so after the merits review proceedings are concluded. However, there is disagreement between the AER and ActewAGL as to the precise form that the correction should take. Because of this disagreement, and to ensure regulatory certainty, ActewAGL considers that the error ought to be corrected by order of the Tribunal in this proceeding;

61.5 *return on equity:* the AER's decision to reject ActewAGL's proposed return on equity methodology (that resulted in a final return on equity of 9.83%) for use in the determination of the allowed rate of return for the 2014/19 period, and to instead adopt a return on equity for that period of 7.1%*;*

61.6 *return on debt:* the AER's decision to reject ActewAGL's proposed trailing average approach (without transition) to estimation of the return on debt for use in the determination of the allowed rate of return for the 2014-19 period, and to instead adopt an approach that involves a form of transition from the previous 'on the day' approach to the trailing average approach*;* and

61.7 *value of imputation credits (gamma):* the AER's decision to reject ActewAGL's proposed value of imputation credits of 0.25 for use in the estimation of the cost of corporate income tax for the 2014-19 period, and to determine that the value of imputation credits ought to be 0.4,

each of which is, or is an element of, a constituent decision by the AER pursuant to clause 6.12.1 of the NER on which the Final Determination is predicated.

D GROUNDS FOR REVIEW

(1) Opex allowance

Background

62. One of the 'building blocks' in determining a DNSP's annual revenue requirement (referred to in paragraphs 35 and 36 above) is the forecast opex for each regulatory year of the regulatory control period as accepted or substituted by the AER in accordance with clause 6.5.6 of the NER (clause 6.4.3(a)(7) and (b)(7)).

63. As set out in paragraph 40 above, clause 6.12.1 of the NER provides that the constituent decisions of a distribution determination include:

63.1 a decision on the relevant DNSP's building block proposal (known as a 'building block determination') in which the AER either approves or refuses to approve the annual revenue requirement for the DNSP, as set out in the DNSP's building block proposal, for each regulatory year of the regulatory control period (clause 6.12.1(2)(i)); and

63.2 a decision in which the AER either accepts the DNSP's total opex forecast for that regulatory control period, as set out in the DNSP's building block proposal, or does not accept that forecast, in which case the AER must determine an estimate of the DNSP's required opex for that period (clause 6.12.1(4)).

64. The AER is required to accept a DNSP's forecast opex where it is satisfied that the forecast opex for the regulatory control period reasonably reflects each of the following criteria (**opex criteria**) in clause 6.5.6(c) of the NER being:

64.1 the efficient costs of achieving the opex objectives in clause 6.5.6(a) of the NER (**opex objectives**);

64.2 the costs that a prudent operator would require to achieve the opex objectives; and

64.3 a realistic expectation of the demand forecast and cost inputs required to achieve the opex objectives.

65. The opex objectives in clause 6.5.6(a) of the NER are to:

65.1 meet or manage the expected demand for standard control services over the regulatory control period;

65.2 comply with all applicable regulatory obligations or requirements associated with the provision of standard control services;

65.3 to the extent that there is no applicable regulatory obligation or requirement in relation to:

65.3.1 the quality, reliability or security of supply of standard control services; or

65.3.2 the reliability or security of the distribution system through the supply of standard control services,

to the relevant extent:

65.3.3 maintain the quality, reliability and security of supply of standard control services; and

65.3.4 maintain the reliability and security of the distribution system through the supply of standard control services; and

65.4 maintain the safety of the distribution system through the supply of standard control services.

66. In deciding whether or not it is satisfied that the forecast opex for the regulatory control period reasonably reflects the opex criteria, the AER must have regard to the factors specified in clause 6.5.6(e) of the NER (**opex factors**), being:

66.1 the most recent annual benchmarking report that has been published under clause 6.27 and the benchmark opex that would be incurred by an efficient DNSP over the relevant regulatory control period;

66.2 the actual and expected opex of the DNSP during any preceding regulatory control periods;

66.3 the extent to which the opex forecast includes expenditure to address the concerns of electricity consumers as identified by the DNSP in the course of its engagement with electricity consumers;

66.4 the relative prices of operating and capital inputs;

66.5 the substitution possibilities between opex and capital expenditure (**capex**);

66.6 whether the opex forecast is consistent with any incentive scheme or schemes that apply to the DNSP under clauses 6.5.8 or 6.6.2 to 6.6.4;

66.7 the extent the opex forecast is referable to arrangements with a person other than the DNSP that, in the opinion of the AER, do not reflect arm’s length terms;

66.8 whether the opex forecast includes an amount relating to a project that should more appropriately be included as a contingent project under clause 6.6A.1(b);

66.9 the extent the DNSP has considered, and made provision for, efficient and prudent non-network alternatives; and

66.10 any other factor the AER considers relevant and which the AER has notified the DNSP in writing, prior to the submission of its revised regulatory proposal under clause 6.10.3, is an opex factor.

67. If the AER is not satisfied that a DNSP's forecast opex for the regulatory control period reasonably reflects the opex criteria, then the AER must set out its reasons for that decision and an estimate of the DNSP’s total required opex that it is satisfied reasonably reflects the opex criteria taking into account the opex factors (clauses 6.5.6(d) and 6.12.1(4)(ii) of the NER).

68. Under clause 6.27(a) of the NER, the AER must prepare and publish an annual benchmarking report the purpose of which is to describe the relative efficiency of each DNSP in providing direct control services over a 12 month period. Clause 6.27(c) of the NER provides that, subject to paragraphs (d) and (e), the AER must publish an annual benchmarking report at least every 12 months. Clause 6.27(d) and (e), in turn, provide that the first annual benchmarking report must be published by 30 September 2014 and the second annual benchmarking report by 30 November 2015.

69. Clause 8.7.4 (excluding clause 8.7.4(a)) applies in respect of the preparation of an annual benchmarking report (clause 6.27(b)). Clause 8.7.4 relevantly provides:

> (b) In the course of *preparing a network service provider performance report*, the AER:
>
> (1) must consult with the network service provider or network service providers to which the report is to relate; and
>
> (2) must consult with the authority responsible for the administration of relevant *jurisdictional electricity legislation* about relevant safety and technical obligations; and

(3) may consult with any other persons who have, in the AER's opinion, a proper interest in the subject matter of the report; and

(4) may consult with the public.

….

(c) A *network service provider* to which the report is to relate:

(1) must be allowed an opportunity, at least 30 business days before publication of the report, to submit information and to make submissions relevant to the subject matter of the proposed report; and

(2) must be allowed an opportunity to comment on material of a factual nature to be included in the report.

70. In accordance with clauses 6.2.8(a) and 6.4.5(a) of the NER, in November 2013 the AER published a *Better Regulation Expenditure Forecast Assessment Guideline for Electricity Distribution, November 2013* (**Expenditure Forecast Assessment Guideline**) which specifies the approach that the AER proposes to use to assess the forecasts of opex and capex that form part of a DNSP's regulatory proposal and the information the AER requires for the purpose of that assessment. Clause 6.2.8(c) of the NER provides that the Expenditure Forecast Assessment Guideline is not mandatory, however, if the AER makes a distribution determination that is not in accordance with the Guideline, the AER must state its reasons for departing from the Guideline in that determination.

71. In its Expenditure Forecast Assessment Guideline, the AER states that it prefers to follow a 'base-step-trend' approach to assessing opex.[2] Under this approach, the AER uses a 'revealed cost' approach to assessing opex in the 'base year'. It assesses whether opex in the base year is efficient and, if necessary, adjusts the DNSP's revealed costs to remove inefficient costs. The AER then accounts for any changes in efficient costs in the base year and each year of the forecast regulatory control period.

72. The AER states in its Expenditure Forecast Assessment Guideline that, typically, it will adjust base year opex by applying an annual rate of change for each year of the forecast regulatory control period (which accounts for changes in real prices, output growth and productivity in that period).[3] In addition, step changes may be added or subtracted for any other costs not captured in base opex or the rate of change that are required for forecast opex to meet the opex criteria in the NER.[4]

73. In determining whether or not it is appropriate for the AER to rely on a DNSP's revealed costs the AER states in its Expenditure Forecast Assessment Guideline that it will assess the efficiency of base year expenditures, including whether the DNSP's past performance was efficient relative to its peers and whether the DNSP has improved its efficiency over time,

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2 Expenditure Forecast Assessment Guideline, page 22.

3 Expenditure Forecast Assessment Guideline, page 23.

4 Expenditure Forecast Assessment Guideline, page 23.

using its assessment techniques, beginning with economic benchmarking and category analysis.[5]

74. The intended role of economic and category level benchmarking is described in the AER's accompanying *Better Regulation Explanatory Statement Expenditure Forecast Assessment Guideline, November 2013* (**Expenditure Forecast Assessment Guideline Explanatory Statement**). In that Explanatory Statement, the AER states that it 'will predominantly use benchmarking for the first pass approach',[6] this in turn being described in the Explanatory Statement as a high level assessment the AER will conduct at the issues paper stage to provide its preliminary view on a DNSP's proposed expenditure forecasts.[7] The AER states that in assessing a DNSP's expenditure forecasts in greater detail and deriving its own alternative estimate, it will take a holistic approach and apply a range of assessment techniques, with the assessment techniques applied depending on the proposal being assessed.[8] The AER observes that 'typically, we expect we would apply a filtering process, where high level techniques indicate relative efficiency and particular areas to target for further review', while noting that '[t]his does not necessarily mean that we will only use benchmarking in the first pass approach'.[9]

75. In purported compliance with its obligation under clause 6.27 of the NER to publish an annual benchmarking report, the AER published its first annual benchmarking report for distribution, *Electricity distribution network service providers Annual benchmarking report*, on 27 November 2014 (**Annual Benchmarking Report**). The AER had released a *Draft Electricity distribution network service providers Annual benchmarking report* (**Draft Annual Benchmarking Report**) to ActewAGL and other DNSPs on a confidential basis for comment in August 2014.

76. The AER's publication of its Annual Benchmarking Report post-dated the stipulated statutory date of 30 September by close to two months and, thus, coincided with publication of the Draft Decision. At the same time, the AER published its Draft Decision and an accompanying Economic Insights report, titled *Economic Benchmarking Assessment of Operating Expenditure for NSW and ACT Electricity DNSPs* and dated 17 November 2014 (**Economic Insights Report**). The Report contains substantial additional economic benchmarking analysis that is not reflected in the Draft Annual Benchmarking Report on which the AER consulted. The AER relied on the Economic Insights Report in making the Draft Decision.

77. While the AER provided ActewAGL with a copy of the Annual Benchmarking Report and the Economic Insights Report prior to their publication, under cover of a letter from Ms Paula Conboy, Chair of the AER, dated 18 November 2014, their provision to ActewAGL nonetheless post-dated the stipulated statutory date for publication of the Annual

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5 Expenditure Forecast Assessment Guideline, page 8.

6 Expenditure Forecast Assessment Guideline Explanatory Statement, page 32.

7 Expenditure Forecast Assessment Guideline Explanatory Statement, pages 3-4 and 32.

8 Expenditure Forecast Assessment Guideline Explanatory Statement, pages 34, 35, 41, 44 and 76.

9 Expenditure Forecast Assessment Guideline Explanatory Statement, page 35. See also page 76.

Benchmarking Report by in excess of 6 weeks and pre-dated publication of the Draft Decision by only 9 days.

ActewAGL's proposal and the AER's decision

78. In its Regulatory Proposal for the subsequent regulatory control period, ActewAGL proposed total forecast standard control service opex of $377.3 million ($ 2013–14) for the 2014–19 period (excluding debt raising costs). ActewAGL's forecast was developed in the following way:[10]

78.1 ActewAGL used the actual opex it incurred in 2012/13 (ie, the 'base year') as the base for forecasting its opex for the 2014-19 period.[11] ActewAGL's 2012/13 base year opex was $66.7 million ($ 2013/14). ActewAGL forecast that this would lead to its total 'base' opex for the 2014-19 period being $368.7 million ($ 2013/14); and

78.2 after adjustments to the 'base' opex for the 2014-19 period to account for, among other matters, step changes and real prices changes, ActewAGL forecast its total opex for 2014-19 as $377.3 million ($ 2013/14).

79. ActewAGL's approach was, thus, broadly consistent with the 'revealed cost' methodology referred to in the AER's Expenditure Forecast Assessment Guideline.

80. In its Draft Decision, the AER rejected ActewAGL's proposed forecast opex of $377.3 million ($ 2013/14) for the 2014–19 period. The AER decided, instead, that ActewAGL's opex allowance ought to be $220.3 million ($ 2013/14). This represented a reduction in total opex of $157 million ($ 2013/14).[12]

81. The most significant driver of the difference between ActewAGL's proposed forecast opex, and the AER's Draft Decision about ActewAGL's opex allowance, was the AER's decision about the 2012/13 base year opex. The AER considered that ActewAGL's 2012/13 base year opex did not represent that which would be incurred by an efficient and prudent service provider, and therefore substituted ActewAGL's 2012/13 proposed base opex of $66.8 million with its own assessment of $42.2 million, a reduction of 36.8%.[13] This efficiency

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10 Draft Decision, pages 7-8 to 7-9.

11 In its Regulatory Proposal of June 2014, while it otherwise used a revealed cost approach to forecasting opex, ActewAGL used a zero-based approach to forecasting its network maintenance and vegetation management categories of opex. That is to say, it used its adjusted actual opex it incurred in 2012/13 excluding maintenance and vegetation management. In respect of those categories of expenditure, it used 'zero based category specific forecasts' (ie, bottom up forecasts) of $110.7 million ($ 2013/14). However, this is not material for the purpose of this Application as ActewAGL adopted a revealed cost approach for forecasting all categories of opex in its Revised Regulatory Proposal. See Revised Regulatory Proposal, page 85 and pages 254 to 257.

12 Draft Decision, page 7-7.

13 Draft Decision, page 7-19, Table 7.4 and page 7-26, Table A.1.

adjustment resulted in $122 million of the difference between ActewAGL's 'revealed opex' of $368.7 million in the base year ($ 2013/14) and the AER's proposed forecast opex.[14]

82. In its Draft Decision, the AER explained the procedure it adopted in the following way:[15]

> Our approach is to compare the service provider's total forecast opex with an alternative estimate that we develop ourselves. By doing this we form a view on whether we are satisfied that the service provider's proposed total forecast opex reasonably reflects the criteria. If we conclude the proposal does not reasonably reflect the opex criteria, we use our estimate as a substitute forecast.
>
> ...
>
> Our estimate is unlikely to exactly match the service provider's forecast because the service provider may not adopt the same forecasting method. However, if the service provider's inputs and assumptions are reasonable, its method should produce a forecast consistent with our estimate.
>
> If a service provider's total forecast opex is materially different to our estimate and there is no satisfactory explanation for this difference, we may form the view that the service provider's forecast does not reasonably reflect the opex criteria. Conversely, if our estimate demonstrates that the service provider's forecast reasonably reflects the expenditure criteria, we will accept the forecast.

83. The AER’s alternative assessment of $42.2 million for 2012/13 base year opex was constructed in the following way.

84. The AER had regard to a report prepared by its consultant, Economic Insights, who used a range of benchmarking methods to assess the relative opex cost efficiency of Australian DNSPs, including a Cobb Douglas stochastic frontier analysis opex cost function model (**CD SFA**), Cobb Douglas and Translog least squares econometrics (**LSE**) opex cost function models and multilateral total factor productivity (**MTFP**) and multilateral partial factor productivity (**MPFP**) indexes.

85. The Australian data used in Economic Insights’ models was sourced from responses by all 13 Australian DNSPs to economic benchmarking regulatory information notices (**RIN**s) issued by the AER requesting eight years of historic data (for the years 2005/06-2012/13

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14 Draft Decision, page 7-17, Figure 7-3. As discussed in footnote 11, in its Regulatory Proposal, ActewAGL's forecast was based on its revealed costs for 2012/13 except for the network maintenance and vegetation management categories of opex, in respect of which ActewAGL adopted a zero-based category specific forecast. The AER constructed its own forecast, in the manner set out below, which was not based on ActewAGL's revealed costs in the base year. Accordingly, the 'efficiency adjustment' does not represent a deduction by the AER from ActewAGL's forecast. The efficiency adjustment is better described as a reconciliation between the AER's view of efficient costs in the base year and ActewAGL's revealed costs in the base year. In its Revised Regulatory Proposal, ActewAGL adopted a revealed cost approach for forecasting all categories of opex. From that point, there is a direct nexus between the 'efficiency adjustment' made by the AER, and the difference between ActewAGL's proposed forecast opex, and the AER's decision about ActewAGL's opex allowance.

15 Draft Decision, page 7-12.

(inclusive)).[16] However, Economic Insights concluded that there was insufficient variation in the RIN data to allow it to reliably estimate even a simple version of an opex cost function model.[17] Accordingly, Economic Insights decided that it was necessary to include data from New Zealand and Ontario, Canada, into its models to increase the sample size so as to obtain more 'robust' estimates.[18] In the result, the Australian DNSPs accounted for 19% of the sample used in Economic Insights' models. The New Zealand DNSPs accounted for 26%, and the Ontarian DNSPs accounted for 54%.[19]

86. The AER used the results of only one of Economic Insights' models, the CD SFA model, as the starting point of its assessment of ActewAGL's 'efficient' opex. ActewAGL's 'raw' efficiency score, according to the CD SFA model, was 0.40. That is to say, the CD SFA model implied that ActewAGL was 40% as efficient over the benchmarking period (2005/06 to 2012/13 (inclusive)) as the National Electricity Market (**NEM**) 'frontier' service provider, CitiPower Pty (**CitiPower**). Were that score to be applied without modification, the AER concluded that ActewAGL's opex should be reduced by 61% in the base year.[20]

87. However, the AER concluded that the 'raw' results from the CD SFA model ought to be adjusted in two respects:

87.1 rather than using CitiPower as the benchmark for efficiency comparisons, the first adjustment made by the AER was to set a lower benchmark based on the weighted average of the efficiency scores of the asserted most efficient service providers in the NEM, specifically those service providers with efficiency scores of 0.75 or above (i.e. CitiPower, Powercor Australia Limited, United Energy Distribution Pty Ltd, SA Power Networks and AusNet Services (Distribution) Ltd (**AusNet**)). This reduced the benchmark efficiency target by 9 percentage points to 0.86 from 0.95;[21] and

87.2 the AER sought to further modify the benchmark efficiency target to account for operating environment factors (**OEFs**) specific to the ACT, and which were not otherwise accounted for in the CD SFA model. The AER asserted that differences in those OEFs may account for up to 30% of the apparent difference in efficiency between ActewAGL and the comparison DNSPs, and therefore the efficiency score applicable to ActewAGL ought to be further adjusted outside the

16 Economic Insights, *Economic Benchmarking Assessment of Operating Expenditure for NSW and ACT Electricity DNSPs*, 17 November 2014, page 2. See also *Ausgrid, Essential Energy, Endeavour Energy: Appropriateness of RIN data for benchmarking*, pwc, 9 January 2015 page 5.

17 Economic Insights, *Economic Benchmarking Assessment of Operating Expenditure for NSW and ACT Electricity DNSPs*, 17 November 2014, page 28.

18 Economic Insights, *Economic Benchmarking Assessment of Operating Expenditure for NSW and ACT Electricity DNSPs*, 17 November 2014, page 31.

19 Frontier Economics, *Review of AER's econometric models and their application in the draft determination for Networks NSW*, January 2015, page xi.

20 Draft Decision, page 7-27.

21 Draft Decision, pages 7-26 to 7-27.

CD SFA model by that amount. This effectively reduced the benchmark efficiency target by 20 percentage points to 0.66.[22]

88. The 'adjusted' efficiency score represents ActewAGL's assumed average efficiency for the benchmarking period (2005/06 to 2012/13 (inclusive)). The next step in the AER's methodology was to apply the efficiency reduction implied by the CD SFA model (with the AER's ad-hoc post-modelling adjustments) to ActewAGL' average opex over the benchmarking period. Given that the benchmarking period was from 2005/06 to 2012/13 (inclusive), ActewAGL's average opex was notionally assumed to have been incurred in 2009/10 (being the midpoint of the benchmarking period) for the purposes of the AER's calculations. The AER then applied a 'trend' to escalate that assumed 'efficient' opex for 2009/10 to the base year (2012/13).[23]

89. The assumed 'efficient' opex for the 2012/13 base year, derived from the methodology referred to above, was $42 million ($ 2013/14). This compares to ActewAGL's proposed opex of $66.8 ($ 2013/14) for the base year. Thus, the outcome of the AER's analysis was a reduction of 36.8% in the base year.

90. The steps taken by the AER to construct a substitute base year opex for ActewAGL are depicted in Table A.3 to the Draft Decision:[24]

Stage of estimate	Contribution to estimate
Starting point: 'Raw' CD SFA forecast with frontier service provider as benchmark	26.0
Adjustment 1: Change benchmark to weighted average of top quartile efficiency score range	+ 2.7
Adjustment 2: Adjust benchmark to account for operating environment factors	+ 8.6
Adjustment 3: Adjust benchmark to move from average results to 2013 results	+ 4.9
Substitute base opex	**42.2**

91. The outcome of the analysis, when compared to ActewAGL's proposal, is depicted in Table 7.4 to the Draft Decision:[25]

22 Draft Decision, pages 7-26 to 7-27 and 7-90.

23 Draft Decision, page 7-27, and DD C5 - Opex base year adjustment draft decision - November 2014.xls.

24 Draft Decision, page 7-28.

25 Draft Decision, page 7-19.

Table 7.4 Comparison of our estimate of base opex with ActewAGL's actual opex in 2012–13

	ActewAGL
Proposed base opex (adjusted)[a]	66.8
Substitute base opex	**42.2**
Difference	24.6
Percentage opex reduction	**36.8%**

92. The AER also conducted two further analyses of ActewAGL's historical opex. The first was a simple form of benchmarking that focuses on partial performance indicators (**PPIs**), including PPIs that focus on particular categories of opex (referred to as 'category analysis') in isolation. A PPI is a ratio that is derived from the quantity of an input (e.g. opex) with the quantity of a single output produced by the business (e.g. customer numbers). The AER concluded that on the majority of the measures, ActewAGL appeared to have high costs relative to other NEM DNSPs.[26] The AER also concluded that given that ActewAGL had high expenditure (according to its PPI analysis) for most significant categories of expenditure, this supports the view that it is likely systemic issues exist within ActewAGL.[27]

93. The second analysis was a qualitative review of two categories of opex: labour costs and vegetation management costs.[28] The AER concluded from those reviews that there were inefficiencies in ActewAGL's workforce and vegetation management practices (although the AER did not attempt to quantify the opex impact of those asserted inefficiencies).

94. In concluding that there were inefficiencies in ActewAGL's workforce practices, the AER relied on an analysis undertaken by Deloitte titled *NSW Distribution Network Service Providers Labour Analysis* (**Deloitte Report**).[29] The AER did not provide ActewAGL with a copy of the Deloitte Report despite requests by ActewAGL.[30]

95. The AER concluded that the PPIs and review analysis supported the results of its benchmarking analysis,[31] and therefore concluded that ActewAGL's proposed base year opex should be rejected and substituted with base year opex of $42 million ($ 2013/14).

96. ActewAGL, in its Revised Regulatory Proposal, forecast standard control services opex of $371.2 million ($ 2013–14) for the 2014–19 period (excluding debt raising costs and DMIA). This was a reduction from the $377.3 million ($ 2013–14) it proposed in its original

26 Draft Decision, page 7-31.

27 Draft Decision, page 7-31.

28 Draft Decision, pages 7-32 and 7-77 to 7-89.

29 Draft Decision, page 7-78 and Confidential Appendix to Attachment 7, page 18.

30 ActewAGL made a general request to the AER on 19 November 2014 to be provided with all material on which the AER relied in making the Draft Decision. On 5 December 2014, ActewAGL specifically requested that the AER provide it with the Deloitte Report.

31 Draft Decision, page 7-33.

Regulatory Proposal. The reduction in opex was mainly attributable to correction of an error ActewAGL had made in its original Regulatory Proposal.[32]

97. ActewAGL submitted that the Draft Decision would, if implemented, reduce ActewAGL's opex to levels not seen since before 1999, despite an approximate 40% increase in customer numbers, and close to a 40% increase in new assets that now form part of ActewAGL's electricity network.[33]

98. ActewAGL observed in its Revised Regulatory Proposal that the opex allowed in the AER's Draft Decision for the transitional regulatory control period was $30.9 million less than that allowed in the Transitional Determination. Given the AER's adjustment of ActewAGL's total revenue requirement for the subsequent regulatory control period by reference to the difference between the annual revenue requirement for the transitional regulatory control period determined in the Transitional Determination and that determined in the Final Determination for that period required by clause 11.56.4(h) and (i) of the NER (discussed at paragraphs 41 and 42 above), ActewAGL would need to spend less than the AER's estimate of the efficient level of opex in the subsequent regulatory control period to keep within the overall $220.3 million opex allowance for the 2014-19 period. This would result in an effective opex reduction of over 50% for the subsequent regulatory control period.[34]

99. ActewAGL's Revised Regulatory Proposal set out the restructuring costs that ActewAGL would have to incur to achieve those levels of opex reduction, and submitted that in an industry recognised as a largely fixed cost business, the costs of moving to a theoretically efficient opex level determined by the AER should be funded through the expenditure allowances determined by the AER. ActewAGL also stated:[35]

> To work within approved expenditure allowances, ActewAGL Distribution would have to quickly adopt a fundamentally different business model: a 'care and maintenance model'. This means that current activities would be scaled back to the provision of essential business activities only, which are required to maintain network reliability and public safety.
>
> Operating such a business model is expected to have significant impacts on ActewAGL Distribution's current service levels, reliability and safety.

100. ActewAGL also stated that:[36]

100.1 to transform its business model and operations to meet the harsh expenditure cuts proposed by the AER requires significant restructuring costs to be incurred, and there was no allowance for such costs in the AER's opex allowance in the Draft Decision; and

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32 ActewAGL otherwise altered its approach in its Regulatory Proposal of using zero based category specific forecasts for maintenance and vegetation management. Instead it adopted a base year (base-step-trend) approach for all opex categories. See the Revised Regulatory Proposal, page 256.

33 Revised Regulatory Proposal, page v and 62-63.

34 Revised Regulatory Proposal, pages 52 to 54.

35 Revised Regulatory Proposal, page 68.

36 Revised Regulatory Proposal, page 260.

100.2 ActewAGL must ensure that organisational change is managed over a sufficient time period such that the intended benefits of the change, such as expected cost reductions, are sustainable in the long-term and do not put at risk the security, reliability, quality and safety of supply of electricity.

