
Expenditure on mine subsidence activities

Submission to the Australian Energy Regulator

Submitted on behalf of Jemena Gas Networks (NSW) Ltd

15 July 2011

Sydney

2 Park Street Sydney NSW 2000 Australia
GPO Box 3810 Sydney NSW 2001
T +61 2 9263 4000 F +61 2 9263 4111

Melbourne

120 Collins Street Melbourne VIC 3000 Australia
GPO Box 90 Melbourne VIC 3001
T +61 3 8656 3300 F +61 3 8656 3400

www.gtlaw.com.au

1 Background

- 1.1 On 20 July 2010, Jemena Gas Networks (NSW) Ltd (**JGN**) made an application under section 245 of the National Gas Law, as set out in the Schedule of the *National Gas (South Australia) Act 2008* (SA) (**National Gas Law**), for a review of a full access arrangement decision made by the Australian Energy Regulator (**AER**) in relation to JGN pursuant to Rule 64 of the National Gas Rules (**AER's decision**).
- 1.2 JGN's application for review raised five grounds for review in respect of the AER's decision, including a ground in relation to the AER's decision to treat expenditure on mine subsidence activities as operating expenditure rather than capital expenditure (**mine subsidence ground for review**). The matter was heard before the Australian Competition Tribunal (**Tribunal**) on 6 December 2010.
- 1.3 On 25 February 2011, the Tribunal delivered reasons for decision in respect of the mine subsidence ground for review: *Re Application by Jemena Gas Networks (NSW) Ltd* [2011] ACompT 6 at [41]. In setting aside the AER's decision in relation to mine subsidence and remitting the matter to the AER for reconsideration, the Tribunal was satisfied that the AER had applied an incorrect test in determining whether mine subsidence expenditure should be treated as capital expenditure.
- 1.4 The Tribunal expressed its opinion that expenditure on mine subsidence (other than that incurred for monitoring) should be treated as capital expenditure [38]. The Tribunal went on to say that:

[T]he cost of "monitoring" plant and equipment is "not readily treated as capital expenditure. On the one hand preliminary investigations and the like undertaken to determine whether, by reason of the occurrence of a specific event, an item of plant has been damaged may be a capital expense. We think this type of expenditure should be treated as capital expenditure if it is actually followed up by capital works: see eg *BP Oil Refinery (Bulwer Island) Ltd v Federal Commissioner of Taxation* (1991) 33 FCR 594, 604, where there is a suggestion that this is the correct view. On the other hand the cost of "monitoring" is unlikely to be a capital expense if no damage shows up. [39]

- 1.5 The Tribunal indicated that it had not been able to extract the cost of "monitoring" from the overall mine subsidence costs. The Tribunal also did not know when (if at all) the monitoring was followed by restoration works. The Tribunal said that it was therefore not possible for the Tribunal to determine which of the claimed capital expenditure is in fact properly characterised as capital expenditure [40].
- 1.6 In light of the above circumstances, the Tribunal considered it appropriate the set aside the part of the AER's decision relating to the characterisation of mine subsidence costs and to remit the matter to the AER for reconsideration. The Tribunal identified three issues that would need to be addressed in the AER's reconsideration (at [41]).
- 1.7 The Tribunal issued a determination on 30 June 2011 which, amongst other things, provided for the mine subsidence ground for review to be remitted to the AER in accordance with a number of directions, including that:
 - (a) Mine subsidence expenditure other than "monitoring" expenditure that was incurred during the regulatory period 2005-2010 be included in the opening capital base for the regulatory period 2010-2015;
 - (b) Forecast mine subsidence expenditure in respect of the regulatory period 2010-2015 other than "monitoring" expenditure be allocated as forecast capital expenditure; and

- (c) The inclusion of the mine subsidence “monitoring” expenditure in the opening capital base for the regulatory period 2010-2015 and the allocation of forecast “monitoring” expenditure in the forecast capital expenditure be reconsidered by the AER, taking into account the following issues:
 - (i) The nature of “monitoring” and its costs;
 - (ii) The degree of connection between “monitoring” and mine subsidence expenditure that is of a capital nature for the purposes of rule 72(1), 77 and 79 of the National Gas Rules; and
 - (iii) If there is no connection, whether the cost of “monitoring” can be sufficiently determined so that it can be separated from mine subsidence capital expenditure.

1.8 Prior to the Tribunal making its determination, the parties had also exchanged correspondence regarding the three issues identified by the Tribunal in its reasons for decision. On 15 April 2011, the AER’s lawyers indicated that the AER agreed that it is efficient to progress the mine subsidence matter by JGN providing the requisite information to the AER. The AER specified certain information that it required to remake its determination in relation to mine subsidence.

1.9 JGN has prepared a short narrative document that is directed at responding to the Tribunal’s reasons for decision and determination, as well as the information the AER indicated it would require in reconsidering the mine subsidence expenditure aspect of its decision. The narrative document is provided at Attachment A. For the AER’s convenience, a short summary of this narrative document as it is directly relevant to the information identified by the AER in its letter of 15 April 2011 is set out in sections 2 to 4 of this document. Section 5 of this document sets out JGN’s submissions as to why the AER, in remaking its decision on this issue, should determine that the relevant expenditure amounts are