101. ActewAGL submitted a witness statement of Stephen Patrick Devlin, General Manager, Asset Management at ActewAGL, signed on 13 February 2015, who deposed that the level of reductions proposed by the AER would likely lead to substantial underinvestment by ActewAGL in capex and opex, and would likely compromise the safety, reliability and on-going sustainability of its electricity network.[37]

102. ActewAGL submitted a report by AECOM, which concluded:[38]

> A reduction in operations budgets of 42% as determined by AER will force ActewAGL to reduce its staffing on a permanent basis. The effect of this budget reduction would be:
>
> - **An increased response time,** to more than double current performance, therefore increasing the total customer minutes of service interruption and delivering a reduction in level of service.
> - **A reduction in ActewAGL's ability to carry out planned maintenance** by more than 33%.
> - **A vicious cycle of increasing numbers of unplanned faults because planned maintenance would not be carried out, causing further increases to response times.**
>
> If renewal capital budgets are reduced, and operational budgets also reduced to the extent determined by AER, the impact will be far more dramatic.
>
> **ActewAGL will be faced with aging assets failing more frequently, an inability to carry out planned maintenance, and steadily worsening response times. The cumulative impact will be a drastically lower level of service for customers**. [Emphasis in original]

103. ActewAGL submitted that in the event that the AER maintains its position on opex in its Final Determination, the AER has an obligation to establish a 'glide path' in order to allow ActewAGL to transition over time to any lower opex allowance through the control mechanism.[39]

104. In its Final Determination, the AER rejected ActewAGL's proposed opex allowance in its Revised Regulatory Proposal, and determined that ActewAGL's opex allowance ought to be $240.6 million ($ 2013/14). This represented an increase of $20.3 million ($ 2013/14) from its opex allowance in the Draft Decision.[40]

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37 Devlin, 13 February 2015, at [22] et seq.

38 Attachment B8 to the Revised Regulatory Proposal: AECOM, *The Impact of the AER's Draft Decision on ActewAGL's Service and Safety Performance*, January 2015, pages 20 to 21.

39 Revised Regulatory Proposal, pages 260 to 267.

40 Final Determination, page 7-11.

105. The AER did not alter its overall methodology set out in its Draft Decision for assessing ActewAGL's forecast opex against its own forecast, or the data and benchmarking models used for the purposes of constructing its own forecast. In particular, the AER confirmed:

> If we are not satisfied there is an adequate explanation for the difference between our opex forecast and the service provider's opex forecast, we will use our opex forecast in determining a service provider's total revenue requirement.[41]

106. However, although it is unclear, in its Final Determination the AER appeared to alter the position it had taken in the Draft Decision that its PPI analysis was capable of corroborating its own forecast. Rather, the AER stated that 'category analysis' by way of PPIs is an appropriate technique for diagnosing areas for further qualitative review, and that the PPIs deployed by the AER indicated, in particular, that there were inefficiencies in ActewAGL's workforce and vegetation management practices.[42]

107. In that regard, the AER relied on a report by EMCa on ActewAGL's labour resourcing and vegetation management practices which was commissioned by, and provided to, the AER subsequent to the Draft Decision (**Final EMCa Report**).[43]

108. On 18 February 2015, the AER provided ActewAGL with a copy of a draft report by EMCa on ActewAGL's labour resourcing and vegetation management practices (**Draft EMCa Report**)[44] and invited any comments on that report by close of business on 4 March 2015.[45] The AER did not inform ActewAGL of the use that the AER intended to make of the Draft EMCa Report or the way in which the AER proposed to take it into account. The AER asked ActewAGL to notify it within two business days if ActewAGL had any difficulty meeting the deadline.

109. On 20 February 2015, within two business days of receiving the Draft EMCa Report, ActewAGL requested an extension until Wednesday 11 March 2015 to respond to that Report. The AER declined to grant that extension.

110. ActewAGL was not provided with an opportunity to comment on the Final EMCa Report. Nevertheless, in the Final Determination, the AER concluded, in reliance on the Final EMCa Report, that ActewAGL's labour and workforce and vegetation practices were likely a cause of high expenditure in the base year.[46] Neither the Final EMCa Report, nor the AER, sought to quantify ActewAGL's asserted inefficiencies in respect of those categories of expenditure.

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41 Final Determination, page 7-21.

42 Final Determination, page 7-143.

43 EMCa, *Review of ActewAGL Distribution's Labour Resourcing and Vegetation Management Practices at 2012/*13, April 2015; Final Determination, pages 7-146 to 7-161.

44 EMCa, *Review of ActewAGL Distribution's Labour Resourcing and Vegetation Management Practices at 2012/*13, Draft, 18 February 2015.

45 Email from Kurt Stevens, AER to Bjorn Tibell, ActewAGL dated 18 February 2015.

46 Final Determination, pages 7-146 to 7-147.

111. The alteration from the AER's Draft Decision to the Final Determination about the level of opex allowed to ActewAGL was largely driven by two factors, which did not relate to the AER's overall decision making methodology:

111.1 first, the AER decided that a more appropriate benchmark comparison point for ActewAGL was the lowest of the efficiency scores in the top quartile of possible scores, which is equivalent to the efficiency score for the business at the bottom of the upper third (top 33 per cent) of companies in the benchmark sample (represented by AusNet), rather than the average score of those businesses. That alteration reduced the benchmark comparison point from 0.86 (used in the Draft Decision) to 0.77;[47] and

111.2 secondly, the AER concluded that due to ActewAGL's change in capitalisation approach in the forecast period, a proportion of one of the key OEFs from the Draft Decision now forms part of the AER's estimate of total forecast capex. This means the OEF adjustment is 23%, which is lower than the Draft Decision adjustment of 30%.[48]

112. The AER did not otherwise make provision in its opex allowance for ActewAGL to allow for the unfunded costs of restructuring ActewAGL's business to operate at the levels of opex contemplated by the Final Determination. Further, the AER concluded that it had no power to allow additional opex by way of a 'glide path' through the control mechanism or otherwise to allow ActewAGL to transition over time to the level of opex that the AER had determined was 'efficient'.[49]

AER's errors

113. The exercise of the AER's discretion, or the AER's decision, to reject ActewAGL's forecast opex, and to decide an alternative opex allowance, was incorrect or unreasonable, because it involved a decision making methodology which was inconsistent with that prescribed by clauses 6.5.6 and 6.12.1 of the NER. In particular:

113.1 the NER mandates that a DNSP's building block proposal is the starting point for the AER's decision to determine its opex allowance;

113.2 the DNSP's total forecast opex for the regulatory control period is to be assessed against each of the opex criteria in clause 6.5.6(c), and each such criterion is directed to achieving the opex objectives in clause 6.5.6(a);

113.3 in deciding whether each of the opex criteria in clause 6.5.6(c) of the NER is satisfied in respect of the DNSP's opex forecast, the AER must have regard to each of the opex factors in clause 6.5.6(e) of the NER;

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47 Final Determination, page 7-55 and section A.7.2 (page 7-253 et seq).

48 Final Determination, page 7-48.

49 Final Determination, pages 7-39 to 7-41.

113.4 despite these matters, the AER's methodology for determining ActewAGL's opex was contrary to the methodology prescribed by the NER, in that it:

113.4.1 inverts the approach mandated by the NER in that the AER has used its own forecast, derived from a benchmarking model (not referred to in the report referred to in clause 6.5.6(e)(4)) and the AER's ad-hoc post-modelling adjustments, as the starting point for determining ActewAGL's opex allowance;

113.4.2 involves the assumption that unless there is a satisfactory explanation for the difference between ActewAGL's forecast opex and the AER's own forecast, derived from that benchmarking model and the AER's ad-hoc post-modelling adjustments, then the AER's forecast should apply, thereby creating an onus on ActewAGL to explain those differences;

113.4.3 involves the assumption that the AER's own forecast, derived from that benchmarking model and the AER's ad-hoc post-modelling adjustments, reasonably reflects the opex criteria in clause 6.5.6(c) of the NER without giving separate and independent regard to each of those criteria;

113.4.4 has resulted in the AER failing to consider or determine whether the DNSP's total forecast opex reasonably reflects each of the opex criteria, including the costs of maintaining the quality, reliability, security and safety of the distribution system or of the supply of standard control services as required by clause 6.5.6(a)(2) and (3);

113.4.5 elevates benchmarking (being only one of the opex factors to which the AER must have regard under clause 6.5.6(e) in determining whether the opex criteria is met) to a level of importance that elides a proper consideration of any other opex factor prescribed by clause 6.5.6(e) of the NER; and

113.4.6 has resulted in the AER failing to have sufficient regard to, and/or failing to exercise its discretion as to the appropriate weight to be given to, the opex factors prescribed by clause 6.5.6(e) of the NER.

114. Further or alternatively, the exercise of the AER's discretion, or the AER's decision, to reject ActewAGL's forecast base year opex, and to decide an alternative base year opex, was incorrect or unreasonable, because the AER:

114.1 failed to accept that ActewAGL's forecast opex, including ActewAGL's revealed costs in the 2009/10-2013/14 regulatory control period, constituted probative evidence of the opex that is required to meet the opex objectives;

114.2 failed to give proper consideration pursuant to clause 6.5.6(e)(8) of the NER to the fact that the AER's methodology for forecasting opex is inconsistent with:

114.2.1 the Efficiency Benefit Sharing Scheme (**EBSS**), which depends, for its efficacy, on the adoption of a revealed cost approach to setting opex rather than a benchmarking approach; and

114.2.2 the STPIS, in that there is a disconnection between the performance targets set under the STPIS and ActewAGL's opex allowance in the Final Determination, which exposes ActewAGL to likely financial penalties;

114.3 failed to give proper consideration to the opex objective prescribed by clause 6.5.6(a)(3) of the NER, and in particular, failed to have any, or sufficient, regard to the fact that:

114.3.1 clause 6.5.6(a)(3) is directed to the opex that ActewAGL requires, to the extent that there is no applicable regulatory obligation or requirement, to maintain the quality, reliability and security of supply of standard control services;

114.3.2 in determining the opex that ActewAGL requires to achieve that objective, clause 6.5.6(e)(5) requires the AER to have regard to the actual and expected opex of ActewAGL during any preceding regulatory control periods;

114.3.3 the standards of quality, reliability and security of supply of standard control services of ActewAGL, the DNSPs against which ActewAGL has been benchmarked, and the international firms used within the AER's benchmarking models, are different;

114.3.4 the historical opex of ActewAGL, the DNSPs against which ActewAGL has been benchmarked, and the international firms used within the AER's benchmarking models, are different;

114.3.5 ActewAGL will be unable to maintain the quality, reliability and security of supply of standard control services that it has achieved in previous regulatory control periods with:

(a) opex determined by reference to opex incurred by the DNSPs against which ActewAGL has been benchmarked, and the international firms used within the AER's benchmarking models; and

(b) the opex allowance in the Final Determination, in circumstances where that opex allowance is substantially less than ActewAGL's historical opex, and its expected opex (as set out in its Regulatory Proposal and Revised Regulatory Proposal, and previous distribution determinations) in previous regulatory periods;

114.4 erred in concluding that previous incentive signals and schemes used to motivate service providers (including, implicitly, ActewAGL) have not been sufficient to promote opex[50] and that it should therefore adopt a benchmarking approach to settling ActewAGL's opex allowance.

114.5 failed to have proper regard to the fact that the abandonment of a revealed cost approach to setting ActewAGL's opex has had the consequence of rendering the EBSS that would otherwise have been applicable to ActewAGL redundant, and has thereby:[51]

114.5.1 imposed a substantial material negative financial loss to ActewAGL, which materially increases the regulatory risk applying to all network service providers, and is not in the NEO;

114.5.2 undermined the incentive for ActewAGL to reduce future opex costs, by discouraging it from efficiently incurring expenditure to restructure;

114.5.3 failed to provide a continuous incentive when outturn opex is below benchmark levels, and so encourage ActewAGL to defer efficiency improvements;

114.5.4 increased the incentive to capitalise expenditure when opex is above benchmark levels while providing an incentive to substitute capex for opex when below benchmark levels; and

114.5.5 frustrated the incentive to procure demand management services since the penalty for spending additional opex is over three times greater than the reward offered under the Capital Expenditure Sharing Scheme for deferring network investments;

114.6 placed reliance on benchmarking models and the AER's ad-hoc post-modelling adjustments without paying proper regard to the limitations of those models, the data used in those models, and the analysis underlying those ad-hoc post-modelling adjustments, and their inability to generate an outcome that reasonably reflects the opex criteria;

114.7 despite quoting the AEMC's view that the purpose of benchmarking is not to normalise for every possible difference in networks, but to provide a high level view of efficiency taking into account certain exogenous factors',[52] nevertheless used its benchmarking models and ad-hoc post-modelling adjustments as the primary determinant of the level of opex to be allowed to ActewAGL;

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50 Final Determination, page 7-88.

51 HoustonKemp, *Opex and Efficiency Benefit Sharing Scheme*, January 2015, pages 31 to 32.

52 Final Determination, page 7-180.

114.8 failed to have proper regard, or alternatively gave insufficient weight, to evidence of error and bias in the benchmarking data set and the CFD SFA model;

114.9 failed to have regard to, or alternatively sufficient regard to, the deficiencies in the AER's methodology for determining ActewAGL's opex referred to in ActewAGL's proposals and submissions;

114.10 failed to have regard to direct, probative evidence of the safety and reliability of the opex allowances determined by application of the AER's benchmarking analysis and ad-hoc ex-post modelling adjustments;

114.11 failed to have regard to the impact of its decision on the ability of ActewAGL to fund its business in the subsequent regulatory control period and future regulatory control periods;

114.12 placed reliance on PPIs as corroborating its alternative forecast of ActewAGL’s opex or as otherwise indicating that inefficiencies existed in respect of certain categories of ActewAGL's opex, without paying proper regard to the limitations of that analysis, including by reason of inconsistent reporting by DNSPs of data used in the PPI analysis, and the inability of PPIs to account for operating environment variations between DNSPs;

114.13 concluded that there were inefficiencies in ActewAGL’s labour and vegetation management practices, in circumstances where:

114.13.1 the material before the AER did not support that conclusion; and

114.13.2 the AER denied ActewAGL procedural fairness by failing to properly consult on its decision on labour costs and vegetation management expenditure in the base year;

114.14 placed reliance on reports issued by EMCa about ActewAGL’s labour and vegetation management practices without proper regard to the deficiencies in the analysis contained within those reports;

114.15 concluded that to the extent that there are inefficiencies in ActewAGL’s labour and vegetation management practices, the existence of those inefficiencies corroborated the outcome of its benchmarking models and the AER’s ad-hoc post-modelling adjustments, without any attempt to identify the quantum of those inefficiencies, or their relevance to other aspects of ActewAGL's operations;

114.16 failed to have sufficient regard to the deficiencies in the AER’s methodology for determining ActewAGL’s opex referred to in ActewAGL’s proposals and submissions; and

114.17 concluded that an opex allowance determined using the AER’s benchmarking analysis and ad-hoc ex-post modelling adjustments represents the opex that ActewAGL, acting efficiently and prudently, required to achieve the opex objectives, in circumstances where the material before the AER did not support that conclusion.

115. Further or alternatively, the AER made an error of fact in its findings of facts, and that error was material to the making of the decision. This is because the AER concluded that:

115.1 an opex allowance determined using the AER's benchmarking analysis and ad-hoc ex-post modelling adjustments represents the opex that ActewAGL, acting efficiently and prudently, required to achieve the opex objectives;

115.2 ActewAGL's forecast opex was inefficient or reflected inefficient costs, or alternatively that ActewAGL's forecast base year opex was inefficient or reflected inefficient costs to the extent identified by the AER; and/or

115.3 there were inefficiencies in ActewAGL's labour and vegetation management practices, in circumstances where the material before the AER did not support that conclusion,

in circumstances where the material before the AER did not support that conclusion.

116. Further or alternatively, the exercise of the AER's discretion, or the AER's decision, to reject ActewAGL's forecast opex, and to decide an alternative opex, was incorrect or unreasonable, because in the course of exercising its discretion or making its decision, the AER:

116.1 erred in concluding that it was prohibited by the NER from considering circumstances that were endogenous to ActewAGL, and that might impact on its capacity to ensure safety, reliability and security of supply of electricity;

116.2 erred in concluding that the opex criteria should be understood as solely applying an objective test, namely, whether a DNSP's opex forecast would reasonably reflect the costs of an objectively prudent provider, and that it was impermissible when considering the opex criteria to give any consideration to the particular endogenous circumstances of the service provider concerned;

116.3 failed to have regard, or proper regard, to relevant considerations, being material submitted to the AER by ActewAGL about the likely consequences of the AER's decision on ActewAGL's ability to maintain and ensure safety, reliability and security of the distribution system and of supply of electricity;

116.4 failed to undertake any risk assessment of its proposed opex reductions on ActewAGL's ability to maintain the safety, reliability, security and quality of the distribution system and of supply of electricity;

116.5 failed to accord procedural fairness to ActewAGL and/or contravened section 16(1)(b) of the NEL by concluding that its opex allowance would not adversely affect ActewAGL's financial viability, without providing ActewAGL with an opportunity to respond to or make submissions about the analysis on which the AER's conclusions were based;[53]

116.6 erred in concluding[54] that expenditure which ActewAGL requires to meet the opex objective specified in clause 6.5.6(a)(2) of the NER does not extend to compliance with the terms of ActewAGL's Enterprise Bargaining Agreements (**EBA**s) (including as to redundancy costs). The AER should have concluded that ActewAGL's EBAs are a 'regulatory obligation or requirement' within the meaning of section 2D of the NEL; and

116.7 failed to consider whether it would be in the NEO to allow ActewAGL opex in excess of that which would be incurred by an objectively prudent provider.

117. Further or alternatively, the exercise of the AER's discretion, or the AER's decision, not to include in its opex allowance for ActewAGL an amount to reflect the costs of restructuring its business to operate at the levels of opex that reasonably reflect the costs of an objectively prudent provider was incorrect or unreasonable in that the AER:

117.1 erred in concluding that it was prohibited by the NER from considering circumstances that were endogenous to ActewAGL, and might impact on ActewAGL's capacity to ensure safety, reliability, security and quality of supply of electricity;

117.2 erred in concluding that the opex criteria should be understood as applying solely an objective test, namely, whether a DNSP's opex forecast would reasonably reflect the costs of an objectively prudent provider, and that it was impermissible when considering the opex criteria to give any consideration to the particular endogenous circumstances of the service provider concerned;

117.3 failed to give any regard, or any proper regard, to material submitted to the AER by ActewAGL about the likely consequences of the AER's decision on ActewAGL's ability to ensure safety, reliability and security of supply of electricity;

117.4 failed to undertake any risk assessment of its proposed opex reductions on safety, reliability, security and quality of the distribution system or the supply of electricity;

117.5 failed to consider whether it would be in the NEO to allow ActewAGL an allowance for those restructuring costs; and

117.6 erred in concluding[55] that expenditure which ActewAGL requires to meet the opex objective specified in clause 6.5.6(a)(2) of the NER does not extend to compliance with the terms of ActewAGL's EBAs (including as to redundancy

53 Final Determination, page 7-42.

54 Final Determination, pages 7-79 to 7-83.

55 Final Determination, pages 7-79 to 7-83.

costs). The AER should have concluded that ActewAGL's EBAs are a 'regulatory obligation or requirement' within the meaning of section 2D of the NEL.

118. Further or alternatively, the exercise of the AER's discretion, or the AER's decision, not to include additional opex pursuant to a 'glide path' within the control mechanism or otherwise to allow ActewAGL time to restructure its business to operate at levels of opex that reasonably reflect the costs of an objectively prudent provider was incorrect or unreasonable in that the AER erred in law in concluding that the implementation of a glide path would be inconsistent with the NEL and the NER.

(2) Service Target Performance Incentive Scheme (STPIS)

Background

119. As set out in paragraph 40 above, clause 6.12.1(9) and (11) of the NER provides that the constituent decisions by the AER, on which the distribution determination for ActewAGL for the subsequent regulatory control period is predicated, include (among others):

119.1 a decision on how any applicable STPIS is to apply to ActewAGL; and

119.2 a decision on the form of the control mechanisms for standard control services and on the formulae that give effect to those control mechanisms.

120. Clause 6.2.6 of the NER requires that the control mechanism for standard control services must be of the prospective *CPI* minus X form, or some incentive-based variant of the prospective *CPI* minus X form.

121. Clause 6.6.2 of the NER requires the AER to develop and publish, in accordance with the distribution consultation procedures, a service target performance incentive scheme to provide incentives for DNSPs to maintain and improve service performance.

122. Clause 6.6.2(b) of the NER provides as follows:

(b) In developing and implementing a *service target performance incentive scheme*, the *AER*:

(1) must consult with the authorities responsible for the administration of relevant *jurisdictional electricity legislation*; and

(2) must ensure that service standards and service targets (including guaranteed service levels) set by the scheme do not put at risk the *Distribution Network Service Provider's* ability to comply with relevant service standards and service targets (including guaranteed service levels) as specified in *jurisdictional electricity legislation*; and

(3) must take into account:

(i) the need to ensure that benefits to electricity consumers likely to result from the scheme are sufficient to warrant any reward or penalty under the scheme for *Distribution Network Service Providers*; and

(ii) any *regulatory obligation or requirement* to which the *Distribution Network Service Provider* is subject; and

(iii) the past performance of the *distribution network*; and

(iv) any other incentives available to the *Distribution Network Service Provider* under the *Rules* or a relevant distribution determination; and

(v) the need to ensure that the incentives are sufficient to offset any financial incentives the *Distribution Network Service Provider* may have to reduce costs at the expense of service levels; and

(vi) the willingness of the customer or end user to pay for improved performance in the delivery of services; and

(vii) the possible effects of the scheme on incentives for the implementation of non-network alternatives.

123. In November 2009, the AER published the current version of its national STPIS pursuant to clause 6.6.2 of the NER.[56] The STPIS includes an s-factor component which adjusts the revenue that a DNSP earns depending on reliability of supply and customer service performance. The STPIS sets out a formula by which the value of the s-factor (expressed as a percentage change in revenue) is to be incorporated into the control mechanism applicable to a DNSP in a distribution determination, such that allowed revenue is *incremented* when service performance is better than performance targets, and *decremented* when service performance is worse than performance targets.[57]

124. The STPIS provides that the performance targets to apply during the regulatory control period for the purposes of the s-factor formula must not deteriorate across regulatory years and must be based on average performance over the past five regulatory years, subject to modifications made in the application of that STPIS by a distribution determination.[58] Thus, the performance targets contemplated by the AER's STPIS are not determined by reference to regulatory obligations; they are designed to impose financial penalties or rewards by reference to whether *historical* standards of reliability are maintained (even if those historical standards are in excess of regulatory requirements).

125. Clause 6.8.1(b) of the NER provides that the AER's framework and approach paper should set out the AER's proposed approach (together with its reasons for the proposed approach), in the forthcoming distribution determination, to the application to a DNSP of the STPIS. In its

56 AER, *Electricity distribution network service providers—service target performance incentive scheme*, 1 November 2009.

57 AER, *Electricity distribution network service providers—service target performance incentive scheme*, 1 November 2009, Appendix C.

58 AER, *Electricity distribution network service providers—service target performance incentive scheme*, 1 November 2009, clause 3.2.1.

Stage 2 Framework and Approach Paper, ActewAGL published in January 2014, the AER proposed to apply the s-factor component of the STPIS to the NSW and ACT distributors (including ActewAGL) for the subsequent regulatory control period.[59]

126. Pursuant to clause 6.3.2 of the NER, a DNSP's building block proposal must specify how the DNSP proposes the STPIS should apply for the relevant regulatory control period.

ActewAGL's proposal and the AER's decision

127. In its Regulatory Proposal, ActewAGL proposed that the s-factor component of the STPIS be applied to ActewAGL with two modifications:

127.1 to the performance targets for the reliability of supply component, so that rather than being based on historical performance over the last five years, they should be based on the minimum standards in the ACT Supply Standards Code;[60] and

127.2 to the value of customer reliability (**VCR**) used to set incentive rates for the reliability of supply component in order to reflect the willingness of the ACT based customer or end user to pay for improved performance in the delivery of services.

128. The AER's Draft Decision was to apply the s-factor component of the national STPIS to ActewAGL without the modifications proposed by ActewAGL.[61] As to the performance component, the AER did not accept ActewAGL's proposed performance targets for the reliability of supply component because those targets were based on minimum standards which the AER considered that ActewAGL is currently comfortably outperforming. The AER instead set ActewAGL's performance targets based on its average performance over the past five regulatory years in accordance with the STPIS. It was implicit in the Draft Decision that the AER concluded that it was not necessary to align the performance targets with the level of reliability reflected in the opex allowance.[62]

129. In its Revised Regulatory Proposal, ActewAGL continued to propose that the s-factor component of the STPIS be applied to ActewAGL with modifications to the:

129.1 performance targets for the reliability of supply component; and

129.2 VCR used to set incentive rates for the reliability of supply component.

130. ActewAGL submitted, in particular, that ActewAGL's opex allowances in the Draft Decision for the subsequent regulatory control period are far below opex previously allowed to ActewAGL, and proposed expenditure allowances that were sufficient to enable it to meet its

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59 AER, *Stage 2 framework and approach ActewAGL Transitional regulatory control period 1 July 2014 to 30 June 2015 Subsequent regulatory control period 1 July 2015 to 30 June 2019*, January 2014, pages 14 to 15.

60 Regulatory Proposal, pages 361 and 365 to 367 .

61 See generally Attachment 11 to the Final Determination.

62 Draft Decision, page 11-14.

regulatory obligations and requirements in respect of quality and reliability. Accordingly, ActewAGL submitted that the opex allowed to ActewAGL is not sufficient to maintain its materially higher historical performance, and the Draft Decision would operate to impose an expected loss on ActewAGL, in the form of a STPIS penalty, which is inconsistent with section 7A(2) of the NEL, in that a reasonable opportunity would not be provided to ActewAGL to recover at least its efficient costs.[63]

131. ActewAGL proposed revised performance targets on the basis of the following assumptions:[64]

131.1 weather-corrected reliability outcomes in the 2014-19 period are a function of existing assets as at 1 July 2014, capex in the 2014-19 period, and controllable opex in the 2014-19 period;

131.2 the impact of each of these three components on reliability in a given year is proportionate to the component of the residual RAB in that year relating to existing assets (assets contained in the opening RAB as at 1 July 2014), the component of the residual RAB in that year relating to capex in the 2014-19 period, and controllable opex in that year, respectively;

131.3 the existing assets as at 1 July 2014 have the effect of maintaining reliability at the average performance observed over the past five years;

131.4 capex in the 2014-19 period has the effect of aligning reliability with the minimum standards; and

131.5 controllable opex has the effect of aligning reliability with the minimum standards.

132. In the Final Determination, the AER conceded that ActewAGL has been delivering performance levels higher than the minimum standards it is required to achieve under its licence obligations.[65] However, the AER maintained the position that it took in the Draft Decision, that is, to apply the STPIS to ActewAGL for the subsequent regulatory control period without modification. In particular, the AER concluded that allowed expenditure in the Final Determination reasonably reflects an amount that ActewAGL needs to maintain reliability at the current level. Therefore the AER remained of the view that ActewAGL's reliability of supply performance targets should be based on its average performance over the past five regulatory years without adjustment.[66]

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63 Revised Regulatory Proposal, page 606.

64 Revised Regulatory Proposal, pages 617-618.

65 Final Determination, page 11-12.

66 Final Determination, page 11-8.

AER's errors

133. The exercise of the AER's discretion, or the AER's decision, to apply the STPIS to ActewAGL for the subsequent regulatory control period without modification to the performance targets applicable to ActewAGL, was incorrect or unreasonable, because:

133.1 the AER's reasoning in the Final Determination is largely unarticulated, by reason of which it may be inferred that the decision contains an element of arbitrariness;

133.2 the AER failed to conduct any, or any sufficient, factual investigation as to the drivers of ActewAGL's reliability;

133.3 the AER placed unreasonable weight on the MPFP model and its relationship to the CD SFA model to draw inferences about the extent to which ActewAGL could be expected to maintain historical standards of reliability with opex allowances set by reference to the CD SFA model;

133.4 the AER placed principal reliance on the fact that opex scores derived by Economic Insights in its MPFP model were correlated with the efficiency scores in the CD SFA model, in circumstances where that fact was of little or no probative value to the issue which the AER was required to consider;

133.5 the AER concluded, incorrectly, that the correlation between the efficiency scores between the MPFP and CD SFA models meant that to the extent that reliability performance is different across DNSPs, its impact on opex efficiency is not significant, in circumstances where there was no logical basis to draw that conclusion;[67]

133.6 the AER concluded, incorrectly, that the opex MPFP scores are 'closely aligned' with efficiency scores in the CD SFA model,[68] in circumstances where the implied opex reductions of the two models are significantly different;

133.7 the AER concluded that while ActewAGL performs better using MPFP benchmarking,[69] ActewAGL has a higher proportion of underground lines which the AER expects will lead to higher reliability,[70] in circumstances where the impact of omitting underground cables in the MPFP was considered by Economic

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67 Final Determination, page 7-196.

68 Final Determination, page 7-196.

69 The AER notes the opposite that ActewAGL Distribution performs better under the SFA model but this appears to be a typographical error.

70 Final Determination, pages 7-196 to 7-197.

Insights who found that including undergrounding of cables did not have a statistically significant impact on the results and did not need to be considered;[71]

133.8 the AER failed to place sufficient weight on 'real world' factual material placed before the AER concerning the drivers of reliability, including the witness statement of Steven Patrick Devlin signed 13 February 2015, which dealt with the relationship between levels of opex and levels of reliability; and

133.9 the AER failed to have sufficient regard to the fact that:

133.9.1 three of the top five firms in the AER's benchmarking analysis (including the benchmarking comparator firm, AusNet) would breach the ACT regulatory obligations in relation to total (planned plus unplanned) supply interruptions considering only their unplanned supply interruptions;

133.9.2 the AER has therefore based ActewAGL's base year opex on the costs of firms whose reliability performance would be in breach of ACT regulatory obligations; and

133.9.3 in the circumstances, there is a disconnection between the performance targets in the STPIS applicable to ActewAGL, and the opex allowed to ActewAGL in the Final Determination.

134. Further or alternatively, the AER made an error of fact in its findings of facts, and that error was material to the making of the decision. This is because the AER concluded, incorrectly, and without basis, that:

134.1 to the extent that reliability performance is different across service providers, its impact on opex efficiency is not significant;[72]

134.2 it had provided sufficient revenue to allow ActewAGL acting prudently and efficiently to maintain its current reliability level with the AER's approved opex allowance;[73] and

134.3 as ActewAGL's current reliability level is higher than the minimum reliability standards applicable to it, ActewAGL would also be able to meet, and indeed exceed, those minimum standards.[74]

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71 Economic Insights, *Economic Benchmarking Assessment of Operating Expenditure for NSW and ACT Electricity DNSPs*, 17 November 2014, page 24.

72 Final Determination, page 7-196.

73 Final Determination, page 11-12.

74 Final Determination, page 11-12.

(3) Alternative control metering services annual charges (annual metering services opex)

Background

135. As set out in paragraph 40 above, pursuant to clause 6.12.1 of the NER, the constituent decisions on which a distribution determination is predicated include:

135.1 a decision on the classification of the services to be provided by the DNSP during the course of the regulatory control period (clause 6.12.1(1)); and

135.2 a decision on the form of the control mechanisms for alternative control services and on the formulae that give effect to those control mechanisms (clause 6.12.1(12)).

136. Clause 6.2 of the NER governs the classification of distribution services by the AER. Clause 6.2.1 confers on the AER a discretion to classify a distribution service to be provided by a DNSP as a direct control service or a negotiated distribution service in accordance with that provision. Clause 6.2.2 requires the AER to, in turn, classify a direct control service as either a standard control service or an alternative control service in accordance with that provision.

137. Pursuant to clause 6.2.3 of the NER, the classification forms part of the distribution determination and operates for the regulatory control period for which the distribution determination is made.

138. Clause 6.2.5 of the NER provides that:

138.1 a distribution determination is to impose controls over the prices of direct control services, the revenue to be derived from direct control services or both; and

138.2 such a control mechanism may consist of a schedule of fixed prices, caps on the prices of individual services, caps on the revenue to be derived from a particular combination of services, tariff basket price control, revenue yield control or a combination of any of these.

139. For alternative control services, the control mechanism must have a basis stated in the distribution determination (clause 6.2.6(b)). That control mechanism may (but need not) utilise elements of Part C of Chapter 6 (which governs the making of building block determinations for standard control services) with or without modification (clause 6.2.6(c)).

The AER's decision

140. In its Final Determination, the AER classified:[75]

140.1 various network services (specifically, constructing, maintaining, operating, planning and designing the network, emergency response and administrative

75 Final Determination, pages 13-6 to 13-7 and Appendix A to Attachment 13, pages 13-18 to 13-22.

services) and connection services (specifically, premises connections, extensions and augmentations) as standard control services; and

140.2 the following services as alternative control services:

140.2.1 type 5 and 6 meter reading, maintenance and data services;

140.2.2 type 5 and 6 meter installation and commissioning;

140.2.3 type 5 and 6 meter provision (before 1 July 2015);

140.2.4 type 5 and 6 meter provision (after 1 July 2015);

140.2.5 type 7 metering services; and

140.2.6 various ancillary network services (such as re-energising or de-energising a site, temporary connections, upgrade services, rescheduled visits etc).

141. In respect of alternative control type 5 and 6 metering services, the AER determined the control mechanism to be caps on the prices of individual services, pursuant to which a schedule of prices is determined for the first year of the subsequent regulatory control period and, for the following years, the previous year's prices are adjusted by CPI and an X factor.[76]

142. Against the background of the expected introduction of metering service contestability from 1 July 2017,[77] the AER approved two types of type 5 and 6 metering service charges as follows:[78]

142.1 an upfront capital charge (for all new and upgraded meters installed from 1 July 2015); and

142.2 an annual charge comprising of two components:

142.2.1 capital - recovery of the metering asset base (**MAB**); and

142.2.2 non-capital - opex and tax.

143. For existing connections before 30 June 2015:[79]

143.1 where they remain with the regulated type 5 or 6 metering service, both components of the annual charge apply; and

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76 Final Determination, pages 16-22 and 16-26 to 16-27.

77 Discussed in summary terms in the Final Determination, pages 16-21 to 16-22.

78 Final Determination, page 16-22.

79 Final Determination, pages 16-23 to 16-24.

143.2 if they switch to an alternative metering service, only the capital component of the annual charge applies.

144. For new connections after 1 July 2015, the customer pays the capital component upfront and incurs only the non-capital component of the annual charge and only for so long as they remain with the regulated type 5 or 6 metering service.[80]

145. The MAB, recovered through the capital component of the annual charge, is largely comprised of the undepreciated value of all existing meters at 1 July 2015.[81] For regulated meters installed before 30 June 2015, metering capital costs were amortised - that is, DNSPs paid upfront for the capital costs of the meter which were then added to the MAB and recovered over time through annual meter charges.[82]

146. Pursuant to the AER's approved metering charge structure, the MAB is recovered from all customers with existing connections before 30 June 2015, regardless of whether they subsequently switch from their existing regulated type 5 or 6 meter.[83] This minimises cross-subsidies between customers with existing connections that remain with their regulated type 5 or 6 meter and customers that switch, while also providing for the recovery of the MAB by ActewAGL through relatively small annual charges rather than an upfront exit fee which the AER considered would be a barrier to competitive entry.[84]

147. For new regulated meter connections installed after 1 July 2015, the customer will pay the capital costs upfront such that no capex related to such new connections will be added to the MAB and, accordingly, the customer is required to pay only the non-capital component of the annual charge and not the capital component.[85]

148. Accordingly, the AER determined an X factor for each of the upfront capital charge and the annual metering charge, and the control mechanism formula for alternative control metering services set out in the Final Determination defined the X^t_i term by reference to these AER determined X factors.[86]

149. The AER's Final Determination does not establish any control mechanism in respect of type 7 metering services, as these services are provided by ActewAGL at no charge.[87]

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80 Final Determination, page 16-24.

81 Final Determination, page 16-23, footnote 42.

82 Final Determination, page 16-23.

83 Final Determination, page 16-24.

84 Final Determination, pages 16-24 and 16-41 to 16-43.

85 Final Determination, page 16-24.

86 Final Determination, pages 16-26 to 16-27 and Appendix A.1 to Attachment 16, Tables 16-20 to 16-23 at pages 16-61 to 16-63.

87 AER, *Stage 1 Framework and approach paper ActewAGL Transitional regulatory control period 1 July 2014 to 30 June 2015 Subsequent regulatory control period 1 July 2015 to 30 June 2019*, March 2013, page 24. A type 7 metering service does not measure the flow of electricity. DNSPs instead charge customers, usually councils or government agencies, for unmetered connections by estimating usage using standard data. ActewAGL does not charge for type 7 meters.

150. In respect of ancillary network services, the AER determined on a separate control mechanism for each of fee-based services and quoted services.[88] Fee-based services are those ancillary network services for which a fixed fee has been determined based on the cost of providing the service (labour rates) and the average time taken to perform it.[89] The AER determined a price cap as the form of control for fee-based services, pursuant to which a schedule of prices is determined for the first year of the subsequent regulatory control period and, for the following years, the previous year's prices are adjusted by CPI and an X factor.[90]

151. Quoted services are those which are once off and specific to a particular customer's request, such that the cost of service will depend on the actual time taken to perform the service.[91] The AER determined that prices would be set using the formula:

$$Price = Labour + Contractor\ Services + Materials + Other\ Costs + Risk\ Margin,$$

where the terms 'Labour', 'Contractor Services', 'Materials', 'Other Costs' and 'Risk Margin' take the defined meaning specified in the Final Determination.[92] For 'Labour', the AER determined labour rates to apply for the first year of the subsequent regulatory control period and that labour rates for the following years would be the previous year's labour rates escalated by CPI and a labour escalation X factor determined by the AER.[93]

152. As permitted by clause 6.2.6(c) of the NER, the AER determined on a building block approach as the basis for establishing annual metering service charges, with the building blocks being opening MAB, depreciation, forecast capex and forecast opex.[94] The AER's Final Determination was not to accept ActewAGL's total proposed building block requirement for annual metering services, specifically it did not accept the following components of ActewAGL's proposal:[95]

152.1 forecast opex; and

152.2 adoption of accelerated 9 year, depreciation.

153. The AER therefore determined on annual metering service charges that differed from those proposed by ActewAGL.[96]

154. In assessing the metering opex building block, the AER used a base-step-trend approach to developing an alternative forecast.[97] That is, the AER determined ActewAGL's efficient base

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88 Final Determination, pages 16-6 to 16-10.

89 Final Determination, page 16-6.

90 Final Determination, pages 16-7 to 16-8 and Appendix A.1 to Attachment 16, Table 16.17 at pages 16-56 to 16-59.

91 Final Determination, page 16-6.

92 Final Determination, pages 16-9 to 16-10.

93 Final Determination, page 16-9 and Appendix A.1 to Attachment 16, Tables 16.18 and 16.19 at page 16-60.

94 Final Determination, page 16-25.

95 Final Determination, page 16-43.

96 Final Determination, page 16-43.

opex and accounted for any (positive or negative) step changes, and then trended forward that amount over the subsequent regulatory control period.[98] The AER's cost assessment led it to approve $10.8 million ($ 2013/14) in opex (exclusive of debt raising costs) for annual metering services in place of ActewAGL's proposed opex of $15.7 million ($ 2013/14) (exclusive of debt raising costs).[99]

155. The AER's assessment of base opex, including through benchmarking ActewAGL against comparable network businesses, used historical data over a five year period, rather than a single base year (as in the case of its assessment of base opex for standard control services).[100] Specifically, the AER used 'opex for metering' data collected pursuant to its economic benchmarking RIN as the AER considered that the data was then suitable for comparison.[101]

156. The AER concluded that ActewAGL's historical opex is relatively efficient.[102] As a consequence, the AER did not apply an efficiency adjustment to ActewAGL's base opex on the basis of the AER's benchmarking results.[103] On the face of the Final Determination, the AER's decision not to accept ActewAGL's forecast opex for metering services is referable to the AER's decisions not to accept all of ActewAGL's proposed step changes and its application of zero forecast real price and productivity growth, rather than the escalators proposed by ActewAGL.[104] However, an analysis of the models underlying the AER's decision discloses a further, and more significant, reason for the AER's decision.

157. The AER's detailed calculations of metering opex are set out in its model titled *'ActewAGL - AER 2014-19 Final Decision - metering opex capex analysis'* that was provided to ActewAGL by the AER on a confidential basis on 29 April 2015 (**Metering Model**). [redacted]

[redacted]

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97 Final Determination, page 16-25.

98 Final Determination, page 16-33.

99 Final Determination, pages 16-25 and 16-47.

100 Final Determination, pages 16-33 and 16-47.

101 Final Determination, page 16-33.

102 Final Determination, pages 16-48 to 16-49.

103 Final Determination, pages 16-48 to 16-49.

104 Final Determination, pages 16-49 to 16-50.

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162. This is unsurprising given that:

162.1 [redacted] and

162.2 the AER's Reset RIN operated to require that, in allocating expenditure between different categories of distribution services in preparing ActewAGL's RIN Templates, the same expenditure not be allocated more than once. Specifically:

162.2.1 the Reset RIN required that, in responding to that RIN, ActewAGL allocate costs for the 2008/09 to 2012/13 regulatory years (inclusive) in accordance with the cost allocation method for ActewAGL approved by the AER in accordance with the NER that will be in

[redacted]

effect from the start of the period commencing 1 July 2014 and ending 30 June 2019;[119]

162.2.2 any cost allocation method approved by the AER under the NER must conform with the cost allocation principle established by the NER that, in allocating costs between different categories of distribution services, the same cost must not be allocated more than once;[120] and

162.2.3 the cost allocation method for ActewAGL approved by the AER under the NER and that will be in effect from the start of the period commencing 1 July 2014 and ending 30 June 2019 is in accordance with this cost allocation principle in that it ensures that the same costs are not allocated more than once.[121]

[redacted]

AER's errors

164. The exercise of the AER's discretion, or the AER's decision, to reject ActewAGL's proposed opex for annual metering services of $15.7 million ($ 2013/14), and to decide an alternative opex allowance of $10.8 million ($ 2013/14) (excluding debt raising costs), was incorrect or unreasonable, because it was predicated on an incorrect:

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119 The Reset RIN required ActewAGL to provide the information specified in Schedule 1 to that RIN. Paragraph 1.1 of Schedule 1 required ActewAGL to provide the information required in each regulatory template in the Microsoft Excel Workbooks attached at Appendix A to the Reset RIN completed in accordance with (amongst other things) that RIN and the Principles and Requirements in Appendix E to that RIN. Schedule 2 to the Reset RIN requires ActewAGL to prepare the Microsoft Excel workbooks attached at Appendix A to the Reset RIN in the manner and form specified in the worksheets therein and in accordance with that RIN and, in particular, the requirements specified at Schedule 1 (paragraphs 1.1 and 1.3(a) of Schedule 2 to the Reset RIN). Paragraph 1.1 of Appendix E to Schedule 2 to the Reset RIN requires ActewAGL, in responding to that RIN, to allocate costs for the 2008/09 to 2012/13 regulatory years (inclusive) in accordance with the cost allocation method for ActewAGL approved by the AER in accordance with the NER that will be in effect from the start of the regulatory period commencing on 1 July 2009 and ending 30 June 2019 (see the definition of 'Application Cost Allocation Method' in Appendix F to Schedule 2 to the Reset RIN and the definitions of 'Forthcoming Regulatory Control Period' and 'Initial Regulatory Years' in the body of the Reset RIN at page 3).

120 A cost allocation method submitted by a DNSP for the AER's approval under clause 6.15.4(a) of the NER must give effect to and be consistent with the cost allocation guidelines made and published by the AER under clause 6.15.3 of the NER (clause 6.15.4(b)). Any cost allocation guidelines made and published by the AER under clause 6.15.3 must, in turn, give effect to and be consistent with the cost allocation principles set out in clause 6.15.2 of the NER (clause 6.15.3(b)). The cost allocation principles set out in clause 6.15.2 of the NER relevantly include that 'the same cost must not be allocated more than once' (clause 6.15.2(5)).

121 ActewAGL, *ActewAGL Distribution Cost Allocation Methodology*, November 2012 (submitted to the AER by ActewAGL in its response to the Reset RIN, Schedule 1, paragraph 1.4 by way of attachment to the Regulatory Proposal (Attachment B18)), pages 4-5 and 11.

164.1 calculation of ActewAGL's metering opex for the years 2008/09 to 2012/13 (inclusive) in respect of those annual metering services; and/or

164.2 assumption that the metering opex in the years 2008/09 to 2012/13 (inclusive) reported in the RIN Templates [redacted]

165. Further or alternatively, the AER made an error of fact in its findings of facts, and that error was material to the making of the decision. [redacted].

(4) Classification of metering services

Background

166. Further to ground D(3) above, the AER's constituent decision on the classification of metering services pursuant to clause 6.12.1(1) of the NER was made in error.

167. Appendix A of the Overview in the Final Determination is a table of the AER's constituent decisions. The first entry in that table states:

> In accordance with clause 6.12.1(1) of the NER, the following classification of services will apply to ActewAGL for the 2015–19 regulatory control period (listed by service group):
>
> - Standard control services include network services, connection services, type 5 and 6 unrecovered meter cost
> - Alternative control services include metering types 5 and 6 provision, installation, maintenance, reading, data services and transfer administration services, type 7 metering services and ancillary network services
> - Unregulated services include type 1 to 4 metering services.

(**Classification Determination**)

168. As discussed in paragraphs 140 to 147 above, the AER decided to classify discrete alternative control services in respect of type 5 and 6 meters, so as to enable recovery of the capital component of those meters from customers on a different basis, depending on whether those customers had a connection before or after 1 July 2015. The classification of services was intended to facilitate metering contestability, expected to be introduced from 1 July 2017. In particular the classification structure is intended to be robust enough to allow ActewAGL to recover the residual costs of its regulated metering where a customer with an existing regulated connection before 1 July 2015 switches metering provider following the

introduction of metering contestability, while allowing transparent stand alone prices for meter provision for all new or upgraded meter connections after 1 July 2015.[122]

169. The discrete alternative control services, which the AER intended to put in place to achieve those objectives, are specified in Annexure A to Attachment 13 of the Final Determination as follows:

Type 7 metering services		Alternative control
Types 5 and 6 meter reading, maintenance and data services	Meter maintenance covers works to inspect, test, maintain, repair and replace meters. Meter reading refers to quarterly or other regular reading of a meter. Metering data services are those that involve the collection, processing, storage and delivery of metering data and the management of relevant NMI Standing Data in accordance with the Rules.	Alternative control
Types 5 and 6 meter installation and commissioning	Installing and commissioning types 5 and 6 meters & load control equipment.	Alternative control
Types 5 and 6 meter provision (before 1 July 2015)	By charging for this service, distributors may recover the capital cost of types 5 and 6 metering equipment (including meters with internally integrated load control devices) installed before 1 July 2015.	Alternative control
Types 5 and 6 meter provision (after 1 July 2015)	By charging for this service, distributors may recover the capital cost of types 5 and 6 metering equipment (including meters with internally integrated load control devices) installed on or after 1 July 2015.	Alternative control

170. The decision on the control mechanisms for alternative control services in Attachment 16 of the Final Determination is predicated on the classification of services in accordance with Attachment 13 of the Final Determination.

171. There is, therefore, a disconformity between the classification of alternative control services in Attachments 13 and 16 of the Final Determination, and the Classification Determination in Appendix A of the Overview in the Final Determination. Among other things, it is apparent from Attachments 13 and 16 of the Final Determination that metering services in respect of types 5 and 6 meters were to be alternative control services (not standard control services), that the services were to be classified separately (rather than globally as appears in Appendix A of the Overview), that it was not intended to classify ‘transfer administration services’, and that it was intended to classify ‘types 5 and 6 meter installation and commissioning’ services.

172. Were the Classification Determination not to be corrected, the control mechanisms in Attachment 16 of the Final Determination would be unworkable.

173. The AER has, in correspondence with ActewAGL, acknowledged that it has made an error in the Classification Determination in Appendix A of the Overview, and that the error must be corrected.[123]

122 Final Determination, page 16-21.

123 Letters dated 13 May 2015 and 20 May 2015 from the AER to ActewAGL.

AER's errors

174. By reason of the matters set out in paragraphs 166 to 172 above, individually or collectively:

174.1 the AER made an error of fact in its findings of facts, and that error of fact was material to the making of the Classification Determination;

174.2 the AER made more than one error of fact in its findings of facts, and that those errors of fact, in combination, were material to the making of the Classification Determination;

174.3 the exercise of the AER’s discretion in making the Classification Determination was incorrect, having regard to all the circumstances; and/or

174.4 the AER’s Classification Determination was unreasonable, having regard to all the circumstances.

(5) Return on equity

Background

175. Clause 6.4.3(a)(2) of the NER provides that one of the 'building blocks' in determining a DNSP's annual revenue requirement (referred to in paragraphs 35 and 36 above) is 'a return on capital for that year'. Clause 6.4.3(b)(2) provides that the rate of return on capital is calculated in accordance with clause 6.5.2 of the NER.

176. As set out in paragraph 40 above, clause 6.12.1(5) of the NER provides that a constituent decision of a distribution determination includes a decision on the allowed rate of return for each regulatory year of the regulatory control period in accordance with clause 6.5.2.

177. Clause 6.5.2(a) of the NER provides that the return on capital for each regulatory year must be calculated by applying a rate of return for the relevant DNSP for that regulatory year that is determined in accordance with clause 6.5.2 (the **allowed rate of return**) to the value of the regulatory asset base for the relevant distribution system as at the beginning of that regulatory year.

178. The AEMC's 2012 Rule Determination made significant amendments to the rules governing the determination of the return on capital.[124] The version of clause 6.5.2 that applied prior to that Determination required the return on equity to be determined using the Sharpe Lintner Capital Asset Pricing Model (**SL CAPM**) and the determination of a single value for the return on debt to apply for the regulatory control period.[125]

124 2012 Rule Determination, pages 67 to 68.

125 See, for example, clause 6.5.2 of (historical) version 52 of the NER.

179. The AEMC's 2012 Rule Determination removed the requirement to determine the return on equity using the SL CAPM and instead required that regard must be had to relevant estimation methods, financial models, market data and other evidence.[126]

180. In relation to debt, the 2012 Rule Determination removed the requirement that a single value for the return on debt be used for the regulatory control period. Clause 6.5.2 now instead provides that the return on debt may be estimated using a methodology that results in the return on debt being, or potentially being, different for different regulatory years in the regulatory control period.[127] The amendments to clause 6.5.2 made by the 2012 Rule Determination also make clear that the return on debt methodology is not limited to one that seeks to estimate the return required by debt investors in an entity if it raised debt at the time or shortly before the making of the distribution determination. Rather, a methodology that is designed to result in the return on debt reflecting the average return that would have been required by debt investors in an entity if it raised debt over an historical period prior to the commencement of a regulatory year in the regulatory control period can now be used.[128]

181. One of the most significant amendments to clause 6.5.2 made by the 2012 Rule Determination was the introduction of the allowed rate of return objective.

182. Clause 6.5.2(c) of the NER provides that the allowed rate of return objective is that the rate of return for a DNSP 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 DNSP in respect of the provision of standard control services (**allowed rate of return objective**).[129]

183. Clause 6.5.2(b) of the NER provides that the allowed rate of return is to be determined such that it achieves the allowed rate of return objective. It further requires that both the return on equity and the return on debt are to be estimated such that they contribute to the achievement of the allowed rate of return objective.[130]

184. In making the amendments to clause 6.5.2 of the NER, the AEMC stated that those amendments provided the regulator with the flexibility to adopt the approach it considers appropriate to estimate the rate of return, provided that it considers relevant estimation methods, financial models, market data and other information.[131] The AEMC noted that this was so the best estimate of the rate of return can be obtained that reflects efficient financing costs of the service provider at the time of the regulatory determination.[132]

185. Clause 6.5.2(d) of the NER provides that, subject to clause 6.5.2(b), the allowed rate of return for a regulatory control period must be:

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126 2012 Rule Determination, pages iii, 66, 67 and 69.

127 2012 Rule Determination, pages 72 to 91.

128 2012 Rule Determination, page 76.

129 See clause 6.5.2 of (historical) version 53 of the NER.

130 Clause 6.5.2(f) and (h) of (historical) version 53 of the NER.

131 2012 Rule Determination, pages iii, 66, 67 and 69.

132 2012 Rule Determination, page 8.

185.1 a weighted average of the return on equity for the regulatory control period in which that regulatory year occurs (as estimated under clause 6.5.2(f)) and the return on debt for that regulatory year (as estimated under clause 6.5.2(h)); and

185.2 determined on a nominal vanilla basis that is consistent with the estimate of the value of imputation credits referred to in clause 6.5.3.

186. Under clause 6.5.2(e), in determining the allowed rate of return, regard must be had to:

186.1 relevant estimation methods, financial models, market data and other evidence;

186.2 the desirability of using an approach that leads to the consistent application of any estimates of financial parameters that are relevant to the estimates of, and that are common to, the return on equity and the return on debt; and

186.3 any interrelationships between estimates of financial parameters that are relevant to the estimates of the return on equity and the return on debt.

187. Clause 6.5.2(f) and (g) of the NER requires that the return on equity must be estimated such that it contributes to the achievement of the allowed rate of return objective, having regard to the prevailing conditions in the market for equity funds.

188. In accordance with clauses 6.2.8(a) and 6.5.2(m) and (n) of the NER, on 17 December 2013 the AER published a *Better Regulation Rate of Return Guideline*, December 2013 (**Rate of Return Guideline**) which sets out the AER's proposed approach to determining the allowed rate of return (including the return on equity) in accordance with the NEL and the NER. Clause 6.2.8(c) of the NER provides that the Rate of Return Guideline is not mandatory, however, if the AER makes a distribution determination that is not in accordance with the Guideline, the AER must state its reasons for departing from the Guideline in that determination.

189. The Rate of Return Guideline states that the AER's proposed approach to estimating the return on equity is to:

189.1 use the SL CAPM as the 'foundation model'. The SL CAPM is estimated by adding the product of the equity beta and market risk premium (**MRP**) to the risk free rate;[133]

189.2 adopt a risk free rate determined by reference to the yields on Commonwealth Government Securities (**CGS**) with a 10 year term over an averaging period of 20 consecutive business days as close as practicably possible to the commencement of the regulatory control period;[134]

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133 Rate of Return Guideline, pages 13, 15.

134 Rate of Return Guideline, page 15.

189.3 use a point estimate of 0.7 for the equity beta;[135]

189.4 estimate a range for the MRP having regard to theoretical and empirical evidence, and then select a point estimate from within that range;[136] and

189.5 determine a final point estimate for the expected return on equity equal to the foundation model point estimate, or alternatively, a different value that is a multiple of 25 basis points (drawing on the analysis and evaluation of a range of other information).[137]

190. The Rate of Return Guideline states that the AER proposes that:[138]

190.1 the Black capital asset pricing model (**Black CAPM**) inform the equity beta estimate input to the SL CAPM;

190.2 dividend growth models inform the MRP estimate input to the SL CAPM; and

190.3 the Fama-French Three Factor Model has no role.

ActewAGL's proposal and the AER's decision

191. In its Regulatory Proposal, ActewAGL proposed an approach to estimating the return on equity that departed from the Rate of Return Guideline. Relevantly, ActewAGL proposed that the return on equity be estimated consistently with the approach recommended by the expert engaged by ActewAGL (SFG Consulting[139]), including that the return on equity be estimated by reference to four models as follows (in accordance with SFG Consulting's 2014 recommendation):

Model	**Return on equity**	**Weighting**
SL CAPM	10.01%	12.5%
Black CAPM	10.62%	25.0%
Fama-French Three Factor Model	10.87%	37.5%
Dividend Growth Model	10.92%	25.0%

135 Rate of Return Guideline, page 15.

136 Rate of Return Guideline, page 16.

137 Rate of Return Guideline, pages 16 to 17.

138 Rate of Return Guideline, page 13.

139 SFG Consulting, *The required return on equity for regulated gas and electricity network businesses, Report for Jemena Gas Networks, ActewAGL Distribution, Ergon, and Transend*, 27 May 2014 (Attachment E3 to the Regulatory Proposal).

192. ActewAGL's proposal resulted in a return on equity of 10.71%.[140]

193. In the Draft Decision, the AER adopted the methodology for estimating the return on equity outlined in the Rate of Return Guideline.[141] The AER proposed to use the point estimate from the SL CAPM, using an equity beta of 0.7 and an MRP of 6.5%.[142] The AER's Draft Decision resulted in a return on equity of 8.1%.[143]

194. In its Revised Regulatory Proposal, ActewAGL maintained its position set out in the Regulatory Proposal with one exception.[144] Rather than the weightings originally recommended by SFG Consulting, ActewAGL proposed that each of the four models being given equal weighting.[145] ActewAGL submitted that its revised weighting was consistent with SFG Consulting's default starting point and its conclusion that no model is superior.[146]

195. In response to the AER's request for written submissions on the Draft Decision, on 13 February 2015 ActewAGL made a submission to the AER (**February Submission**),[147] which, among other things, provided further material in support of, and updated, ActewAGL's proposal for the return on equity. ActewAGL's proposed estimate of the cost of equity taking into account the further supporting and updated material was 9.87%,[148] (based on a notional averaging period given the actual period had not yet occurred at that time), by reference to four models as follows (in accordance with SFG Consulting's 2015 recommendation):

Model	**Return on equity**	**Weighting**
SL CAPM	9.32%	25.0%
Black CAPM	9.93%	25.0%
Fama-French Three Factor Model	9.93%	25.0%
Dividend Growth Model	10.32%	25.0%

196. In the Final Determination, the AER maintained the methodology for estimating the return on equity outlined in the Rate of Return and the Draft Decision (including the use of the point

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140 Regulatory Proposal, page 259.

141 Draft Decision, pages 3-10.

142 Draft Decision, page 3-78, 3-82, 3-102.

143 Draft Decision, page 3-10.

144 Revised Regulatory Proposal, page 437.

145 Revised Regulatory Proposal, pages 434, 437.

146 Revised Regulatory Proposal, page 437.

147 ActewAGL, *Submission on the AER's Draft decision ActewAGL distribution determination 2015-16 to 2018-19 dated November 2014 pursuant to clauses 6.10.2(c) and 6.10.3(e) of the National Electricity Rules*, 13 February 2015.

148 February Submission, page 36.

estimate from the SL CAPM, using an equity beta of 0.7 and an MRP of 6.5%).[149] The AER's Final Determination resulted in a return on equity of 7.1%.[150]

197. The AER maintained its 'foundation model' approach to estimating the return on equity and the use of the SL CAPM as the 'foundation model' on the basis that it considered the SL CAPM to be superior to all other models for estimating the expected return on equity by reference to the benchmark efficient entity.[151] Although the AER found other models that are used to estimate equity returns to be relevant, the AER did not estimate the return on equity from any other models.[152]

198. The AER used the 'theory' of the Black CAPM model to inform its estimate of the equity beta parameter to be used in the SL CAPM.[153] The AER estimated the range for the equity beta based on empirical analysis of nine Australian energy firms from the period 1992 to 2013, five of which were no longer listed.[154] The AER established a range of 0.4 to 0.7 and considered that a point estimate of 0.7 was reasonably consistent with international empirical estimates and the theoretical underpinnings of the Black CAPM.[155]

199. The AER used the Dividend Growth Model to inform its estimate of the MRP parameter to be used in the SL CAPM.[156] The AER established a range for the MRP based on the geometric average of historical excess returns and the AER's preferred construction of the Dividend Growth Model. This gave a range of 5.1 to 8.6 per cent.[157] The AER estimated a point estimate for the MRP of 6.5 per cent based on:[158] historical excess returns which indicated a MRP of approximately 6.0 per cent from a range of 5.1 to 6.5 per cent; Dividend Growth Model estimates which indicated an MRP estimate with a range of 7.4 per cent to 8.6 per cent; survey evidence and conditioning variables, which supported an MRP estimate of 6 per cent; and other regulators' estimates as a cross-check, which the AER considered indicated a MRP estimate of around 6.5 per cent is reasonable.

200. The AER considered that the Fama-French Model was relevant, but did not give it any weight.[159]

201. In the Draft Decision, the AER determined a value for the risk free rate of 3.55 per cent based on an indicative averaging period of 17 September to 15 October 2014.[160] This value was

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149 Final Determination, pages 3-13 (Table 3-1).

150 Final Determination, page 3-13 (Table 3-1).

151 Final Determination, pages 3-32 and 3-225.

152 Final Determination, page 3-32.

153 Final Determination, page 3-36.

154 Final Determination, page 3-386 (Table 3-50).

155 Final Determination, page 3-36.

156 Final Determination, page 3-34.

157 Final Determination, pages 3-353 and 3-354.

158 Final Determination, pages 3-354 and 3-555.

159 Final Determination, pages 3-32 to 3-341.

applied to a market risk premium of 6.5 per cent, and combined with an equity beta of 0.7, to give an overall return on equity of 8.1 per cent.[161]

202. In the Final Determination, the AER determined a value for the risk free rate of 2.55 per cent based on the averaging period of 9 February to 6 March 2015.[162] This represented a reduction of one per cent in the risk free rate relative to the Draft Decision that used an indicative averaging period only six months prior to that used in the Final Determination. The value of 2.55 per cent for the risk free rate was applied to an unchanged market risk premium of 6.5 per cent, and combined with an equity beta of 0.7, to give an overall return on equity of 7.1 per cent. This was a full percentage point less than the return on equity in the Draft Decision and in excess of three percentage points less than the return on equity determined by the AER for the 2009/10 to 2013/14 regulatory control period.[163]

AER's errors

203. The AER made an error of fact, or alternatively an incorrect exercise of discretion or an unreasonable decision, in concluding that the return on equity for a benchmark efficient entity with a similar degree of risk to ActewAGL was 7.1%.[164]

204. In making the erroneous decision referred to in the previous paragraph, the AER made the following errors:

204.1 the AER did not comply with clause 6.5.2(e) of the NER in that, having determined that the Black CAPM, the Fama-French Three Factor Model and the Dividend Growth Model were all relevant models, the AER had no regard to the estimates of the return on equity for the benchmark efficient entity derived from those models, but rather placed sole reliance on its 'foundation model', the SL CAPM;[165]

204.2 the AER asked itself the wrong question by seeking to identify a single model that is superior to all other models that could be used (alone) to estimate the return on equity;

204.3 the AER made an error or errors of fact, or alternatively an incorrect exercise of discretion or an unreasonable decision, in concluding that the SL CAPM was superior to all other models and that it was not appropriate to use the Black

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160 Draft Decision, page 3-30.

161 Draft Decision, pages 3-30 to 3-31.

162 Final Determination, page 3-33.

163 AER, *Final decision Australian Capital Territory distribution determination 2009-10 to 2013-14*, 28 April 2009, page 108, Table 12.6; Final Determination, page 3-13 (Table 3-1). The AER determined a return on equity for the 2009/10 to 2013/14 regulatory control period of 10.29%.

164 Final Determination, page 27 (Table 5); Final Determination, page 3-13 (Table 3-1).

165 Final Determination, pages 3-31 to 3-32, 3-55 and 3-60.

CAPM, the Fama-French Three Factor Model and the Dividend Growth Model to derive the return on equity,[166] including because:

204.3.1 the evidence before the AER was that the SL CAPM has well-recognised weaknesses, including that it is a poor fit to empirical data and suffers from downwards bias for low beta stocks (i.e. stocks with a beta of less than one) and value stocks (i.e. high book-to-market ratio stocks);[167]

204.3.2 the AER was inconsistent, unbalanced and irrational in its assessment of the relative merits of the various models, including because the AER applied standards of reliability and precision to the Black CAPM, the Fama-French Three Factor Model and the Dividend Growth Model which, if applied to the SL CAPM, would cause the SL CAPM to fail the standards;[168]

204.3.3 the evidence before the AER was that all of the models had strengths and weaknesses;[169]

204.3.4 the AER erred in dismissing or limiting the weight to be given to other financial models on the basis that different estimates have been produced by practitioners applying those models in various contexts,[170] without assessing the quality and relevance of those estimates, or whether the particular application of the financial model by ActewAGL is of an appropriate standard such that it should be given weight in estimating the return on equity;

204.3.5 a proper and rational approach to assessing the reliability of alternative models, and deriving the best estimate from those models, would be to give greater emphasis to studies or applications of the models that:

(a) reflected the most recent advances in econometric methodology;

(b) used more recent data;

(c) used larger, more comprehensive data sets; and

(d) had been subject to more scrutiny.

166 Final Determination, pages 3-31 to 3-32, 3-55 and 3-60.

167 Final Determination, pages 3-240, 3-425, 3-432 (footnote 1715) and 3-437 (footnote 1736).

168 See, for example, Final Decision, pages 3-76 to 3-77, at which the AER expressed concern that dividend growth models are 'highly sensitive to input assumptions'.

169 Final Determination, pages 3-221 to 3-222.

170 See, for example, Final Determination, pages 3-254, 3-259 and 3-265.

The AER erred in not adopting that approach;

204.3.6 it was not an appropriate basis for the AER to dismiss the use of a model on the basis that additional factors had, from time to time, been suggested for incorporation in the model.[171] The mere fact that researchers and PhD students suggest the use of additional factors from time to time does not invalidate the use of the original form of the model or suggest that it does not have predictive power, in the same way that this fact alone does not impugn the use of the SL CAPM (which is a single factor model); and

204.3.7 the AER:

(a) impermissibly gave presumptive weight to the SL CAPM and then rejected or limited the application of other financial models on the basis of deficiencies or limitations that also applied to the SL CAPM;

(b) failed to have proper regard, or alternatively gave insufficient weight, to evidence of bias in the SL CAPM;

(c) failed to adequately have regard to evidence of the prevailing return on equity from other relevant financial models, including the Black CAPM, the Fama-French Three Factor Model and the Dividend Growth Model; and

(d) failed to adequately have regard to expert evidence which recommended that multiple return on equity models be used;

204.4 the AER's approach of using other models only to inform its foundation model parameter estimates was illogical and lacking any analytical validity or rigour; and

204.5 the AER's approach erroneously confines the role of other models to confirming or supporting its application of the foundation model. The consequences of this approach is that other models are not allowed to be used for their proper purpose, which is to derive estimates of the prevailing return on equity for the benchmark efficient entity.

205. Further, the evidence before the AER was that a return on equity of 7.1% was too low and the product of declining yields of CGS coupled with a fixed or relatively inflexible MRP as applied by the AER under the SL CAPM.[172] The inflexibility in the AER's approach to estimating the MRP is demonstrated by the fact that it has continued to apply an MRP of

171 Final Determination, page 3-250.

172 Final Determination, pages 3-134 and 3-126 and footnote 431. The AER's return on equity estimate of 7.1% is derived by adding the 'prevailing risk free rate' of 2.55% to the product of its equity beta estimate of 0.7 and its MRP estimate of 6.5%.

either 6.0% or 6.5%[173] (i.e. its estimate has only varied by 50 basis points) through the largest bull market and the largest financial crisis in modern times. The evidence was that the output of the AER's application of the SL CAPM was being driven down by declining CGS yields, which were caused by factors that did not impact, or did not impact to the same extent, on the return on equity. The evidence before the AER included evidence that CGS yields had been driven down by factors including:[174]

205.1 a flight to quality and the recognition of Australian CGS as a safe haven investment;

205.2 a shrinking supply of AAA rated sovereign debt globally;

205.3 a heightened risk aversion and increased levels of perceived risk (which would depress CGS yields but elevate the required return on equity); and

205.4 heightened demand for liquid assets including demand produced by changes in banking regulations.

The evidence before the AER was that CGS yields had recently declined by 1.8% over 14 months and 1% over 4 months, and that there was no reason to think that the return on equity had declined by these amounts over this time.[175] This indicated that the AER's application of the SL CAPM was not a reliable sole means of deriving the return on equity, and therefore not one that contributes to the achievement of the allowed rate of return objective. In failing to have proper regard to this evidence, and in determining that the return of equity was 7.1%, the AER made an error or errors of fact, or alternatively an incorrect exercise of discretion or an unreasonable decision.

206. Further to the previous paragraph, the evidence before the AER (including the evidence referred to in the previous paragraph) suggested that:

206.1 the AER’s approach of taking an MRP that is largely derived from historical measures[176] and combining it with a prevailing risk free rate to derive the return on equity is not an appropriate approach, and accordingly not one that contributes to the achievement of the allowed rate of return objective; and

206.2 there was no proper basis for concluding that a largely fixed MRP (based primarily on historical measures) could be used with a prevailing (and depressed) risk free rate to make an accurate calculation of the return on equity, and one that contributes to the achievement of the allowed rate of return objective,[177] as the evidence suggested at least that realised excess returns have varied over time

173 Final Determination, pages 3-13 (Table 3-1) and 3-294.

174 Final Determination, pages 3-122 to 3-123 (see, especially, footnotes 411 and 412).

175 Final Determination, pages 3-122 to 3-123 (see, especially, footnotes 411 and 412); see also ActewAGL's submission on risk free rate dated 30 March 2015.

176 Final Determination, page 3-357.

177 Final Determination, pages 3-350 to 3-352.

(meaning that the MRP must have fluctuated from time to time) and that current equity returns were not simply reducing in line with CGS yields. This means that before simply applying an MRP based primarily on historical average excess returns, it was necessary for the AER to consider whether the resulting return on equity would reflect prevailing conditions in the market for equity funds, which the AER failed to do.

207. The AER erred in concluding that its implementation of the SL CAPM, with a fixed or relatively inflexible MRP, would provide for certainty and predictability,[178] in a manner that is consistent with achieving the allowed rate of return objective. In fact, the AER's approach leads to unprecedented instability in estimates of the return on equity.

208. The AER made an error or errors of fact, or alternatively an incorrect exercise of discretion or an unreasonable decision, in concluding that it could overcome recognised difficulties with the SL CAPM and nevertheless use the SL CAPM as its sole or 'foundational' model by using the 'theory of the Black CAPM' to choose an equity beta of 0.7 from the top of the AER's equity beta range,[179] including because:

208.1 the AER's beta range was not a correct range for beta, as discussed further below, and 0.7 is lower than the correct figure for equity beta;

208.2 there was no basis or analysis undertaken by the AER to determine whether selecting a figure for beta at the top of its range compensated for the downwards bias or other difficulties in the application of the SL CAPM, and the selected equity beta did not compensate for other inadequacies in the sole use of the SL CAPM and a largely historical MRP;

208.3 further, it is impossible to consider the quantum of any adjustment needed to account for the theory of the Black CAPM, without estimating the return on equity using the Black CAPM (which the AER did not do); and

208.4 the correct application of the 'theory of the Black CAPM' was to use the Black CAPM itself in the calculation of the return on equity.

209. The AER made an error of fact, or alternatively an incorrect exercise of discretion or an unreasonable decision, in concluding that the Dividend Growth Model was not suitable for use in calculating the return on equity for the benchmark efficient entity, including because:

209.1 the Dividend Growth Model derives a discount rate from current prices or market values by reference to future cashflows (dividends). That is akin to the estimation task with which the AER is charged in estimating return on equity under the NER;

209.2 the evidence showed that the Dividend Growth Model is widely used in practice;

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178 See, for example, Final Determination, pages 3-369 and 3-427.

179 Final Determination, pages 3-64, 3-123 to 3-124, 3-223 and 3-424 to 3-434.

209.3 the AER's observation that estimates of the return on equity from the Dividend Growth Model are 'very high[180] does not provide a proper basis for rejecting use of this model - it could equally be said that the AER's SL CAPM estimates are 'very low'; and

209.4 the fact that estimates of the return on equity from the Dividend Growth Model are sensitive to input assumptions[181] does not provide a proper basis for rejecting the use of this Model. The same could be said of other return on equity models, including the SL CAPM (which is sensitive to choices around the equity beta and MRP in particular).

210. The AER made an error or errors of fact, or alternatively an incorrect exercise of discretion or an unreasonable decision, in concluding that the Black CAPM was not suitable for use in calculating the return on equity,[182] including because:

210.1 contrary to the observations of the AER, the Black CAPM is commonly used to calculate the return on equity (although not always labelled the 'Black CAPM', but sometimes labelled the 'empirical CAPM');

210.2 contrary to the conclusions of the AER, the AER had been provided with a reliable calculation of the zero beta premium (based on analysis by SFG)[183] and was in a sound position to utilise the Black CAPM model, including because the calculation had been performed in such a way that high book-to-market stocks did not affect the estimate of the zero beta premium; and

210.3 it was unreasonable for the AER to reject SFG's estimate of the zero beta premium on the basis that there had previously been a range of estimates from other studies, and that there were other estimates that were inconsistent with SFG's estimate.[184]

211. The AER made an error or errors of fact, or alternatively an incorrect exercise of discretion or an unreasonable decision, in concluding that the Fama-French Three Factor Model was not suitable for use in calculating the return on equity,[185] including because:

211.1 the evidence before the AER was that the empirical performance of the Fama-French Three Factor Model is superior to the SL CAPM and provides a superior fit to the observable data, including in Australia;

180 Final Determination, page 3-76 to 3-77.

181 Final Determination, page 3-275.

182 Final Determination, pages 3-72 to 3-75 and 3-424.

183 Final Determination, footnotes 927 to 930.

184 Final Determination, pages 3-258 to 3-259.

185 Final Determination, pages 3-67 to 3-72 and Appendix A.3.2.

211.2 the AER's concern that the Fama-French Three Factor Model did not have a sound theoretical basis was erroneous and unreasonable in circumstances where the Fama-French Three Factor Model was an empirically based model designed to provide, and which provides, a much better fit to the empirical data than the SL CAPM;[186] and

211.3 the AER's concern that the Fama-French Three Factor Model is complex[187] is not a proper basis for rejecting use of the model to estimate the return on equity.

212. The AER failed to have proper regard to estimates of the market return on equity from the Dividend Growth Model, because it failed to consider the market-wide estimate from its Dividend Growth Model as an indicator of the prevailing market return on equity, which could then be compared to the market-average output of the AER's SL CAPM (i.e. at an equity beta of one, being the risk free rate plus the MRP). In circumstances where there was evidence that the output of the AER's implementation of the SL CAPM was being impacted in a volatile way by global developments affecting CGS yields,[188] the AER had an alternative means of assessing the prevailing conditions in the market for equity funds (being the market-wide return on equity from the Dividend Growth Model), and yet irrationally chose not to have regard to it. Further, the AER erred in applying the Dividend Growth Model in examining estimates for the MRP, by making an adjustment to GDP growth rates that was without any proper basis.

213. The AER made an error or errors of fact, or alternatively an incorrect exercise of discretion or an unreasonable decision, in concluding that an appropriate figure for the MRP was 6.5 per cent,[189] including because:[190]

213.1 the AER incorrectly analysed the historical range for MRP as suggesting that MRP could be found in the range of 5.1 per cent to 6.5 per cent,[191] whereas all that this range suggested was that the MRP for average market conditions had a range of somewhere between 5.1 per cent to 6.5 per cent, the range merely reflecting the statistical uncertainty around such estimates of the MRP in average market conditions. This measure said nothing about the range of the MRP itself;

213.2 the empirical evidence before the AER (including the AER’s own analysis) indicated that the current MRP is likely to be significantly above 6.5 per cent;

213.3 the unprecedented impact on CGS yields suggested that, as equity returns were unlikely to be affected to the same extent, the MRP was growing;

186 Revised Regulatory Proposal, page 445; Regulatory Proposal, Attachment E5, page 27.

187 Final Determination, page 3-68.

188 See, for example, ActewAGL's submission to the AER dated 30 March 2015.

189 Final Determination, page 3-359.

190 Final Determination, pages 3-270 and Appendix C.

191 Final Determination, pages 3-34 and 3-111.

213.4 the AER did not have proper regard, or alternatively gave insufficient weight, to evidence of the current MRP, as reflected in Dividend Growth Model results (including results of its own Dividend Growth Model);

213.5 the AER gave undue weight to evidence of historical average excess returns;

213.6 the AER erred in its interpretation of the historical excess returns data, by failing to make appropriate adjustments to that data;

213.7 the AER erred in considering that the geometric average of historical excess returns is relevant to estimation of the prevailing MRP;

213.8 the AER failed to adequately have regard to evidence of the historical average market return; and

213.9 the AER improperly and illogically considered whether other evidence fell within a range that overlapped with the AER's specified estimate, in circumstances where the preponderance of other evidence suggested that the MRP was higher than 6.5%.

214. The AER made an error or errors of fact, or alternatively an incorrect exercise of discretion or an unreasonable decision, in concluding that its method for determining the return on equity is consistent with its estimate of the value of imputation credits,[192] whereas in fact the AER did not properly adjust its estimate to account for the value of imputation credits.

215. The AER made an error or errors of fact, or alternatively an incorrect exercise of discretion or an unreasonable decision, in concluding that an appropriate figure for the equity beta was 0.7, and indeed in selecting 0.7 so as to give effect to the 'theory of the Black CAPM' in calculating the return on equity.[193] The errors of the AER in this regard include:[194]

215.1 the AER gave undue weight to the empirical estimates of Professor Henry, which (at the AER's instruction) were based on a very small sample of domestic energy network businesses, including five businesses that are no longer listed, and notwithstanding other evidence as to the unreliability of estimates based on this small sample;[195]

215.2 further, the AER erred in adopting a range of 0.4 - 0.7 for the equity beta based on the evidence of Professor Henry, whereas Professor Henry in fact concluded that the point estimate for the equity beta lies in the range of 0.3 - 0.8;[196]

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192 Final Determination, pages 3-336 to 3-350 (Appendix C.6)

193 Final Determination, pages 3-223 and 3-424 to 3-434.

194 Final Determination, Appendix D.

195 Final Determination, page 3-386 (Table 3-50)

196 Henry, *Estimating β: An update*, April 2014, page 63.

215.3 the AER did not have proper regard, or alternatively gave insufficient weight, to the empirical estimates of SFG, which were based on a larger sample of businesses;[197]

215.4 the AER has excluded international comparators on the basis of a wide range of results,[198] but has erred in doing so by combining and comparing estimates from companies that are not geared at 60% (and not adjusted to reflect this gearing);

215.5 the AER erred in its 'conceptual analysis',[199] including because it concluded that business risk factors would outweigh financial risk factors (i.e. the level of gearing), without any proper basis for such a conclusion;

215.6 the AER erred as a matter of logic and approach in considering whether its primary beta range of 0.4 – 0.7 is confirmed by the ranges produced by other types of information, such as international comparators.[200] For example, a range of 0.4 – 0.7 is not confirmed or supported by another body of information that suggests that the range is 0.7 – 1.1, yet this was the approach adopted by the AER. Contrary to the illogical position adopted by the AER, the latter range suggests that the correct value is higher than the value which would be produced by the former range. In the present case, the preponderance of other evidence suggested an equity beta above 0.7;

215.7 the AER erred in concluding that an equity beta range of 0.4 – 0.7 appropriately reflects the degree of risk faced by ActewAGL in the provision of prescribed distribution services, in circumstances where the empirical evidence indicated an equity beta of at least 0.8;[201] and

215.8 the AER failed to have regard to evidence that the equity beta was greater than 0.7.

216. The AER has made an error or errors of fact, or alternatively an incorrect exercise of discretion or an unreasonable decision, in concluding that its 'cross checks' confirm its return on equity estimate of 7.1%.[202] The AER’s errors include the following:

216.1 the AER erroneously applied the Wright approach as a cross-check on its overall return on equity estimate,[203] rather than as a method for estimating the MRP;

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197 Final Determination, page 3-393.

198 Final Determination, page 3-418 and Appendix D.3.

199 See, generally, Final Determination, Appendix D.1.

200 Final Determination, pages 3-427 to 3-430 and 3-424.

201 See, for example, Final Determination, pages 3-428 to 3-429 and footnote 1703.

202 Final Determination, page 3-227.

203 Final Determination, Appendix E.1.

216.2 the AER's application of the Wright approach was illogical and unreasonable. The AER applied the Wright approach using an equity beta range of 0.4 - 0.7,[204] despite having determined that an equity beta of 0.4 (or indeed any equity beta below 0.7) would be inappropriate. The effect of this was to produce a very wide range of return on equity estimates from the Wright approach;

216.3 in relation to the Grant Samuel analysis,[205] the AER has misunderstood the analysis, which does not support the AER's conclusion;

216.4 all other independent valuation evidence cited by the AER does not support, and is above, the equity risk premium derived from the Final Determination (MRP of 6.5% x equity beta of 0.7, i.e. 4.55%);[206]

216.5 the broker reports do not support the AER's conclusion, once appropriate adjustments have been made for imputation and it is appreciated that many apply an uplift factor to the prevailing risk free rate (being a version of the Black CAPM in practice);[207]

216.6 in considering conditioning variables,[208] the AER failed to have regard to movements in the risk-free rate as a potential indicator of movements in the equity risk premium; and

216.7 the AER erred in having regard to previous decisions of other regulators (many of which were made under significantly different market conditions) and submissions from stakeholders as evidence of the prevailing return on equity that confirmed or supported the AER's estimate.[209]

217. Further, the AER made an error or errors of fact, or alternatively an incorrect exercise of discretion or an unreasonable decision, in determining a return on equity for the transitional regulatory control period (2014-15) of 7.1% using a 20-business day averaging period from 9 February to 6 March 2015, where (on the basis of the AER's estimation method for the return on equity) the correct approach would have been to use the averaging period of 28 February to 30 June 2014, which gave a return on equity of 10.42%. There is no basis for the AER calculating a return on equity for the transitional regulatory control period on the basis of a calculation which post-dates most of the period in question, particularly in light of the circumstances that the return on equity calculated by the AER's implementation of the SL CAPM has declined sharply since 1 July 2014, and indeed declined 1% between the Draft Decision and the Final Determination.

204 Final Determination, page 3-443.

205 Final Determination, pages 3-417 and 3-449 to 3-451.

206 Final Determination, pages 3-447 to 3-452.

207 Final Determination, pages 3-452 to 3-453.

208 Final Determination, Appendix C.4.

209 Final Determination, Appendix E.5; Final Determination, page 3-475.

218. Further or alternatively, the Return on Equity Decision was unreasonable, having regard to all the circumstances, because of the matters referred to above and because:

218.1 it was unreasonable to give sole weight to the output of the SL CAPM in determining the return on equity, in circumstances where:

218.1.1 the SL CAPM has known deficiencies, including demonstrated bias in estimating the return on equity for low-beta stocks; and

218.1.2 there are other relevant return on equity models which have been designed to overcome these deficiencies;

218.2 it was unreasonable to give no practically no weight to the evidence of the prevailing return on equity from other relevant financial models, including the Black CAPM, the Fama-French Three Factor Model and the Dividend Growth Model; and

218.3 it was unreasonable for the AER to adopt the output of the SL CAPM as its estimate of the return on equity, without proper consideration of whether the output of this model would deliver an outcome that is consistent with the rate of return objective.

219. By reason of the matters identified in this section as to the return on equity, the AER's decision as to the return on equity:

219.1 does not produce a return on equity that is commensurate with the efficient financing costs of a benchmark efficient entity with a similar degree of risk as ActewAGL; and

219.2 does not have regard to the prevailing conditions in the market for equity funds,

such that the decision is not in accordance with clause 6.5.2 of the NER, and the decision involves an error or errors of fact, or alternatively involves an incorrect exercise of discretion or is unreasonable.

(6) Return on debt

Background

220. As set out under the ground of review with respect to return on equity, clause 6.4.3(a)(2) of the NER provides that one of the 'building blocks' in determining a DNSP's annual revenue requirement is 'a return on capital for that year'. Under clause 6.4.3(b)(2) of the NER the return on capital is calculated in accordance with clause 6.5.2 of the NER.

221. As set out in paragraph 40 above, clause 6.12.1 of the NER provides that the constituent decisions of a distribution determination include:

221.1 a decision on the allowed rate of return for each regulatory year of the regulatory control period in accordance with clause 6.5.2 (clause 6.12.1(5)); and

221.2 a decision on whether the return on debt is to be estimated using a methodology referred to in clause 6.5.2(i)(2) and, if that is the case, the formula that is to be applied in accordance with clause 6.5.2(l) (clause 6.12.1(5A)).

222. ActewAGL refers to and repeats paragraphs 175 to 186 above regarding the NER requirements for the determination of the allowed rate of return.

223. Clause 6.5.2(h) of the NER requires that the return on debt for a regulatory year of a regulatory control period must be estimated such that it contributes to the allowed rate of return objective.

224. Under clause 6.5.2(i) of the NER the return on debt may be estimated using a methodology that results in either:

224.1 the return on debt for each regulatory year in the regulatory control period being the same; or

224.2 the return on debt (and consequentially the allowed rate of return) being, or potentially being, different for different regulatory years in the regulatory control period. If the return on debt is estimated in this manner, then a resulting change to the DNSP's annual revenue requirement must be effected through the automatic application of a formula that is specified in the distribution determination (clause 6.5.2(l)).

225. Clause 6.5.2(j) of the NER provides that subject to clause 6.5.2(h), the methodology adopted to estimate the return on debt may, without limitation, be designed to result in the return on debt reflecting:

225.1 the return that would be required by debt investors in a benchmark efficient entity if it raised debt at the time or shortly before the making of the distribution determination for the regulatory control period (subparagraph (1));

225.2 the average return that would have been required by debt investors in a benchmark efficient entity if it raised debt over an historical period prior to the commencement of a regulatory year in the regulatory control period (subparagraph (2)); or

225.3 some combination of the returns referred to in subparagraphs (1) and (2).

226. In estimating the return on debt, clause 6.5.2(k) of the NER requires the AER to have regard to:

226.1 the desirability of minimising any difference between the return on debt and the return on debt of a benchmark efficient entity referred to in the allowed rate of return objective;

226.2 the interrelationship between the return on equity and the return on debt;

226.3 the incentives that the return on debt may provide in relation to capital expenditure over the regulatory control period, including as to the timing of any capital expenditure; and

226.4 any impacts (including in relation to the costs of servicing debt across regulatory control periods) on a benchmark efficient entity referred to in the allowed rate of return objective that could arise as a result of changing the methodology that is used to estimate the return on debt from one regulatory control period to the next.

227. The return on debt consists of two components:[210]

227.1 a risk free rate (or base rate) component; and

227.2 a risk premium over the base rate or 'debt risk premium' (**DRP**) component.

228. The AER estimated the return on debt for the 2009/10 to 2013/14 regulatory control period using the 'on-the-day' approach, under which the allowed return on debt is based on prevailing interest rates at the start of the regulatory period.[211]

229. The AER's Rate of Return Guideline (referred to at paragraph 188 above) sets out the AER's proposed approach to estimating the return on debt for subsequent regulatory control periods. The Rate of Return Guideline states that the AER proposes to estimate the allowed return on debt using a trailing average portfolio approach following the completion of a transitional arrangement period for all regulated businesses.[212]

230. The Rate of Return Guideline states that the AER proposes the following trailing average portfolio approach to estimating the return on debt:[213]

230.1 a trailing average portfolio approach with the length of the trailing average to be 10 years;

230.2 equal weights to be applied to all elements of the trailing average; and

230.3 the trailing average to be automatically updated every regulatory year within the regulatory control period.

231. In proposing the trailing average portfolio approach to estimating the return on debt, the AER stated that such an approach may be more reflective of the actual debt management approaches of non-regulated businesses and might therefore be more likely to represent efficient financing practice.[214]

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210 Final Determination, page 3-140.

211 Final Determination, pages 3-140, 3-158 to 3-159.

212 Rate of Return Guideline, page 19.

213 Rate of Return Guideline, page 19.

214 AER, *Explanatory Statement, Rate of Return Guideline*, December 2013 (**Rate of Return Explanatory Statement**), page 110.

232. The Rate of Return Guideline states that the AER proposes the period of transition to estimating the allowed return on debt using the trailing average portfolio approach be 10 regulatory years. The Rate of Return Guideline states that during the transitional period, the AER proposes that (both components of) the allowed rate of return on debt be determined as follows:[215]

232.1 in the first regulatory year of the transitional period, the allowed rate of return on debt be based on the estimated prevailing rate of return on debt for that year (that is, the return on debt be estimated using the 'on-the-day' approach);

232.2 in the second regulatory year, the allowed rate of return on debt be the weighted average of the prevailing rates in the first and second regulatory years of the transitional period (with weights of 0.9 and 0.1 respectively);

232.3 in the third regulatory year, the allowed rate of return on debt be the weighted average of the prevailing rates in the first, second and third regulatory years of the transitional period (with weights of 0.8, 0.1 and 0.1 respectively),

and so on (**AER's Transition**).

233. In the tenth year of transition, the allowed return on debt would be an equally weighted sum of the prevailing rates in the ten years of transition (with weights of 0.1).[216]

234. In developing the Rate of Return Guideline, the AER stated that its conceptual approach to estimating the return on debt is as follows:

234.1 For the purposes of applying the allowed rate of return objective, the AER proposes to adopt a single definition of the benchmark efficient entity, namely 'a pure play, regulated energy network business operating within Australia'.[217]

234.2 As the AER proposes that the benchmark efficient entity should be a regulated business, it then follows that the efficiency of different debt financing practices of the benchmark efficient entity needs to be considered in the context of the adopted regulatory regime and, specifically, the adopted approach to estimating the return on debt.[218]

234.3 The AER interprets 'the efficient financing costs of a benchmark efficient entity' as financing costs resulting from the benchmark efficient entity minimising the expected present value of its financing costs over the life of its assets, taking into

215 Rate of Return Guideline, page 20; Rate of Return Explanatory Statement, Appendices, page 131.

216 Rate of Return Explanatory Statement, Appendices, page 131.

217 Rate of Return Explanatory Statement, page 32.

218 Rate of Return Explanatory Statement, page 103.

account the regulatory framework and associated financial risks it expects to face in the future.[219] These risks are:[220]

234.3.1 refinancing risk, being the risk that a firm would not be able to efficiently finance its debt at a given point in time; and

234.3.2 interest rate risk, being the risk of a potential mismatch between the regulatory return on debt allowance and the firm's actual return on debt.

235. As a result of changing the approach to estimating the return on debt, the AER concluded in developing the Rate of Return Guideline that:[221]

235.1 under the 'on-the-day' approach to estimating the return on debt, the benchmark efficient entity would hold a debt portfolio with staggered maturity dates and use swap transactions to hedge interest rate exposure (that is, 'lock in' the base rate component) for the duration of a regulatory control period;

235.2 under the trailing average approach to estimating the return on debt, the benchmark efficient entity would hold a (fixed rate) debt portfolio with staggered maturity dates; and

235.3 thus the benchmark efficient entity would need to unwind its hedging contracts if the AER changes from estimating the return on debt using the 'on-the-day' approach to the trailing average approach.

ActewAGL's proposal and the AER's decision

236. ActewAGL is currently, and was in and prior to the 2009/10 to 2013/14 regulatory control period, 100% financed by equity and has no debt financing.[222]

237. In its Regulatory Proposal, ActewAGL proposed an approach to estimating the return on debt that departed from the Rate of Return Guideline. Relevantly, ActewAGL proposed that the 10 year trailing average portfolio approach proposed by the AER in the Rate of Return Guideline be applied to ActewAGL from 1 July 2014, with no period of transition.[223] ActewAGL's proposal resulted in a return on debt of 7.85% for 2014/15 (which value would be updated annually for each of the 2015/16, 2016/17, 2017/18 and 2018/19 regulatory years).[224]

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219 Rate of Return Explanatory Statement, page 103.

220 Rate of Return Explanatory Statement, page 104.

221 Rate of Return Explanatory Statement, pages 107 to 109, 121 to 123.

222 Regulatory Proposal, page 282; Revised Regulatory Proposal, page 476.

223 Regulatory Proposal, pages 278 to 283.

224 Regulatory Proposal, page 292.

238. In its Draft Decision, the AER proposed to apply the methodology for estimating the return on debt set out in the Rate of Return Guideline, including the AER's Transition.[225] The AER's Draft Decision resulted in a return on debt of 6.07% for 2014/15 (which value would be updated annually for each of the 2015/16, 2016/17, 2017/18 and 2018/19 regulatory years).[226]

239. In its Revised Regulatory Proposal, ActewAGL maintained its proposal that the trailing average portfolio proposed by the AER in the Rate of Return Guideline be adopted immediately, with no period of transition.[227] ActewAGL's revised proposal resulted in a return on debt of 7.96% for 2014/15 (which value would be updated annually for each of the 2015/16, 2016/17, 2017/18 and 2018/19 regulatory years).[228]

240. In the Final Determination, the AER maintained its Draft Decision to apply the methodology for estimating the return on debt set out in the Rate of Return Guideline, including the AER's Transition.[229] That is, the AER decided that, in and from the 2014-19 period, it would depart from the previous 'on the day' approach to the estimation of the return on debt and adopt a method for estimation of the return on debt whereby:[230]

240.1 it would assume that the benchmark efficient entity had a staggered portfolio of fixed rate debt with 10% per year entered into over the last 10 years, such that 10% of the portfolio is paying at the rate for a relevant facility entered into 10 years ago, 10% is the rate for a relevant facility entered into 9 years ago, and so on (the **trailing average approach**);

240.2 it would, however, apply the AER's Transition, pursuant to which the method for the estimation of the return on debt transitions to the trailing average approach over 10 years (giving it 10% greater weighting each year) and in the meantime simply apply the prevailing rate set in the averaging period for 2014/15, such that the prevailing rate set at that time would continue to apply for 10 years, albeit with 10% less weight each year.

241. The application of the AER’s Transition meant that the rate for debt was set in the following manner:

241.1 for 2014/15, estimating the return on debt by reference to the risk free rate (using 10-year CGS as a proxy)[231] and the DRP (measured by reference to a simple average of the Reserve Bank of Australia broad BBB-rated 10 year curve, extrapolated to an effective term of 10 years, and the Bloomberg broad-BBB

225 Draft Decision, pages 3-23 to .3-24, 3-102 to 3-163, 3-287 to 3-317.

226 Draft Decision, page 3-102.

227 Revised Regulatory Proposal, pages 472 to 481.

228 Revised Regulatory Proposal page 469.

229 Final Determination, page 3-139.

230 Final Determination, pages 3-140 to 3-141.

231 Final Determination, pages 3-32 to 3-42.

rated curve, also extrapolated to an effective term of 10 years)[232] which prevailed during the averaging period of 30 April 2014 to 30 June 2014;[233]

241.2 for 2015/16, estimating the return on debt using 90 per cent of the rate for the cost of debt that applied in 2014/15, and 10 per cent by reference to the risk free rate and the DRP that prevailed during the 20 business day averaging period ending 31 January 2015;[234]

241.3 for 2016/17, estimating the return on debt in a manner that gives 80 per cent weight to the return on debt that applied in 2014/15, 10 per cent to the return on debt that applied in 2015/16, and 10 per cent by reference to the risk free rate and the DRP that will prevail in the averaging period in respect of 2016/17 set out in confidential Appendix K to Attachment 3 to the AER's Final Determination;

241.4 for 2017/18, estimating the return on debt in a manner that gives 70 per cent weight to the return on debt that applied in 2014/15, 10 per cent to the cost of debt that applied in 2015/16, 10 per cent to the return on debt that applied in 2016/17, and 10 per cent by reference to the risk free rate and the DRP that will prevail in the averaging period in respect of 2017/18 set out in confidential Appendix K to Attachment 3 to the AER's Final Determination; and

241.5 for 2018/19, estimating the return on debt in a manner that gives 60 per cent weight to the return on debt that applied in 2014/15, 10 per cent to the cost of debt that applied in 2015/16, 10 per cent to the return on debt that applied in 2016/17, 10 per cent to the return on debt that applied in 2017/18, and 10 per cent by reference to the risk free rate and the DRP that will prevail in the averaging period in respect of 2018/19 set out in confidential Appendix K to Attachment 3 to the AER's Final Determination.

242. The AER's Final Determination provides that the methodology set out above will continue in future regulatory years until the return on debt estimate that applied in the transitional regulatory control period falls to zero and the return on debt reflects a 10-year trailing average.[235]

243. While the AER maintained the method for estimation of the return on debt, including the AER's Transition, adopted in its Draft Decision and set out in the Rate of Return Guideline, the reasoning adopted by the AER in its Final Determination in support of the AER's Transition, in particular, departs substantially from that outlined in the Rate of Return Explanatory Statement and the Draft Decision. In its Final Determination, the AER relied upon (and published at the same time) two reports relevant to the return on debt issue:

232 Final Determination, pages 3-143 and 3-144.

233 Final Determination, confidential Appendix K to Attachment 3, page 3-6 (Table K.1).

234 Final Determination, confidential Appendix K to Attachment 3, page 3-7 (Table K.1).

235 Final Determination, page 3-141.

243.1 a report of Dr Martin Lally, Capital Financial Consultants Ltd (**Lally**),entitled *Review of Submissions on the Cost of Debt*, dated 21 April 2015; and

243.2 a report of Chairmont Consulting (**Chairmont**), entitled *Cost of Debt: Transitional Analysis*, dated April 2015.

244. These reports related to material issues under consideration by the AER as to the approach to defining the benchmark efficient entity and included, in the case of the Lally report, an examination of the 'risk' of departure of actual debt costs from a hypothetical regulatory allowance based on a time-series data from the US over the period April 1953 to January 2015.

245. The resulting return on debt adopted by the AER in the Final Determination is 6.07% for 2014/15 and 5.91% for 2015/16, with the value to be updated annually for each of the 2016/17, 2017/18 and 2018/19 regulatory years.[236]

AER's errors

246. The AER's decision estimating the return on debt involved errors of fact which were material to the decision, or an incorrect exercise of discretion, or was unreasonable in the respects set out in paragraphs 247 to 262 below.

<u>General</u>

247. The AER's decision involved an error or errors of fact, or alternatively an incorrect exercise of discretion or was unreasonable, in determining that its specified return on debt (6.07% for 2014/15, 5.91% for 2015/16, and thereafter in accordance with its debt methodology) was the efficient debt financing cost of a benchmark efficient entity with a similar degree of risk as ActewAGL.

248. The AER's decision involved an error of fact, or alternatively an incorrect exercise of discretion or was unreasonable, in that the AER identified the wrong 'benchmark efficient entity'. The AER's decision to impose a transition on the movement to the new trailing average methodology was dependent upon the AER's view of the debt management practices that a hypothetical entity would have adopted under the previous 'on-the-day' approach. In adopting this stance, the AER erred in identifying the relevant benchmark efficient entity as a benchmark <u>regulated</u> efficient entity, whereas the correct benchmark entity was a benchmark <u>unregulated</u> efficient entity, i.e. an entity competing in a workably competitive unregulated market. Such a benchmark entity would have a conventional debt portfolio of the type held by privately-owned entities in unregulated markets, namely a staggered portfolio of fixed rate debt. The debt financing costs of such a portfolio matches the debt cost calculated under the AER's new trailing average approach. Therefore, once the correct benchmark entity is identified, there is no basis for the imposition of a transition. The AER's selection of an incorrect benchmark entity, and imposition of a transition, involved:

236 Final Determination, pages 3-13 (Table 3-1), 3-139.

248.1 an error in the construction and application of clause 6.5.2, particularly subclauses 6.5.2(c), (j) and (k); and

248.2 a decision contrary to the NEO and the Revenue and Pricing Principles, in that the selection of a regulated entity as a benchmark would not impose an appropriate pricing signal for investment, i.e. the pricing signal that would be sent as a result of competition in a workably competitive market, rather than a pricing signal from the idiosyncratic application of a prior regulatory methodology.[237]

249. Even if, contrary to the fact, the AER was correct to consider the efficient financing costs of a benchmark regulated efficient entity, the AER erred in concluding that the AER’s Transition was commensurate with the efficient financing costs of such an entity,[238] including for the following reasons:

249.1 It was impossible under the 'on-the-day' approach to hedge the DRP component of the allowed debt financing costs.[239] The efficient financing costs of this component of the benchmark’s portfolio was therefore the financial costs of a staggered portfolio of fixed rate debt, being a cost equivalent to that produced by the application of the trailing average approach to the DRP component. There was therefore no basis for imposing any delay or transition to the imposition of the trailing average approach to the DRP component of ActewAGL’s cost of debt allowance. Even the AER’s own experts (Chairmont) observed that 'the AER should not transition the DRP, but instead move immediately to a ‘trailing average’ for this element'.[240]

249.2 Contrary to the Final Determination, the AER’s Transition is not a transition from the 'on-the-day' approach to the trailing average approach. Under the 'on-the-day' approach, the cost of debt was fixed every five years for a five year regulatory period at the rate prevailing at the commencement of the regulatory period. Under the AER’s Transition, the prevailing rate in 2014 is fixed for 10 years (not 5 years), and would therefore continue to have application over two regulatory control periods. The fixing of a rate in 2014 for a ten year period is not justified by the cost of debt that would now be facing even the AER’s hypothetical benchmark entity. Further, there is nothing that the hypothetical benchmark entity could now do to match that regulatory allowance. The AER does not explain why a fixed rate over a 10 year period is imposed, rather than re-setting the rate in 5 years.

249.3 Although the AER in its decision found that efficient financing practices of its benchmark efficient entity depend on and change with the regulatory regime adopted,[241] the evidence before the AER identified and established efficient

237 Revised Regulatory Proposal, pages 473 to 474.

238 Final Determination, pages 3-144 to 3-145 and 3-166.

239 Final Determination, page 3-164.

240 Chairmont, *Cost of Debt: Transitional Arrangements*, April 2015, page 47.

241 Final Determination, page 3-150 (footnote 499).

financing practices which did not depend on, and change with, the regulatory regime adopted.

249.4 As set out under the heading 'Efficiency findings' below, the AER erred in concluding that the use of a staggered portfolio of fixed rate debt without the use of fixed rate swaps was inefficient under the previous 'on-the-day' regulatory approach. Given that the AER's new methodology (the trailing average approach) coincided with ActewAGL being 100% financed by equity, there was no basis for imposing a transition.

250. Further, in circumstances where:

250.1 it was common ground that the efficient debt management practice under the AER's new trailing average methodology for the calculation of the cost of debt was for the business to hold a staggered portfolio of fixed rate debt; and

250.2 ActewAGL is currently, and was in and prior to the 2009/10 to 2013/14 regulatory control period, 100% financed by equity (that is, has no issued debt),

there was no basis for the imposition of any transition. A transition is only appropriate where the application of a new methodology will cause some disruption or dislocation (i.e. some 'impact', to use the words of clause 6.5.2(k)(4) of the NER), having regard to steps taken or commitments entered into by the business *in reliance upon the previous regulatory approach*. No such reliance, and no such disruption or dislocation, was present in this case. There is no basis in the NER for postulating the existence of some hypothetical or fictional reliance upon the previous regulatory approach giving rise to a hypothetical or fictional problem resulting from the immediate application of the new methodology, where no such problem arose in reality for the business in question. The AER's decision in this regard involved an error of fact (as to the existence of a problem or 'impact'), and was incorrect and unreasonable.

<u>No issued debt</u>

251. As to the finding that ActewAGL's zero debt financing in and prior to the 2009/10 to 2013/14 regulatory control period is not relevant to the estimation of the cost of debt allowance, or alternatively supports the application of the AER's Transition,[242] the AER's decision in that regard involved an error or errors of fact, or alternatively involved an incorrect exercise of discretion or was unreasonable. This is because, in circumstances where:

251.1 the issuance of debt financing was, in and prior to the 2009/10 to 2013/14 regulatory control period, left to ActewAGL's equity investors and those equity investors have adopted differing debt management strategies; and

251.2 the AER has determined that issuing debt with staggered maturity dates over a 10 year period is and was an efficient debt management strategy,

there is no principled basis for applying the AER's Transition.

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242 Final Determination, pages 3-142, 3-489.

252. Alternatively, the AER made an error or errors of fact in concluding that ActewAGL has issued debt over the past 10 year period.[243]

Efficiency findings

253. As to the finding that it was not an efficient financing strategy to manage interest rate risk under the 'on-the-day' approach by issuing debt with staggered maturity dates over a 10 year period without using swap transactions to hedge interest rate exposure (and therefore a benchmark efficient entity would not pursue this strategy),[244] the AER's decision in that regard involved an error or errors of fact, or alternatively involved an incorrect exercise of discretion or was unreasonable, including because -

253.1 the debt management activities of the NSW network service providers (**NSPs**) during prior regulatory control periods managed refinancing risk by issuing debt with staggered maturity dates over a 10 year period;[245]

253.2 the AER has determined that issuing debt with staggered maturity dates over a 10 year period is and was an efficient debt management strategy;

253.3 the debt management activities of the NSW NSPs during prior regulatory control periods provided them with a range of advantages (including flexibility to issue nominal or inflation indexed debt);

253.4 the debt management activities of the NSW NSPs during the 2009/10 to 2013/2014 regulatory control period resulted in a benchmark cost of debt lower than that which would have been achieved assuming the NSW NSPs were able to and had entered into interest rate swaps in the manner that the AER asserts was efficient to seek to manage the risk of a mismatch between the allowed return on debt and the actual cost of debt;[246]

253.5 given the debt funding requirements of the NSW NSPs, or alternatively given the debt funding requirements of a benchmark efficient entity with an assumed gearing of 60% and a similar degree of risk as that which applies to ActewAGL, the material before the AER established that (in particular having regard to the value of the swap transactions required, the time it would take to effect those swaps (if at all), the cost of effecting such swaps, and the swap demands of other entities in the market)[247] -

253.5.1 it was not possible in the previous regulatory control period, or alternatively not practicable or commercially sensible, for these NSPs

243 Final Determination, page 3-158.

244 Final Determination, pages 3-492 to 3-494.

245 Final Determination, page 3-500.

246 CEG, *Efficient debt financing costs*, 19 January 2015 (Attachment F2 to the Revised Regulatory Proposal) (**CEG January 2015 Report**), at [7.b.i] and [61]-[66].

247 CEG May 2014 Report at [58].

to seek to use swap contracts in the manner asserted by the AER to be efficient in order to manage the risk of a mismatch between the allowed return on debt and actual cost of debt in that earlier regulatory control period;

253.5.2 it was not possible, or alternatively not practicable or commercially sensible, for these NSPs to use swap contracts in the manner asserted by the AER to be efficient in order to seek to manage the risk of a mismatch between the allowed return on debt and actual cost of debt in the expectation that the 'on-the-day' approach would be applied to the estimation of the return on debt in the transitional and subsequent regulatory control periods;

253.5.3 accordingly, it was not possible for these NSPs to pursue debt management activities consistently with the AER's determination of those pursued by the benchmark efficient firm;

253.5.4 alternatively it was not practical or reasonable for these NSPs to pursue debt management activities consistently with the AER's determination of those pursued by the benchmark efficient firm; and

253.5.5 it could not be demonstrated that there would be any advantage in doing so;

253.6 further, the material before the AER established that, given the dispute and uncertainty as to the averaging period to be applied to estimate the risk free rate for the 2009/10 to 2013/14 regulatory control period - [248]

253.6.1 it was not possible to pursue debt management activities consistently with the AER's determination of those pursued by the benchmark efficient firm;

253.6.2 alternatively it was not practical to pursue debt management activities consistently with the AER's determination of those pursued by the benchmark efficient firm; and

253.6.3 it could not be demonstrated that there would be any advantage in doing so;

253.7 the material before the AER (including material relating to government ownership) did not establish that the debt management activities of the NSW NSPs during the prior regulatory control period were inefficient (and therefore not those which would be pursued by a benchmark efficient entity); and

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248 CEG January 2015 Report at [7.b.iii], [38]-[42].

253.8 the material before the AER established that the debt management activities of the NSW NSPs during the relevant prior regulatory control periods were efficient (and therefore those which would be pursued by a benchmark efficient entity).

Life of assets- other indeterminate period

254. As to the finding as to the basis for estimating the return on debt for each year of the regulatory control period, and in particular the AER's adoption of the methodology in its final decision (option 2) on the basis that it determined a return on debt which would be commensurate with the efficient financing costs over the life of the assets of the benchmark efficient entity, and (or alternatively) over a large (but indeterminate) number of regulatory control periods -

254.1 the material before the AER did not establish that to be the case;

254.2 further, given that regulated businesses do not take on debt instruments by reference to particular assets, but rather are regularly cycling and renewing their facilities so that the business is debt-financed to a certain extent at all times, it is meaningless and illogical to speak of efficient financing costs 'over the life of the assets' in considering the efficient financing costs of a benchmark efficient entity; and

254.3 further, the approach taken by the AER is inconsistent with the NER in that-

254.3.1 it does not contribute to the achievement of the allowed rate of return objective for the regulatory control period (only);

254.3.2 it does not represent an estimate of the return required by debt investors in the benchmark efficient entity if it raised debt at the time or shortly before the making of the AER decision or if it raised debt over an historical period prior to the commencement of a regulatory year;

254.3.3 the AER did not have regard to the incentives that the return on debt may provide in relation to capex over the regulatory control period (only); and

254.3.4 the NER require the return on debt in each regulatory control period to be commensurate with the efficient financing costs of the benchmark efficient entity and do not permit any adjustment of that determination to take account of asserted over or under estimations in past regulatory control periods, or an expectation that during some indeterminate future regulatory control period not itself the subject of the determination, there will be some asserted over or under estimation.

AER's option not achievable

255. Further, as to the adopted basis for estimating the return on debt for each year of the regulatory control period, and in particular the AER's adoption of the AER's Transition -[249]

255.1 it is not possible, or alternatively not practicable, for a benchmark efficient entity to implement a debt management strategy which reflects or mirrors that methodology;

255.2 it is unreasonable to estimate the return on debt for each year in the regulatory control period the subject of the AER decision by a methodology which cannot be, or alternatively cannot practically be, adopted by any regulated business; and

255.3 the estimate pursuant to that methodology-

255.3.1 accordingly does not contribute to the achievement of the allowed rate of return objective;

255.3.2 is not a measure of the return required by debt investors in the benchmark efficient entity if it raised debt at the time or shortly before the making of the AER decision or if it raised debt over an historical period prior to the commencement of a regulatory year; and

255.3.3 has no regard to the incentives that the return on debt may provide in relation to capex over the regulatory control period (only).

The 'regulated' efficient entity

256. In identifying what it assessed to be 'the efficient financing costs of a benchmark efficient entity' -

256.1 the AER considered (wrongly) that there could be only one benchmark entity, and that it must be a regulated entity;[250]

256.2 the AER found that efficient financing practices of its benchmark efficient entity depend on and change with the regulatory regime adopted,[251] when the material before the AER identified and established efficient financing practices which did not depend on and change with the regulatory regime adopted;

256.3 the AER took into account conduct taken by such an entity in response to the regulatory revenue setting decision of the AER in prior regulatory control periods, that is, to use swap contracts in the manner asserted by the AER to be efficient, so as to seek to manage the risk of a mismatch between the allowed

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249 CEG May 2014 Report at [108]-[114].

250 Final Determination, pages 3-147 to 3-148 and 3-158 to 3-159.

251 Final Determination, page 3-150 (footnote 499).

return on debt in those prior regulatory control periods and the entity's actual cost of debt in those earlier regulatory control periods;[252]

256.4 the AER took into account conduct taken by such an entity (to use swap contracts in the manner asserted by the AER to be efficient so as to manage the risk of a mismatch between the allowed return on debt and the entity's actual cost of debt) in the expectation that the 'on-the-day' approach would be applied to the estimation of the return on debt in the transitional and subsequent regulatory control periods;[253]

256.5 those matters were not relevant to -

256.5.1 the determination of the allowed rate of return in order to achieve the allowed rate of return objective;

256.5.2 the estimation of the return on debt for a regulatory year in the regulatory control period the subject of the AER decision;

256.5.3 the estimation of the return on debt for a regulatory year in order to contribute to the achievement of the allowed rate of return objective; or

256.5.4 the return required by debt investors in the benchmark efficient entity if it raised debt at the time or shortly before the making of the AER decision or if it raised debt over an historical period prior to the commencement of a regulatory year;

256.6 the AER did not seek to assess 'the efficient financing costs of a benchmark efficient entity' -

256.6.1 being those costs which do not have regard to conduct of the kind referred in subparagraphs 256.5.3 and 256.5.4 or conduct involving entering into interest swaps to seek to manage the risk of a mismatch between the allowed return on debt and the entity's actual cost of debt; and

256.6.2 by having regard to the conduct of the kind referred to in subparagraphs 256.5.3 and 256.5.4 the AER did not seek to assess the return required by debt investors in the benchmark efficient entity if it raised debt at the time or shortly before the making of the AER decision or if it raised debt over an historical period prior to the commencement of a regulatory year;

256.7 the NER do not require or permit the approach taken by the AER;

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252 Final Determination, pages 3-157 to 3-161.

253 Final Determination, pages 3-157 to 3-161.

256.8 the material before the AER established that the efficient financing costs of a benchmark efficient entity were those contended for by ActewAGL; and

256.9 accordingly the AER should have estimated the return on debt by using a 10 year trailing average without the gradual transition the subject of its determination.

257. Further, the AER was wrong to conclude that the use of a staggered portfolio of fixed rate debt without interest rate swaps is ineffective to provide a reasonable match to the regulatory allowance under the on-the-day approach.

258. In identifying what it assessed to be the basis for the estimate of the return on debt in each regulatory year of the regulatory control period (and its adoption of the gradual transition to a trailing average) -

258.1 the AER identified the impacts of its decision to change from an 'on-the-day' estimation to a trailing average approach having regard to the impacts (as it assessed or assumed them to be) on a regulated entity which had taken steps (the entry into of interest rate swaps) so as to seek to manage the risk of a mismatch between the allowed return on debt and the entity’s actual cost of debt; and

258.2 the AER did not seek to assess the impact -

258.2.1 on any benchmark efficient entity which does not does not enter into interest rate swaps to seek to manage the risk of a mismatch between the allowed return on debt and the entity’s actual cost of debt; or

258.2.2 on the return required by debt investors in such a benchmark efficient entity.

<u>Additional issues for the DRP</u>

259. Further, as to the adoption of the AER's Transition on the basis that it determined the implementation of the trailing average approach would result in a 'one-off windfall gain or loss to service providers by locking- in accumulated benefits (losses) primarily flowing from the debt risk premium spikes observed over the GFC'[254] -

259.1 the material before AER did not establish the existence of that windfall gain and established that there was no such gain;[255]

259.2 the NER require the return on debt in each regulatory control period to be commensurate with the efficient financing costs of the benchmark efficient entity and do not permit any adjustment of that determination to take account of asserted over or under estimations in past regulatory control periods, or an expectation that during some indeterminate future regulatory control period not

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[254] Final Determination, page 3-516.

[255] CEG January 2015 Report at [104]-[118].

itself the subject of the determination, there will be some asserted over or under estimation;

259.3 alternatively, the AER was capricious in seeking to have regard only to assessed gains (identified by it as a windfall) -[256]

259.3.1 over the 2009/10 to 2013/14 regulatory control period, without having regard to possible gains or losses in earlier periods; and

259.3.2 on the return on debt, and not losses over the 2009/10 to 2013/14 regulatory control period and earlier periods affecting the return on capital; and

259.4 the AER applied clause 6.5.2 as permitting it to estimate a return on debt for a regulatory year (and thereby to be used to affect the determination of the allowed rate of return) -

259.4.1 which took account of, and was reduced on account of, the (assumed or assessed) difference between ActewAGL's cost of debt (or assumed cost of debt) and the allowed return on debt in the previous regulatory control period; and

259.4.2 alternatively, which took account of, and was reduced on account of, the (assumed) difference between a benchmark efficient entity's cost of debt and the allowed return on debt in the previous regulatory control period,

in circumstances where these matters were not relevant to:

259.4.3 the determination of the allowed rate of return in order to achieve the allowed rate of return objective;

259.4.4 the estimation of the return on debt for a regulatory year in the regulatory control period the subject of the AER decision;

259.4.5 the estimation of the return on debt for a regulatory year in order to contribute to the achievement the allowed rate of return objective; and

259.4.6 the return required by debt investors in the benchmark efficient entity if it raised debt at the time or shortly before the making of the AER decision or if it raised debt over an historical period prior to the commencement of a regulatory year.

256 CEG January 2015 Report at [109]-[118].

260. Further, to the extent that the AER considered that not adopting a trailing average approach had the advantage that it avoided what the AER considered to be a practical difficulty with the use of historical data:

260.1 that issue was not a substantial issue and was certainly not a proper basis for:

260.1.1 adopting a methodology that produced a return on debt that was not commensurate with the efficient financing costs of a benchmark efficient entity; and

260.1.2 perpetuating a methodology that was recognised to produce a result that could never be replicated by a regulated business; and

260.2 in any event, the RBA curve has been backcast to January 2005 and the Bloomberg curve has been backcast to 1 July 2004, which almost entirely resolves the practical difficulties that the AER identifies with the use of historical data.

261. Alternatively, the decision that a transition should be applied to the DRP component of the return on debt is not required by (and is inconsistent with) the AER's findings that the benchmark efficient entity would raise its debt with staggered maturity dates over a 10 year period, and could not hedge the DRP component of the return on debt with a view to managing a risk of a mismatch between the allowed rate of return on debt and the entity's actual cost of debt.

<u>Failure to inform of material issues and provide a reasonable opportunity to make submissions</u>

262. The AER failed to accord procedural fairness to ActewAGL and/or contravened section 16(1)(b) of the NEL and/or clause 6.11.1(c) of the NER in that the AER failed to inform ActewAGL of material issues under consideration by the AER which were dealt with in the Lally and Chairmont reports and failed to provide ActewAGL with a reasonable opportunity to make submissions on those issues before the AER made the Final Determination.

263. By reason of the matters set out in paragraphs 247 to 262 above:

263.1 the AER made an error of fact in its findings of fact, and that error of fact was material to the making of the AER's decision on the return on debt;

263.2 the AER made more than one error of fact in its findings of fact, and those errors of fact, in combination, were material to the making of the AER's decision on the return on debt;

263.3 the exercise of the AER discretion in making its decision on the return on debt was incorrect, having regard to all the circumstances; and/or

263.4 the AER's decision on the return on debt was unreasonable, having regard to all the circumstances.

(7) Value of imputation credits (gamma)

Background

264. Clause 6.4.3(a)(4) of the NER provides that one of the 'building blocks' in determining a DNSP's annual revenue requirement (referred to in paragraphs 35 and 36 above) is the estimated cost of corporate income tax of the DNSP for that year. Clause 6.4.3(b)(4) provides that the estimated cost of corporate income tax is calculated in accordance with clause 6.5.3 of the NER.

265. As set out in paragraph 40 above, clause 6.12.1 of the NER provides that the constituent decisions of a distribution determination include:

    265.1 a decision on the value of imputation credits (**gamma**) as referred to in clause 6.5.3 (clause 6.12.1(5B)); and

    265.2 a decision on the estimated cost of corporate income tax to the DNSP for each regulatory year of the regulatory control period in accordance with clause 6.5.3 (clause 6.12.1(7)).

266. Clause 6.5.3 of the NER requires an estimate of the value of imputation credits (also referred to as 'gamma') as an input to the calculation of the estimated cost of corporate income tax.

267. Clause 6.5.3 of the NER provides that the estimated cost of corporate income tax for each regulatory year (ETC_t) must be calculated in accordance with the following formula:

$$ETC_t = (ETI_t \times r_t)\,(1 - \gamma)$$

where:

ETI_t is an estimate of the taxable income for that *regulatory year* that would be earned by a benchmark efficient entity as a result of the provision of *standard control services* if such an entity, rather than the *Distribution Network Service Provider*, operated the business of the *Distribution Network Service Provider*, such estimate being determined in accordance with the *post-tax revenue model*;

r_t is the expected statutory income tax rate for that *regulatory year* as determined by the *AER*; and

γ is the value of imputation credits.

268. The symbol γ is also referred to as gamma.

269. The function in the regulatory scheme of calculating gamma is to deduct the value of imputation credits from the amount which the business otherwise requires to provide an appropriate return to investors after meeting its costs (including income taxation costs). This is because some of the corporate tax paid by the business will provide a benefit to some investors in the form of imputation credits against their personal tax liabilities. If that benefit was not taken into account, the amount of revenue required to provide an appropriate return

would be overstated. Mathematically, this benefit could be deducted from the required return or else deducted from the cost of corporate income tax. The NER adopts the latter approach.

270. It is common ground between the AER and ActewAGL that γ (gamma) in the above formula is to be calculated as the product of:

270.1 the distribution rate for imputation credits; and

270.2 the value of distributed imputation credits (**theta**),

(that is, gamma = distribution rate x theta).

271. What is not common ground is:

271.1 the appropriate interpretation of the distribution rate and theta parameters (including what is meant by 'the value of imputation credits' in clause 6.5.3); and

271.2 the appropriate figures for each of the distribution rate and theta, and ultimately, the value for gamma.

ActewAGL's proposal and the AER's decision

272. In ActewAGL's Regulatory Proposal and Revised Regulatory Proposal, ActewAGL proposed a gamma of 0.25,[257] based on a distribution rate of 0.7 and a value for theta of 0.35.[258]

273. ActewAGL's proposed value for the distribution rate was based on analysis of the long-term distribution across Australian companies.[259]

274. ActewAGL's estimate of theta was based on the market value of distributed imputation credits, as indicated by dividend drop-off analysis,[260] consistent with the Tribunal's decision in *Application by Energex Limited (Distribution Ratio (Gamma) No 3* [2010] ACompT 9, and in accordance with the dividend drop off methodology adopted by the Tribunal following that decision and its application in a study conducted by SFG: *Application by Energex Limited (Gamma) No 5* [2011] ACompT 9. Dividend drop-off analysis seeks to infer a market value for imputation credits, based on movements in share prices around the time dividends are paid out. The present SFG study (**SFG Study**)[261] is an updated version of the study commissioned by the Tribunal in the *Energex* proceedings.[262]

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257 Regulatory Proposal, page 251; Revised Regulatory Proposal, pages xiv and 415.

258 Regulatory Proposal, pages 292 to 294*;* Revised Regulatory Proposal, pages 487 to 489. See also, Attachment E2 to Regulatory Proposal and Attachment F5 to Revised Regulatory Proposal.

259 Regulatory Proposal, page 293*;* Revised Regulatory Proposal, page 488. See also, Attachment E2 to Regulatory Proposal.

260 Regulatory Proposal, page 294.

261 SFG Consulting, *Updated estimate of theta for the ENA*, June 2013.

262 Revised Regulatory Proposal, pages 487, 489.

275. In the Final Determination, the AER did not accept ActewAGL's proposed gamma of 0.25.[263] The AER instead adopted a gamma of 0.4, selected from within a range of 0.3 to 0.5 (the **Gamma Decision**).[264]

276. The AER did not specify separate estimates of the distribution rate and theta in its Final Determination. However, it may be inferred that:

276.1 the AER considered that the distribution rate is between 0.7 and 0.8;[265] and

276.2 the AER considered that theta is between approximately 0.4 and 0.7.[266]

277. The Gamma Decision was based on the following reasoning by the AER:

277.1 gamma should represent the proportion of company tax that is returned to investors through utilisation of imputation credits;[267]

277.2 gamma is calculated by multiplying the distribution rate by the 'utilisation rate'. For each individual investor who is eligible to utilise imputation credits, the 'utilisation rate' is 1. For each individual investor who is not eligible to utilise imputation credits (such as investors not resident in Australia), the utilisation rate is 0. The calculation of the utilisation rate should exclude personal tax and personal costs, such as administrative costs, diversification costs and the time delay before the credits provide any benefit to the investor;[268]

277.3 in determining the distribution rate, the AER may have regard to evidence from all equity and/or listed equity only;[269]

277.4 the distribution rate for listed equity is approximately 0.8, while for all equity it is 0.7;[270]

277.5 the estimate of theta should primarily reflect an estimate of the utilisation rate from the 'equity ownership approach', with less reliance placed on evidence of

263 Final Determination, page 4-7.

264 Final Determination, pages 4-7 to 4-8.

265 The AER concludes that the distribution rate across all companies is 0.7, while the distribution rate for listed companies is 0.8: Final Determination, page 4-18 (Tables 4-1 and 4-2).

266 The AER does not state what it considers to be an appropriate range or point estimate for theta. The AER only states that 'a reasonable estimate for the value of imputation credits [gamma] is within the range 0.3 to 0.5': Final Determination, page 4-18. The bottom of the AER's gamma range (0.3) suggests that theta could be as low as 0.4 (ie, 0.3 divided by 0.8, which is the top of the AER's range for the distribution rate). The top of the AER's gamma range (0.5) suggests that theta could be as high as 0.7 (ie, 0.5 divided by 0.7, which is the bottom of the AER's range for the distribution rate).

267 Final Determination, page 4-43.

268 Final Determination, pages 4-8, 4-11 and 4-42 to 4-45.

269 Final Determination, page 4-16.

270 Final Determination, page 4-18 (Tables 4-1 and 4-2).

the credit redemption rate from tax statistics, and less weight again (effectively no weight) placed on market value studies;[271]

277.6 the equity ownership approach indicates a utilisation rate between 0.56 and 0.68 for all equity, and between 0.38 and 0.55 for listed equity;[272]

277.7 the credit redemption rate from tax statistics is 0.43;[273] and

277.8 market value studies indicate a range for theta of 0 to 1.[274]

AER's errors

278. In relation to the Gamma Decision, the AER erred including in the following respects:

278.1 the AER made a factual error in concluding that the value of imputation credits was 0.4;

278.2 the AER misconstrued and misapplied clause 6.5.3 of the NER by concluding that the 'value of imputation credits' means the utilisation of imputation credits, which in turn means the proportion of credits that is likely to be redeemed (calculated by multiplying the distribution rate by the 'utilisation rate'), whereby every person entitled to redeem an imputation credit is assumed to value it at the full face amount;[275]

278.3 the AER erred in determining that theta should reflect the before-personal-tax and before-personal-costs value of imputation credits to investors[276] (which is, by definition, the same as the proportion of credits that is likely to be redeemed) whereas the correct approach is to estimate theta as the value to investors of distributed imputation credits, inclusive of the effects of any personal costs such as administrative costs, diversification costs, and time delays (i.e. it is an error to assume away all of the factors that could result in investors valuing imputation credits below the face amount);

278.4 the AER’s interpretation of the 'value of imputation credits' is not in accordance with its proper meaning. Clause 6.5.3 refers to 'value' and this means the amount that the investor values the imputation credit, in circumstances where there are a number of reasons why investors do not value imputation credits at the face amount, including the costs and inconvenience of redeeming credits, the time value of money, and portfolio effects. ActewAGL’s interpretation of 'value' is

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271 Final Determination, pages 4-16, 4-18 and 4-23.

272 Final Determination, page 4-18 (Tables 4-1 and 4-2).

273 Final Determination, page 4-18 (Table 4-1).

274 Final Determination, page 4-18 (Table 4-2).

275 Final Determination, page 4-15.

276 Final Determination, page 4-11.

consistent with the overall regulatory scheme and the building block framework. Under this framework, the allowed return on equity is reduced by the estimated value of imputation credits. Investors will only discount the return they require to the extent of the value they perceive they have received from imputation credits. All other relevant parameters in the building block framework are estimated using market values where possible (e.g. the equity beta is measured by reference to traded stock prices and the cost of debt is calculated by reference to traded bond prices);

278.5 this error in construction and approach by the AER caused the AER to give weight to measures that could only ever be a theoretical upper bound for theta (such as the percentage of domestic investors, and imputation credit redemption rates from tax statistics), and to give no weight, or alternatively almost no weight, to a proper measurement of market value (i.e. the SFG Study);

278.6 in calculating theta, the AER erred in considering that the 'equity ownership approach' (that is, the proportion of Australian equity held by Australian-resident investors) provides direct evidence as to theta,[277] and erred in giving any weight, or alternatively in giving greatest weight, to such measurements, including because:[278]

278.6.1 such measurements do not measure the 'value' of distributed credits;

278.6.2 such measurements could only ever be a theoretical upper bound for theta. Equity ownership rates will only indicate the maximum set of investors who may be eligible to redeem imputation credits and who may therefore place some value on imputation credits; and

278.6.3 such measurements do not take account of matters that prevent a domestic investor from utilising imputation credits (such as the 45 day rule) or matters that prevent a domestic investor from giving full value to imputation credits (such as transaction costs), and therefore must overstate theta;

278.7 the AER's estimates for Australian domestic equity ownership figures are factually wrong and above those supported by the available data. Analysis by the AER, presented in the Final Determination, shows that the domestic equity ownership rate is approximately 0.45 for listed equity and approximately 0.6 for all equity;[279]

278.8 the AER erred in concluding that equity ownership figures could be used, notwithstanding they did not take into account the impact of the 45 day rule or

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277 Final Determination, pages 4-16 to 4-19.

278 Final Determination, pages 4-23 to 4-29 and 4-54 to 4-56.

279 Final Determination, page 4-74 (Figure 4-3).

other matters preventing utilisation of imputation credits, on the footing that there was insufficient evidence that the 45 day rule had any significant effect;[280]

278.9 the AER likewise erred in disregarding the difference between the figures produced under the equity ownership approach (which do not accommodate the 45 day rule or other reasons why taxpayers would not utilise the imputation credits, including trouble and expense) and the imputation credit redemption rates produced by tax statistics, which are lower;

278.10 the AER erred in giving weight to imputation credit redemption rates from tax statistics in preference to market value results from the SFG Study;

278.11 the AER erred in failing to recognise that the imputation credit redemption rates to which it had regard could only ever be a theoretical upper bound to theta – that is, the imputation credit redemption rates evidenced by tax statistics will be greater than the value to investors of those same imputation credits;

278.12 the AER erred in considering that market value studies provided only limited information as to the value of theta, including because the results of these studies can reflect factors which are not relevant to theta,[281] whereas in fact market value studies provide direct evidence as to the value of distributed imputation credits;

278.13 the AER erred in giving the SFG Study little or no weight;

278.14 the AER erred in concluding that the output of a market value study (e.g. the 0.35 estimate from the SFG Study) had to be adjusted so as to capture the utilisation rate of imputation credits,[282] rather than the value to investors of those credits. The adjustment mechanism adopted was to divide the value of imputation credits by the value of dividends from the same study, which the AER concluded would mean that the 0.35 estimate of theta from the SFG Study should in fact be interpreted as an estimate of around 0.4 (after adjustment).[283] The AER erred in making this adjustment, including because it is inconsistent with the meaning of 'the value of imputation credits' in clause 6.5.3 of the NER, in circumstances where the SFG Study properly measured the value of distributed credits;

278.15 the AER erred in failing to recognise that the estimate of the market value of imputation credits produced by the SFG Study (0.35) was reasonable having regard to the estimate of the imputation credit redemption rate from tax statistics used by the AER (0.43),[284] in that SFG's estimate lay below the upper bound for theta indicated by the redemption rate;

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280 Final Determination, pages 4-54 to 4-56.

281 Final Determination, pages 4-26 to 4-29.

282 Final Determination, page 4-28 (see, especially, footnote 98).

283 Final Determination, page 4-18 (Table 4-2).

284 Final Determination, page 4-18 (Tables 4-1 and 4-2).

278.16 the AER erred in having some regard to a distribution rate for listed equity, in circumstances where the distribution rate for a limited sample of listed entities is unlikely to be representative of the distribution rate for the benchmark efficient entity.[285] Further, the AER erred in concluding that the distribution rate for the benchmark efficient entity may be as high as 0.8,[286] whereas in fact the best estimate of the distribution rate is no higher than 0.7;[287]

278.17 the AER erred in concluding that domestic equity ownership rates indicate a range for theta of 0.56 – 0.68 for all equity, and 0.38 – 0.55 for listed equity, whereas in fact the prevailing domestic ownership rate is currently 0.6 for all equity and 0.45 for listed equity;[288]

278.18 the AER erred in concluding that market value studies can be subject to a number of limitations, and produce a wide range of results, as reasons for giving little or no weight to the SFG Study,[289] without giving proper consideration to:

278.18.1 the superiority of the SFG Study over previous studies;

278.18.2 the fact that the SFG Study was merely an updated version of the study commissioned by the Tribunal in the *Energex* proceedings; and

278.18.3 the careful steps taken in the *Energex* proceedings to commission a study to overcome limitations and difficulties affecting previous dividend drop-off studies, and the participation by the AER in the formulation of the methodology for the study;

278.19 it was unreasonable and erroneous for the AER to seek to discredit the SFG Study by reference to general observations and issues applicable to prior dividend drop-off studies, for example by stating that: 'In light of the differing views on these studies and the range of estimates they produce, we consider that implied market value studies provide limited guidance';[290]

278.20 the AER erred in concluding that market value studies indicate a range for theta of between 0 and 1,[291] in that the AER:

278.20.1 gave undue weight to results of earlier dividend drop-off studies, many of which are known to have methodological problems, or are

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285 Final Determination, pages 4-62 to 4-64. See, also, Final Determination, section A.10.1 of Attachment 4.

286 Final Determination, page 4-18 (Table 4-2).

287 Revised Regulatory Proposal, pages 485 and 488.

288 Final Determination, page 4-74 (including Figure 4.3).

289 Final Determination, pages 4-26 to 4-29.

290 Final Determination, page 4-28.

291 Final Determination, page 4-18 (Table 4-2).

based on out-dated data (shortcomings which the SFG Study was designed to overcome); and

278.20.2 failed to consider the relative merits of the SFG Study, which produced an estimate for theta of 0.35;[292]

278.21 the AER erred in concluding that a reasonable range for theta is approximately 0.4 – 0.7,[293] in circumstances where:

278.21.1 imputation credit redemption rates, as reflected in tax statistics, indicate that the maximum or 'upper bound' value for theta is 0.43;[294] and

278.21.2 market value studies indicate that the best estimate of theta is 0.35;[295]

278.22 the AER erred in concluding that a reasonable estimate of gamma is 0.4,[296] in circumstances where:

278.22.1 the maximum or 'upper bound' value for gamma is 0.3 (combining a distribution rate of 0.7 with the upper bound for theta of 0.43);[297] and

278.22.2 the best estimate of gamma is 0.25 (combining a distribution rate of 0.7 with the best estimate of theta of 0.35);[298]

278.23 in adopting a range of 0.7 – 0.8 for the distribution rate,[299] the AER:

278.23.1 gave undue weight to evidence of the distribution rate for a small, and likely unrepresentative, set of listed companies; and

278.23.2 did not have proper regard, or alternatively gave insufficient weight, to evidence of the distribution rate across all companies;

278.24 in adopting a range for theta of approximately 0.4 – 0.7, the AER:

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292 Final Determination, page 4-18 (Table 4-2).

293 See paragraph 276.2 of this Application and footnote 266 to that paragraph.

294 Final Determination, page 4-18 (Table 4-1).

295 Final Determination, page 4-18 (Table 4-2).

296 Final Determination, page 4-18.

297 Final Determination, page 4-18 (Tables 4-1 and 4-2).

298 The reasons for proposing a different value for theta to that in the Rate of Return Guideline are set out in Revised Regulatory Proposal, pages 293 to 294. Combining that value, as the best estimate of theta, with a distribution rate of 0.7 derives a best estimate of gamma of 0.25.

299 See paragraph 276.1 of this Application and footnote 265 to that paragraph.

278.24.1 did not have proper regard, or alternatively gave insufficient weight, to evidence of the market value of imputation credits, as reflected in the SFG Study; and

278.24.2 gave undue weight to evidence of the domestic equity ownership rate and imputation credit redemption rates, as reflected in tax statistics.

279. Further or alternatively, the gamma decision was unreasonable, having regard to all the circumstances, because of the matters referred to in paragraph 278 above and because:

279.1 it was unreasonable to give no or practically no weight to the evidence of the market value of imputation credits, as reflected in the SFG Study;

279.2 it was unreasonable to disregard or down-weight the results of the SFG Study on the basis that earlier dividend drop-off studies were afflicted by methodological problems (shortcomings which the SFG Study was designed to overcome); and

279.3 it was unreasonable for the AER to determine a point estimate for theta of approximately 0.5, where that was above the upper bound value indicated by imputation credit redemption rates, as reflected in tax statistics (of 0.43).[300]

280. For the reasons set out in this application, in making the Final Determination in relation to the Gamma Decision:

280.1 the AER made an error of fact in its findings of fact, and that error of fact was material to the making of the decision;

280.2 the AER made more than one error of fact in its findings of fact, and those errors of fact, in combination, were material to the making of the decision;

280.3 the exercise of the AER discretion was incorrect, having regard to all the circumstances; and/or

280.4 the AER's decision was unreasonable, having regard to all the circumstances.

E MATERIALLY PREFERABLE NEO DECISION

281. Under section 71C(1a) of the NEL, an application under section 71B must 'specify the manner in which a determination made by the Tribunal varying the reviewable regulatory decision, or setting aside the reviewable regulatory decision and a fresh decision being made by the AER following remission of the matter to the AER by the Tribunal, on the basis of 1 or more

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300 The AER does not state what its point estimate of theta is. However, given that the AER refers to a range for the distribution rate of 0.7 - 0.8 and adopts a point estimate for gamma of 0.4, it may be inferred that its point estimate of theta is at least 0.5 (0.4 divided by 0.8).

grounds raised in the application, either separately or collectively, would, or would be likely to, result in a materially preferable NEO decision'.

282. Further, under section 71E(b) of the NEL, the Tribunal must not grant leave to apply under section 71B(1) unless it appears to the Tribunal that the applicant has established a *prima facie* case that a determination made by the Tribunal varying the reviewable regulatory decision, or setting aside the reviewable regulatory decision and a fresh decision being made by the AER following remission of the matter to the AER by the Tribunal, on the basis of 1 or more grounds raised in the Application, either separately or collectively, would, or would be likely to, result in a materially preferable NEO decision.

283. A determination made by the Tribunal to make one or more of the orders sought in section F of this Application would result in a decision that is materially preferable to the Final Determination in making a contribution to the achievement of the NEO for the reasons set out below.

The NEO

284. As set out in section B above, the NEO is to:[301]

> promote the efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers of electricity with respect to–
>
> (a) price, quality, safety, reliability and security of supply of electricity; and
>
> (b) the reliability, safety and security of the national electricity system.

285. It is accepted by the Tribunal that the long term interests of consumers set out in the NEO requires prices to reflect the long run cost of supply and to support efficient investment by providing investors with a return which covers the opportunity cost of capital required to deliver the relevant services.[302] Similarly, in the Standing Council on Energy and Resources' (**SCER's**) *Regulation Impact Statement Limited Merits Review of Decision-Making in the Electricity and Gas Regulatory Frameworks Decision Paper* dated 6 June 2013 (**Merits Review RIS**), which sets out its policy position on the reform of the limited merits review regime, the SCER observed that:[303]

> The long term interests of consumers are delivered through the timely investment in energy assets to meet quality, safety or reliability requirements, and to deliver secure supplies of energy. … In its economic regulation of network service providers rule change determination, the AEMC noted that efficient investment requires:

301 Section 7 of the NEL.

302 See, for example: *Re Application by ElectraNet Pty Limited (No 3)* [2008] ACompT 3 at [15]; *Application by Energy Australia and Others* [2009] ACompT 8 at [18].

303 SCER, Merits Review RIS, page 28.

- there being a level of investment in network infrastructure so that safety and reliability standards are met in circumstances where consumers pay no more than is necessary for the network services they receive;
- the costs network businesses incur in providing network services to their customers reflecting efficient financing costs. This is to allow those businesses an opportunity to attract sufficient funds for investment while minimising the resultant costs that are borne by consumers;
- the establishment of a certain, robust and transparent regulatory environment. Investors will have more confidence and may be more likely to invest in monopoly infrastructure where the regulatory process is certain and robust, with appropriate checks and balances in place. Consumers will also have more confidence that the outcomes are better in such an environment; and
- regulatory certainty in the application of the improved and strengthened rules.[36]

36 AEMC, 2012. *Rule determinations: National Electricity Amendment (Economic Regulation of Network Service Providers) Rule 2012* and *National Gas Amendment (Price and Revenue Regulation of Gas Services) Rule 2012* p 8.

286. Similarly, the SCER has affirmed that the objective of the limited merits review framework, in common with the NEO, 'is to ensure that relevant decisions promote efficient investment in, operation, and use of energy infrastructure, and are consistent with the revenue and pricing principles of the NEL …, in ways that best serve the long term interests of consumers'.[304]

'Materially preferable NEO decision'

287. Section 71E(b) must be read and construed in the context of the related provisions of the NEL introduced at the same time.[305] These are:

287.1 section 16(1)(c) and (d) of the NEL, which supplements the existing obligation of the AER under section 16(1)(a) of the NEL to perform or exercise its functions or powers in a manner that will or is likely to contribute to the NEO, requires that, in making a reviewable regulatory decision, the AER must:

287.1.1 specify the manner in which the constituent components of the decision relate to each other and how that interrelationship has been taken into account in the making of the decision; and

287.1.2 where there are 2 or more possible reviewable regulatory decisions that will or are likely to contribute to the achievement of the NEO, make the preferable NEO decision and specify reasons as to why the AER is satisfied that decision is the preferable NEO decision; and

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304 SCER, Merits Review RIS, pages1 and 10.

305 Statutes Amendment (National Electricity and Gas Laws - Limited Merits Review) Bill 2013 (SA).

287.2 section 71P(2a), (2b) and (2c) of the NEL provides (among other things) that the Tribunal:

287.2.1 may only vary or set aside and remit a reviewable regulatory decision if satisfied that to do so will or is likely to result in a materially preferable NEO decision;

287.2.2 must consider the reviewable regulatory decision as a whole in assessing the extent of contribution to the achievement of the NEO;

287.2.3 must have regard to how the constituent components of the decision interrelate with each other and with the matters raised as a ground for review; and

287.2.4 must specify in any determination varying or setting aside and remitting the reviewable regulatory decision the manner in which it has taken into account the interrelationship.

288. The establishment of a ground for review under section 71C(1) and the consequences for, and impacts on, the average annual regulated revenue of a regulated network service provider must not, in themselves, determine the question about whether a materially preferable NEO decision exists.[306]

289. This alignment in the obligations of the AER and the Tribunal in respect of the making of the preferable NEO decision reflects a deliberate policy intention that a reviewable regulatory decision by the AER should make explicit how the NEO was taken into account in making that decision and provide the Tribunal with a starting point for its consideration. Specifically, the SCER made the following statement of intent in respect of the relevant NEL amendments:[307]

> …the regulator will be required to provide an explanation of its decision-making process in its final determination and how its overall decision will contribute to delivering the long term interests of consumers as set out in the NEO and NGO. It is intended that this would provide both an explanation of the regulator's decision-making considerations and the logic that underpins its assumptions and approach, including the objectives and key interlinkages between components of the regulatory decision.
>
> It is intended that the record and the final determination will provide a clear starting point for the Tribunal in considering the merits of the matter before it and will ensure that it is explicit how the long term interests of consumers with regard to price, quality, reliability, safety and security of supply were taken into account in the original regulatory process.

290. In construing the statutory scheme for leave to apply for review in previous proceedings, the Tribunal has expressly rejected a contention by counsel for the AER that 'it would be

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306 Section 71P(2b)(d). Section 71P(2b)(d)(iii) also provides that the fact 'that the amount that is specified in or derived from the reviewable regulatory decision exceeds the amount specified in section 71F(2)' is a matter that must not, of itself, determine the question about whether a materially preferable NEO decision exists.

307 SCER, Merits Review RIS, p40.

erroneous to consider extrinsic material before exhausting the ordinary rules of statutory construction'.[308] The Tribunal concluded that this would be incorrect at common law and that, in any event, whatever the common law position may be, the Tribunal is required to apply a purposive approach to the construction of the NEL by section 3 of the NEL and clause 7 of Schedule 2 to the NEL.[309] Section 3 of the NEL provides that Schedule 2 to the NEL applies to the NEL's interpretation. Clause 7 of Schedule 2 to the NEL provides that, in interpreting a provision of the NEL, the interpretation that will best achieve the purpose or object of the NEL is to be preferred to any other interpretation, regardless of whether or not the purpose is expressly stated in the NEL.

291. The Tribunal further observed that clause 8(2) of Schedule 2 to the NEL permits regard to be had to extrinsic material for the purposes of construction, even if only to confirm the interpretation conveyed by the ordinary meaning of a provision.[310] Clause 8(2) of Schedule 2 to the NEL provides that, in the interpretation of a provision of the NEL, consideration may be given to NEL extrinsic material capable of assisting in the interpretation if the provision is ambiguous or obscure or the ordinary meaning of the provision leads to a result that is manifestly absurd or is unreasonable, or to confirm the interpretation conveyed by the ordinary meaning of the provision.

292. In so doing, the Tribunal noted the non-exhaustive nature of the list of 'Law extrinsic material' set out in the definition of that term in clause 8(1) of Schedule 2 to the NEL and concluded that '[t]he extrinsic material to which regard may be had is any material that may assist in the construction process'.[311] Clause 8(1) of Schedule 2 to the NEL defines "Law extrinsic material" to mean "relevant material not forming part of this Law" and sets out a non-exhaustive list of examples.

293. It follows that the SCER's Merits Review RIS, which sets out the SCER's policy position that was given effect to in the reform of the limited merits review regime under the NEL with effect from late 2013, is 'Law extrinsic material' to which the Tribunal may permissibly have regard in ascertaining the purpose of sections 16(1)(c) and (d), 71E(b) and 71P(2a), (2b) and (2c) of the NEL and, thus, construing the term 'materially preferable NEO decision'.

294. In the Merits Review RIS, the SCER concluded in respect of the object of the limited merits review regime under the NEL that:[312]

> … for the purposes of limited merits review applying to covered electricity and gas decisions in Australia, SCER considers the objective is to ensure that a decision is correct, in the sense of being made in accordance with the relevant law, or preferable, in the sense that, if there is a range of decisions that are correct in law, the decision that is ultimately achieved is the best that could have been made on the basis of the relevant facts.

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308 *Application by Energex Limited (No 4)* [2011] ACompT 4 at [21].

309 *Application by Energex Limited (No 4)* [2011] ACompT 4 at [21]-[22].

310 *Application by Energex Limited (No 4)* [2011] ACompT 4 at [23].

311 *Application by Energex Limited (No 4)* [2011] ACompT 4 at [23].

312 SCER, Merits Review RIS, page 6.

295. SCER concluded that the then merits review regime under the NEL had failed to deliver this policy objective in that error correction was occurring without apparent reference to how addressing the error contributed to the NEO against the background of the complex issues arising in reviewable regulatory decisions and the interrelationships between constituent components of those decisions. Specifically, the SCER stated:[313]

> … SCER considers that the majority of the reviews taken to the Tribunal to date relate to differences of opinion on components of a final decision. Consequently, the Tribunal's focus on 'error correction' in isolation was not appropriate for the highly complex interlinkages and contentious nature of the issues for which reviews were sought by monopoly electricity and gas network businesses.
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> The complexity of the issues being investigated has also led to situations where error correction has occurred without apparent reference to how addressing the error contributes to the NEO or NGO. For example, when considering the parameters that contribute to the rate of return that network businesses are allowed, decisions made by the Tribunal have increased the rate of return to about 10 per cent (noting there are some differences between different businesses). This amount was higher than both the original decision and the allowed rate of return previous jurisdictional regulators had set in their regulatory decisions. SCER considers such large changes, without reference to the energy objectives, undermines confidence in the review framework.
>
> While the rate of return for monopoly businesses rightly varies between business [sic] and countries, making comparisons inappropriate, even if these decisions did support the NEO or the NGO there has been inadequate public reporting of these aspects of the decision-making process. SCER notes the notices published by the Tribunal outlining its process and reasoning behind its decisions have not included reference to how the decisions are in the long term interests of consumers with respect to price, quality, safety, reliability, and security of supply of electricity or gas, respectively.
>
> It is this lack of information about how the review process has considered the 'facts, law and policy aspects of the original decision' that restricts the limited merits review regime in the full delivery of the original and recently clarified policy intent and is likely to continue to do so in the future if it is not addressed.
>
> In addition, SCER recognises the intention in establishing the review regime was for the review process to be used rarely and only to address issues with a material consequence in the context of delivering the NEO or NGO, and meeting the review and pricing principles. However, the error correction approach adopted by the Tribunal may be leading to more appeals than would otherwise be the case.

296. It follows that the purpose of the new limitation on the Tribunal's power to vary or set aside a reviewable regulatory decision established by section 71P(2a) of the NEL is twofold, being to:

296.1 require the Tribunal to give explicit consideration to the NEO in determining whether to vary or set aside and remit a reviewable regulatory decision, having

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313 SCER, Merits Review RIS, page 6.

regard in particular to the overall decision and the interrelationships between its constituent components; and

296.2 confine the varying or setting aside and remission of a reviewable regulatory decision to circumstances in which doing so will make a material contribution to the achievement of the NEO.

297. However, consistent with the object of the limited merits review regime discussed in paragraph 294 above, the SCER also emphasised that the intent of section 71P(2a) of the NEL is not to preclude the Tribunal from varying or setting aside and remitting a reviewable regulatory decision where this is necessary to deliver a correct decision; that is, a decision made according to law. Thus, the SCER observed:[314]

> For the purposes of limited merits review applying to the energy sector under the NEL and NGL, the SCER is committed to ensuring that the approach adopted is consistent with wider administrative law, where the objective is to ensure that administrative decisions are 'correct or preferable'. That is, such decisions are:
>
> - correct, in the sense that they are made according to law; *or*
> - preferable, in the sense that, if there are a range of decisions that are correct in law, the decision settled upon is the best that could have been made on the basis of the relevant facts.
>
> It is not the intention of the SCER for limited merits review to result in decisions that are not consistent with law. However, SCER recognises that a focus on error correction may lead to less optimal outcomes, particularly in complex determination processes where there may be disputes about many interlinked matters. In this context, 'error correction' means decisions that have been made without due regard to the facts, law *and* policy aspects of the original decision or decisions that should otherwise be 'preferable' decisions, as defined above. As set out in the consultation RIS, most decisions appealed under the limited merits review framework have been on subjective matters, where there are a range of decisions that are correct in law. Consequently, an undue focus on 'error correction', as defined above, reflects a failure of the limited merits review regime to deliver the policy intention. [Emphasis in original]

298. It follows that a decision that is 'correct', in the sense that it is made according to law, is properly construed as being a 'materially preferable NEO decision' when compared to a purported decision that is not in accordance with law.

299. The expression 'according to law' may be construed as being a decision that the decision maker is empowered to make by the NEL and the NER, and which is otherwise consistent with the requirements of the NEL and the NER and of administrative law. However, the SCER recognised that there may be decisions that do not meet that criterion, that the Tribunal might nevertheless consider are attended by error in the manner in which the decisions are made, in that one or more of the grounds of review in section 71C(1) of the NEL exist.

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314 SCER, Merits Review RIS, pages 9 to 10.

300. It is important to bear in mind, in that context, that the grounds for review in section 71C(1) of the NEL are potentially very broad in their application; they may, for instance, extend even beyond traditional administrative law review grounds, be capable of applying to constituent decisions, and/or involve subjective considerations (particularly as to the exercise of discretions) about which minds may reasonably differ. Accordingly, it is possible that the reviewable regulatory decision under consideration has been made in accordance with law in the sense described above, despite the existence of a ground of review. It is for that reason that section 71P(2a)(d) of the NEL provides that the mere fact of the establishment of a ground for review under section 71C(1) of the NEL must not determine whether a materially preferable NEO decision exists.

301. That situation may be contrasted with a decision that is not made in accordance with law, in the sense that it is not consistent with the NEL and the NER or the requirements of administrative law (for example, a decision that results from a misconstruction of a provision of the NEL and the NER, with the consequence that the decision maker was not authorised by those provisions to make the decision made). It could not be said that, where an error exists of that nature, the decision might nevertheless be a 'materially preferable NEO decision' which could not be varied or set aside to ensure that the decision made is in accordance with the requirements of the NEL and the NER and administrative law.

302. This approach is entirely consistent with the SCER's summary of its policy position concerning the intended effect of new sections 16(1)(d) and 71P(2a) of the NEL as follows:[315]

> [T]he regulator, in regulatory determination processes, and the Tribunal, in review processes, must … *where there is discretion around a range of decisions*, make the overall decision that, on balance, it considers is materially preferable in terms of serving the long term interests of consumers as set out in the NEO or NGO… [emphasis added]

303. 'Range of decisions', in this context, means decisions that are in accordance with law. It does not include decisions which are not in accordance with the NEL and the NER and the requirements of administrative law, or a decision that is premised on an erroneous construction of a distribution determination made pursuant to the NEL and the NER. Put another way, a reviewable regulatory decision that is not made in accordance with law could not be regarded as a 'NEO decision', that is, a decision which contributes to the achievement of the NEO.

304. Such a construction of 'materially preferable NEO decision' is also consistent with a presumption that the provisions of the NEL and the NER promote their statutory object, being the NEO. Insofar as concerns the NER, this is, in turn, consistent with the AEMC's express statutory obligation to make a Rule only if it is satisfied that the Rule will or is likely to contribute to the achievement of the NEO[316] and its statutory discretion to make a Rule that differs from a market initiated proposed Rule if the AEMC is satisfied that the more preferable Rule will or is likely to better contribute to the achievement of the NEO.[317]

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315 SCER, Merits Review RIS, statement of 'SCER's policy position' in the preamble to that RIS.

316 Section 88 of the NEL.

317 Section 91A of the NEL.

305. Where there is discretion around a range of decisions, that is, there is more than one regulatory decision that is in accordance with law, section 16(1)(d) of the NEL requires the AER to make the decision that will or is likely to contribute to the achievement of the NEO to the greatest degree. Likewise section 71P(2a) of the NEL requires the Tribunal to vary or set aside and remit the reviewable regulatory decision only if satisfied that to do so will or is likely to result in an overall decision, having regard to any interrelated matters, that makes a contribution to the NEO that is considerably greater, or greater to an important degree, than that made by the reviewable regulatory decision.

Manner in which Tribunal's relief would be likely to result in a materially preferable NEO decision

306. ActewAGL submits that a determination made by the Tribunal to make one or more of the orders sought in section F of the Application, on the basis of either one or more of the grounds raised in the Application, separately or collectively, would result in a materially preferable NEO decision.

Tribunal determination would result in decision in accordance with law and thus 'materially preferable NEO decision'

307. For the reasons discussed above, the term 'materially preferable NEO decision' in section 71E(b) of the NEL is properly construed as including a decision that, in contrast to the reviewable regulatory decision, is in accordance with law. ActewAGL has asserted errors of law in respect of the opex allowance ground (section D(1) of the Application), the return on debt ground (section D(6)) of the Application) and the value of imputation credits (gamma) ground (section D(7) of the Application). ActewAGL submits that insofar as an error of law is established on the basis of either one or more of the grounds raised in the Application, then a determination made by the Tribunal in accordance the orders sought in section F of the Application in respect of those grounds, separately or collectively, would result in a decision that is in accordance with law, where the Final Determination was contrary to law, and, thus, the Tribunal's determination would be a materially preferable NEO decision.

308. In so contending, ActewAGL should not be understood as asserting that the mere establishment of a ground for review set out in section 71C(1) of the NEL suffices to establish that a determination by the Tribunal varying or setting aside and remitting the Final Determination would result in a materially preferable NEO decision. Rather, ActewAGL submits that the circumstances giving rise to those grounds render the Final Determination not in accordance with law and a decision on remission to the AER to address those grounds will be one that is, by contrast, made in accordance with law and thus a materially preferable NEO decision.

309. As a result of the circumstances giving rise to the grounds set out in section D(1) of the Application concerning the AER's decisions under clause 6.12.1(4) of the NER to reject ActewAGL’s forecast opex and to substitute that forecast with its own estimate of ActewAGL’s opex, the AER's decision was not in accordance with law, in that:

309.1 the AER’s methodology is inconsistent with process mandated by clause 6.5.6 of the NER for making decisions under clause 6.12.1, in that the AER’s methodology:

309.1.1 inverts the approach mandated by the NER in that the AER has used its own forecast, derived from a benchmarking model (not referred to in the report referred to in clause 6.5.6(e)(4)) and the AER's ad-hoc post-modelling adjustments, as the starting point for determining ActewAGL's opex allowance;

309.1.2 involves the assumption that unless there is a satisfactory explanation for the difference between ActewAGL's forecast opex and the AER's own forecast, derived from that benchmarking model and the AER's ad-hoc post-modelling adjustments, then the AER's forecast should apply, thereby creating an onus on ActewAGL to explain those differences;

309.1.3 involves the assumption that the AER's own forecast, derived from that benchmarking model and the AER's ad-hoc post-modelling adjustments, reasonably reflects the opex criteria in clause 6.5.6(c) of the NER without giving separate and independent regard to each of those criteria;

309.1.4 has resulted in the AER failing to consider or determine whether the DNSP's total forecast opex reasonably reflects each of the opex criteria, including the costs of maintaining the quality, reliability, security and safety of the distribution system or of the supply of standard control services as required by clause 6.5.6(a)(2) and (3);

309.1.5 elevates benchmarking (being only one of the opex factors to which the AER must have regard under clause 6.5.6(e) in determining whether the opex criteria is met) to a level of importance that elides a proper consideration of any other opex factor prescribed by clause 6.5.6(e) of the NER; and

309.1.6 has resulted in the AER failing to have sufficient regard to, and/or failing to exercise its discretion as to the appropriate weight to be given to, the opex factors prescribed by clause 6.5.6(e) of the NER;

309.2 the AER erred in law in concluding that it was prohibited by the NER from considering circumstances that were endogenous to ActewAGL, and might impact on its capacity to ensure safety, reliability and security of supply of electricity;

309.3 the AER erred in law in concluding that the opex criteria should be understood as solely applying an objective test, namely, whether a DNSP's opex forecast would reasonably reflect the costs of an objectively prudent provider, and that it was impermissible when considering the opex criteria to give any consideration to the particular endogenous circumstances of the service provider concerned;

309.4 the AER failed to have regard to relevant considerations, being:

309.4.1 direct, probative evidence of the safety and reliability of the opex allowances determined by application of the AER's benchmarking analysis and ad-hoc ex-post modelling adjustments;

309.4.2 the impact of its decision on the ability of ActewAGL to fund its business in the subsequent regulatory control period and future regulatory control periods;

309.4.3 the risks that its proposed opex reductions posed to the safety, reliability and security of supply of electricity; and

309.4.4 whether it would be in the NEO to allow ActewAGL opex in excess of that which would be incurred by an objectively prudent provider and/or its costs of restructuring its business to operate at the levels of opex that reasonably reflect the costs of an objectively prudent provider;

309.5 failed to accord procedural fairness to ActewAGL and/or contravened section 16(1)(b) of the NEL by concluding that ActewAGL opex allowance would not adversely affect ActewAGL's financial viability, without providing ActewAGL with an opportunity to respond or make submissions about the analysis on which the AER's conclusions were based;[318]

309.6 failed to accord procedural fairness to ActewAGL and/or contravened section 16(1)(b) of the NEL by concluding that there were inefficiencies in ActewAGL's labour and vegetation management practices with providing ActewAGL a sufficient opportunity to respond or make submissions about the analysis on which the AER's conclusions were based; and

309.7 the decision was an exercise of power that is so unreasonable that no reasonable person could so exercise the power.

310. Further or alternatively, the exercise of the AER's discretion, or the AER's decision, not to include additional opex pursuant to a 'glide path' within the control mechanism or otherwise to allow ActewAGL time to restructure its business to operate at levels of opex that reasonably reflect the costs of an objectively prudent and efficient provider was not in accordance with law, in that the AER incorrectly concluded that the implementation of a glide path would be inconsistent with the NEL and the NER.

311. As a result of the circumstances giving rise to the grounds set out in section D(6) of the Application concerning the AER's decision under clauses 6.5.2 and 6.12.1(5) of the NER regarding the estimation of the return on debt used in deriving the allowed rate of return was not in accordance with law, in that the AER's selection of a benchmark entity, and imposition of a transition, involved an error or errors in the construction and application of clause 6.5.2, particularly paragraphs (c), (j) and (k). More specifically:

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318 Final Determination, page 7-42.

311.1 the AER identified the relevant benchmark efficient entity as a benchmark *regulated* efficient entity, whereas clause 6.5.2(c) requires that the benchmark entity be a benchmark unregulated efficient entity, i.e. an entity competing in a workably competitive unregulated market;

311.2 the AER's adoption of the methodology in its Final Determination (option 2) on the basis that the return on debt should be commensurate with efficient financing costs over the life of the assets of the benchmark efficient entity, and (or alternatively) over a large (but indeterminate) number of regulatory control periods, is inconsistent with clause 6.5.2(c) of the NER, which requires the return on debt in each regulatory control period to be commensurate with the efficient financing costs of the benchmark efficient entity in that period and does not permit any adjustment of that determination to take account of asserted over or under estimations in past regulatory control periods, or an expectation that during some indeterminate future regulatory control period not itself the subject of the determination, there will be some asserted over or under estimation;

311.3 the AER's Transition is inconsistent with clause 6.5.2(c) and (j) in that it is not a measure of the return required by debt investors in the benchmark efficient entity if it raised debt at the time or shortly before the making of the AER decision or if it raised debt over an historical period prior to the commencement of a regulatory year in that it is not possible, or practicable, for a benchmark efficient entity to implement a debt management strategy which reflects or mirrors that methodology;

311.4 as a consequence of its (incorrect) conclusion that there could be only one benchmark entity, and that it must be a regulated entity, the AER:

311.4.1 took into account:

(a) conduct taken by such an entity in response to the regulatory revenue setting decision of the AER in prior regulatory control periods so as to seek to manage, not the cost of debt, but the risk of a mismatch between the allowed return on debt in those prior regulatory control periods and the entity's actual cost of debt in those earlier regulatory control periods; and

(b) conduct taken by such an entity (so as to seek to manage, not the cost of debt, but the risk of a mismatch between the allowed return on debt and the entity's actual cost of debt) in the expectation that the 'on-the-day' approach would be applied to the estimation of the return on debt in the transitional and subsequent regulatory control periods,

in circumstances where those matters were irrelevant considerations to:

(c) the determination of the allowed rate of return in order to achieve the allowed rate of return objective;

(d) the estimation of the return on debt for a regulatory year in the regulatory control period the subject of the AER decision;

(e) the estimation of the return on debt for a regulatory year in order to contribute to the achievement the allowed rate of return objective; or

(f) the return required by debt investors in the benchmark efficient entity if it raised debt at the time or shortly before the making of the AER decision or if it raised debt over an historical period prior to the commencement of a regulatory year; and

311.4.2 by having regard to conduct of the kind referred in subparagraphs (a) and (b) of paragraph 311.4.1 above, failed to take into account relevant considerations, being:

(a) 'the efficient financing costs of a benchmark efficient entity' being those costs which do not have regard to conduct of the kind referred in subparagraphs (a) and (b) of paragraph 311.4.1 above or conduct involving entering into interest swaps to seek to manage the risk of a mismatch between the allowed return on debt and the entity's actual cost of debt; and

(b) the return required by debt investors in the benchmark efficient entity if it raised debt at the time or shortly before the making of the AER decision or if it raised debt over an historical period prior to the commencement of a regulatory year; and

311.5 as a consequence of its (incorrect) conclusion that clause 6.5.2 permitted it to estimate the return on debt for a regulatory year (and thereby to be used to effect the determination of the allowed rate of return), the AER took account of, and reduced the estimated return on debt on account of:

311.5.1 the (assumed or assessed) difference between ActewAGL's cost of debt (or assumed cost of debt) and the allowed return on debt in the previous regulatory control period; and

311.5.2 alternatively, the (assumed) difference between a benchmark efficient entity's cost of debt and the allowed return on debt in the previous regulatory control period,

in circumstances where these matters were not relevant to:

311.5.3 the determination of the allowed rate of return in order to achieve the allowed rate of return objective;

311.5.4 the estimation of the return on debt for a regulatory year in the regulatory control period the subject of the AER decision;

311.5.5 the estimation of the return on debt for a regulatory year in order to contribute to the achievement the allowed rate of return objective; and

311.5.6 the return required by debt investors in the benchmark efficient entity if it raised debt at the time or shortly before the making of the AER decision or if it raised debt over an historical period prior to the commencement of a regulatory year.

312. As a result of the circumstances giving rise to the grounds set out in section D(7) of the Application concerning the AER's Gamma Decision under clauses 6.5.3 and 6.12.1(5B) of the NER to reject ActewAGL's proposed value for gamma of 0.25 and instead adopt a value for gamma of 0.4, the AER's decision that theta should reflect the before-personal-tax and before-personal-costs value of imputation credits to investors was not in accordance with law, in that the AER incorrectly concluded that the definition of gamma, by reference to the 'value of imputation credits', means the utilisation of imputation credits, which in turn means the proportion of credits that is likely to be redeemed (calculated by multiplying the distribution rate by the 'utilisation rate'), rather than the value of imputation credits to investors.

313. It follows that a determination by the Tribunal making the orders sought in section F of this Application to correct the unreasonableness and errors alleged by ActewAGL in paragraphs 309 to 312 above would result in a decision that, in contrast to the Final Determination, is in accordance with law. Further, in contrast to the AER's decision, it would not be *Wednesbury* unreasonable, would correctly construe the relevant NER provision, would comply with the requirements of that NER provision, would be authorised by the NER, would have an evidentiary basis and would not involve any failure to accord procedural fairness.

Tribunal determination would otherwise be likely to result in 'materially preferable NEO decision'

314. Further, and in any event, even if (contrary to ActewAGL's submission) a reviewable regulatory decision that is not in accordance with law is nonetheless capable of constituting a decision that contributes to the achievement of the NEO, a determination by the Tribunal making the orders sought in section F of this Application would or would be likely to result in a decision that is materially preferable in making a contribution to the achievement of the NEO for the following reasons.

315. A distribution determination that properly applies the building block approach in the NER, with each of the building blocks determined in accordance with the NER, will promote the NEO, by providing sustainably low revenues that are sufficient to ensure the safety, quality,

reliability and security of supply of electricity is in the long term interests of consumers of electricity.[319]

316. Likewise, any decision that, as a consequence of errors in the determination of any one of the building blocks pursuant to the NER, pursues short-term price reductions at the expense of the quality, safety, reliability and security of the supply of electricity, including by failing to provide incentives for efficient investment and leading to higher prices (and upwards price shocks) for consumers in future regulatory control periods, as a consequence of higher required expenditure (including capex) to rectify the impact of lower-than-prudent maintenance of the network and premature deterioration and/or failure of network components, is inconsistent with the NEO. In particular, such a decision delivers short-term gains in productive efficiency at the expense of the dynamic efficiency that the NEO directs should be accorded the balance of emphasis.[320]

317. In the Final Determination, there are very serious errors affecting a number of building blocks, each of which individually are significant in terms of the overall regulated revenues ActewAGL is permitted to earn, and which in combination are very significant. For example:

317.1 the impact on ActewAGL's regulated revenues for the subsequent regulatory control period of the AER's decision on forecast opex is $82.61 million ($ nominal), which is a 24 per cent reduction on ActewAGL's forecast opex proposed in its Revised Regulatory Proposal for the subsequent regulatory control period;[321]

317.2 the impact on ActewAGL's regulated revenues for the subsequent regulatory control period of the AER's decision to apply its national STPIS to ActewAGL for the subsequent regulatory control period without modification to the performance targets for the reliability of supply applicable to ActewAGL is between $1.96 million ($ nominal) and up to $11.04 million ($ nominal);

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319 Houston Kemp, *AER Determination for ActewAGL Distribution - Contribution to NEO and Preferable NEO Decision, A report for ActewAGL Distribution*, 13 February 2015, section 3, pages 6-16. In that report, Houston Kemp concludes (at page 16), in particular, that:

> 'Taken together, the building block approach and the revenue and pricing principles amount to the essential elements of a framework of economic regulation that is capable of achieving the NEO. By contrast, the expenditure factors listed in the rules (including the reference to benchmark expenditure) amount to a series of tools and considerations that may be adopted to assist the regulator, but do not amount to objectives in themselves.
>
> In economic terms, the building block requirements and pricing principles represent fundamental requirements for the achievement of the NEO. Failure to give effect to each and every building block, and to comply with each of the main revenue and pricing principles, will inevitably compromise the achievement of the NEO requirement.'

320 As above, section 3.1, pages 6-8. Houston Kemp observes, in particular, (at page 6) that 'the fundamental architecture of the NEO has been developed on an economic foundation' and (at pages 7-8) that:

> 'To summarise, the NEO is structured to so as to encapsulate all three dimensions of efficiency that are familiar to economists, ie, productive, allocative and dynamic efficiency. As a matter of principle, efficiency can be assess in both static (at a particular point in time) and dynamic terms (over a period of time). However, by its reference to the 'long term' interests of consumers, the NEO is structured so as to clarify that the balance of emphasis is to be given to the long term, dynamic dimension of efficiency'.

321 Revised Regulatory Proposal, PTRM - see H9 - PTRM Transmission file: X factor sheet, E13:I13 cells; H8 - PTRM Distribution file: X factor sheet, E13:I13 cells; H10 - PTRM Metering file: X factor sheet, E13:I13 cells

317.3 the impact on ActewAGL's regulated revenues for the subsequent regulatory control period of the AER's errors in its decision on opex for annual metering services is $2.66 million ($ nominal);

317.4 the impact on ActewAGL's regulated revenues for the subsequent regulatory control period of the AER's errors in its decision on the return on equity is $53.01 million ($ nominal);

317.5 the impact on ActewAGL's regulated revenues for the subsequent regulatory control period of the AER's errors in its decision on the return on debt is $40.96 million ($ nominal);

317.6 the impact on ActewAGL's regulated revenues for the subsequent regulatory control period of the AER's errors in its decision on the value of imputation credits is $8.72 million ($ nominal);

317.7 collectively, the impact of these AER errors on regulated revenues for the subsequent regulatory control period is between $189.92 and $199 million ($ nominal); and

317.8 the amount at issue arising from the grounds for review in this application represents approximately 22% per cent, of the regulated revenue sought in ActewAGL's Revised Regulatory Proposal for the subsequent regulatory control period.[322]

318. The impact on ActewAGL's regulated revenues for the subsequent regulatory control period of the AER's errors set out in the preceding paragraph is understated because the NER require the total revenue requirement for that period to be adjusted for the difference between the annual revenue requirement for the transitional regulatory control period determined by the AER in the Transitional Determination and the 'notional' annual revenue requirement for that period determined in the AER's Final Determination in accordance with clause 11.56.4(c) of the NER.[323] The AER has determined this adjustment amount, which it describes as 'to be returned to customers over the [subsequent] regulatory control period', to be $33.2 million ($ nominal) (comprised of $28.0 million and $5.2 million ($ nominal) for distribution standard control services and transmission standard control services respectively).[324] As the quantum of this adjustment is itself a product of the AER's errors (being, as it is, a product of the 'notional' annual revenue requirement determined by the AER in its Final Determination using the same approach as it adopted in determining the regulated revenues for the subsequent regulatory control period); it follows that the adjustment properly determined is less than $33.2 million ($ nominal). Further, and in any event, the return of the adjustment amount to customers, through a reduction to the regulated revenue for the subsequent regulatory control period that would otherwise apply, accentuates the revenue impact on ActewAGL of the

322 Revised Regulatory Proposal,PTRM total revenue for SRP (Years 2-5): H9 - PTRM Transmission file: X factor sheet, E16:I16 cells; H8 - PTRM Distribution file, X factor sheet, E16:I16 cells; H10 - PTRM Metering file: X factor sheet, E16:I16 cells.

323 NER, clause 11.56.4(h) and (i).

324 Final Determination, page 1-16.

errors made in the Final Determination, which in turn further compromises ActewAGL's ability to ensure the safety, quality, reliability and security of supply of electricity, the incentives for efficient investment, and thus the detrimental impact of those errors in relation to the NEO.

319. Further, in relation to the opex allowance ground (section D(1) of the Application):

319.1 forecast opex for a regulatory control period impacts on the total revenue requirement for that period on a dollar for dollar basis (unlike, for example, forecast capex, where the return on and of that forecast capital referable to the regulatory control period is included in the total revenue requirement, being an amount that is significantly less than the capex forecast to be incurred by a DNSP during that period). Accordingly, errors in the setting of ActewAGL's opex allowance will have a direct and significant impact on ActewAGL's revenue during the subsequent regulatory control period;

319.2 on any view, the AER's decision represents a momentous reduction not only from the opex proposed by ActewAGL in its Revised Regulatory Proposal,[325] but also from the levels of opex that ActewAGL has previously been expending to operate its business, and the amounts previously allowed to ActewAGL by the AER;

319.3 evidence has been placed before the AER that a reduction in opex of the magnitude in the Draft Decision (and, implicitly, in the Final Determination) would likely compromise the safety, reliability and on-going sustainability of its electricity network; [326]

319.4 it may be inferred that a reduction in opex of that magnitude in the Final Determination, if set erroneously, might require opex and capex in future regulatory decisions to be higher than they otherwise might have been, as a result of the inability of ActewAGL to adequately undertake maintenance works during the subsequent regulatory control period, which would be inconsistent with the NEO;

319.5 the AER's methodology for determining ActewAGL's opex allowance, and the magnitude of the reduction, is so unexpected and significant that it will likely create disincentives to investment in the national electricity system generally;

319.6 the consequences of an error by the AER in setting ActewAGL's opex allowance is exacerbated by the AER's error in setting ActewAGL's performance targets under the STPIS, which will almost inevitably lead to ActewAGL suffering

325 ActewAGL, in its Revised Regulatory Proposal, forecast standard control services opex of $371.2 million ($ 2013–14) for the 2014–19 period (excluding debt raising costs and DMIA). In its Final Determination, the AER rejected ActewAGL's proposed opex allowance in its Revised Regulatory Proposal, and determined that ActewAGL's opex allowance ought to be $240.6 million ($ 2013/14). Accordingly, the AER's decision represents a reduction of **$130.6 million** from the opex that ActewAGL considers is required to meet the opex objectives in clause 6.5.6(a) of the NER.

326 Devlin, 13 February 2015, at [22] et seq.

financial penalties, and further reductions in the revenue that it would otherwise have available to it to fund opex;[327]

319.7 the errors asserted by ActewAGL in the manner in which the AER has made its decisions are deep-rooted and extensive, and if established, would lead to the conclusion that it is most unlikely that the AER's decision could be consistent with the NEO. Indeed, one of the review grounds asserted by ActewAGL is to the effect that the AER has not had regard to the NEO in considering whether, and to what extent, endogenous considerations particular to ActewAGL ought to be taken into account in making its decisions;

319.8 the evidence adduced by ActewAGL in support of the forecast opex in its Revised Regulatory Proposal is consistent with that level of opex being required to meet the objectives in clause 6.5.6 of the NER;

319.9 in the circumstances, varying the Final Determination to allow ActewAGL the opex forecast in its Revised Regulatory Proposal would ensure that ActewAGL receives an opex allowance that is required to meet the opex objectives in clause 6.5.6 of the NER, and is therefore more likely to result in a decision that is materially preferable to the Final Determination in making a contribution to the achievement of the NEO; and

319.10 alternatively, were the decision to be remitted to the AER to be considered in a way that does not repeat the errors identified by ActewAGL, the decision is more likely to result in a proper consideration of the opex allowance that ActewAGL requires in order to meet the opex objectives in clause 6.5.6 of the NER, and is therefore more likely to result in a decision that is materially preferable to the Final Determination making a contribution to the achievement of the NEO.

320. In relation to the STPIS (section D(2) of the Application):

320.1 clause 2.5(a) of the STPIS provides that excluding the GSL component, the maximum revenue increment or decrement (the revenue at risk) for the scheme components in aggregate for each regulatory year within the regulatory control period shall be 5%, that is, the sum of the s-factors associated with all parameters must lie between +5% (the upper limit) and –5% (the lower limit);[328]

320.2 the penalty that would apply over the subsequent regulatory control period were ActewAGL to reach the target performance levels it proposed in its Revised Regulatory Proposal rather than the levels applicable under the STPIS (namely, ActewAGL's average reliability levels over the last five years) is $1.96 million ($ nominal);

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327 The AER and the Tribunal are required to have regard to the interrelationship between constituent decisions in determining the materially preferable NEO decision: sections 16(c)-(d) and 71P(2a)-(2c) of the NEL.

328 In the Revised Regulatory Proposal, ActewAGL proposed revenue at risk be set at ± 2.5% and the AER accepted this proposal in its Final Determination.

320.3 in the context of an opex allowance of $240.6 million ($ 2013/14) in the Final Determination, the potential revenue implications of not meeting the performance targets in the STPIS are significant, being $11.04 million ($ nominal);

320.4 it is most unlikely that ActewAGL will be able to maintain its average reliability levels over the last five years in circumstances where the level of opex allowed to it in the Final Determination is $130.6 million **less** than the opex that ActewAGL considers is required to meet the opex objectives in clause 6.5.6(a) of the NER in the subsequent regulatory control period, and is a reduction of a similar magnitude from the levels of opex that ActewAGL incurred in achieving those average reliability levels over the last five years;

320.5 in the circumstances, it is likely that ActewAGL will suffer financial penalties under the performance targets in the STPIS if they are not modified to take into account the opex allowance made in the Final Determination;

320.6 assuming that ActewAGL's opex allowance has been set in a manner that is required to meet the opex objectives in clause 6.5.6(a) of the NER, then any financial penalties that are imposed on ActewAGL by reason of the STPIS will reduce its revenue below that which is required to meet those objectives;

320.7 in circumstances where the Final Determination already imposes drastic reductions to opex from the opex levels that have historically been allowed to ActewAGL, further reductions to ActewAGL's opex, of the order that is likely to occur if the performance targets in the STPIS are not amended to reflect those reductions in opex, would not be in the NEO;

320.8 it is critical to the NEO, therefore, that the Final Determination properly align the performance targets applicable to ActewAGL under the STPIS with the level of opex allowed to ActewAGL in the 2014-19 period; and

320.9 varying the Final Determination to align the performance targets applicable to ActewAGL under the STPIS by reference to the opex allowance in the Final Determination, or alternatively setting the Final Determination aside and remitting it to the AER with a direction that the performance targets applicable to ActewAGL in the STPIS should be aligned to the opex allowance made in the Final Determination, would therefore be in the NEO.

321. In relation to the metering price control ground (section D(3) of the Application):

321.1 the error made by the AER in [redacted]. The AER has made an objectively identifiable slip;

321.2 given that the AER has concluded that ActewAGL's historical opex for metering services is relatively efficient,[329] and that an efficiency adjustment to ActewAGL's base opex should not be applied on the basis of the AER's benchmarking results,[330] it follows that a price cap based on an opex allowance that is less than ActewAGL's historical opex would result in ActewAGL recovering less than its efficient costs for those metering services; and

321.3 varying the Final Determination to correct the AER's error would therefore be in the NEO, in that it would allow ActewAGL the opportunity to recover its efficient costs of providing metering services.

322. In relation to the classification of metering services ground (section D(4) of the Application), the AER concedes that it has made an error, which must be rectified. If the error is not corrected, then the control mechanism specified in Attachment 16 of the Final Determination may become unworkable, or at the very least, there will be confusion and administrative difficulty in assessing whether, and to what extent, ActewAGL can charge for the provision of services in respect of types 5 and 6 metering. Neither of those outcomes would be in the NEO. The NEO preferable decision is that the Final Determination conforms to the AER's intended decision.

323. In relation to the return on equity (section D(5) of the Application), the AER's decision is the first decision under the new NER provisions for assessing the return on equity, which provisions were designed to broaden the estimation methods and financial models that could be utilised by the AER. By concluding that no other method or model other than the SL CAPM is appropriate for measuring the return on equity, the AER's decision has confined its approach to that which prevailed under the old NER provisions. If this is incorrect, and considering that the return calculated under the SL CAPM is materially less than the return calculated under the other models considered by the AER, this will result in a significant precedent for the under-compensation of ActewAGL for investment now and in the future, which can in turn be expected to deter efficient investment.

324. In relation to the return on debt (section D(6) of the Application), the AER's decision delays the full implementation of the new, improved methodology for calculating the cost of debt for 10 years, notwithstanding that ActewAGL did not, in fact, raise debt in or prior to the 2009/10 to 2013/14 regulatory control period. The decision imposes an artificially depressed cost of debt on ActewAGL not only in the transitional and subsequent regulatory control periods but over future regulatory control periods, on the basis of an erroneous approach to the hypothetical benchmark entity. If the AER's decision is incorrect, it will perpetuate a significant under-recovery of debt costs for a decade, which can in turn be expected to deter efficient investment.

325. In relation to the value of imputation credits (section D(7) of the Application), as well as being financially significant to the overall return of ActewAGL (and thus to the achievement of the NEO), the AER's decision on gamma turns on a construction of a new provision in the

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329 Final Determination, pages 16-48 to 16-49.

330 Final Determination, pages 16-48 to 16-49.

NER which, if incorrect as ActewAGL contends, would result in a permanent overstatement of the value of imputation credits, and thus understatement of the cost of corporate income tax, providing an inadequate return for ActewAGL for the transitional and subsequent regulatory control periods, and future regulatory control periods.

F ORDERS SOUGHT

326. ActewAGL seeks the following orders:

326.1 an order that the Tribunal vary the Final Determination by replacing the total revenue requirements in the Final Determination for distribution standard control services and transmission standard control services of $641.6 million ($ nominal) and $129.4 million ($ nominal) with amounts that are calculated by reference to ActewAGL's base year actual opex of $63.28 million ($ 2013/14) (being ActewAGL's base year actual opex set out in section 3.9.3 of ActewAGL's Revised Regulatory Proposal (Table 3.21, page 269) updated for the CPI value used by the AER in the Final Determination of 3.02% (in 2013/14));

326.2 alternatively, an order that the Tribunal set aside the Final Determination, and remit it back to the AER to make the decision again in accordance with directions that the AER make its decisions under clause 6.12.1(4) concerning ActewAGL's opex allowance without the errors referred to in paragraphs 113 to 118 above;

326.3 an order that the Tribunal vary the Final Determination by setting the performance targets applicable to ActewAGL in the STPIS by reference to the opex allowance in the Final Determination;

326.4 alternatively, an order that the Tribunal set aside the Final Determination, and remit it back to the AER to make the decision again in accordance with a direction that the performance targets applicable to ActewAGL in the STPIS should be set by reference to the opex allowance in the Final Determination;

326.5 an order that the Tribunal vary the Final Determination by amending the control mechanism in respect of types 5 and 6 meter reading, maintenance and data services so that the relevant prices caps on annual metering charges are calculated without the errors referred to in paragraphs 164 and 165 above;

326.6 an order that the Tribunal vary the Final Determination by amending the constituent decision on the classification of services in the first row of Appendix A of the Overview to the Final Determination so that it is in the following form:

> 'In accordance with clause 6.12.1(1) of the NER, the following classification of services will apply to ActewAGL for the 2015-19 regulatory control period (listed by service group):
>
> - Standard control services include network services and connection services.

- Alternative control services include:
    - types 5 and 6 meter reading, maintenance and data services;
    - types 5 and 6 meter installation and commissioning;
    - types 5 and 6 meter provision (before 1 July 2015);
    - type 5 and 6 meter provision (after 1 July 2015);
    - type 7 metering services; and
    - ancillary network services.
- Unregulated services include type 1 to 4 metering services.';

326.7 an order that the Tribunal vary the Final Determination by:

326.7.1 replacing the total revenue requirements in that Determination for distribution standard control services and transmission standard control services of $641.6 million ($ nominal) and $129.4 million ($ nominal) respectively with amounts that are; and

326.7.2 amending the control mechanism in respect of types 5 and 6 meter reading, maintenance and data services so that the relevant prices caps on annual metering charges are,

calculated by reference to an allowed rate of return determined using ActewAGL's proposed return on equity of 9.83% (being the return on equity proposed by ActewAGL in its Revised Regulatory Proposal updated for the risk free rate in the averaging period risk free rate which has since occurred);

326.8 an order that the Tribunal vary the Final Determination by:

326.8.1 replacing the total revenue requirements specified in that Determination for distribution standard control services and transmission standard control services of $641.6 million ($ nominal) and $129.4 million ($ nominal) respectively with amounts that are calculated by reference to an allowed rate of return determined using ActewAGL's proposed return on debt for 2014/15 of 7.96% and for 2015/16 of 7.61%;

326.8.2 amending the control mechanism in respect of types 5 and 6 meter reading, maintenance and data services so that the relevant prices caps on annual metering charges are calculated by reference to an allowed rate of return determined using ActewAGL's proposed return on debt for 2014/15 of 7.96%; and

326.8.3 providing for the annual updating of the annual revenue requirements for distribution standard control services and transmission standard control services for the remaining years of the subsequent regulatory control period by reference to an updated return on debt estimated using the trailing average approach (without transition).

326.9 an order that the Tribunal vary the Final Determination by:

326.9.1 replacing the total revenue requirements in that Determination for distribution standard control services and transmission standard control services of $641.6 million ($ nominal) and $129.4 million ($ nominal) respectively with amounts that are; and

326.9.2 amending the control mechanism in respect of types 5 and 6 meter reading, maintenance and data services so that the relevant prices caps on annual metering charges are,

calculated by reference to an estimated cost of corporate income tax based on a gamma of 0.25;

326.10 any other variations to the Final Determination that are required as a consequence of, or to give effect to, the above variations; and

326.11 any other orders the Tribunal sees fit.

Dated: 21 May 2015

Signed on behalf of the Applicant

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Fleur Gibbons
Solicitor for the Applicant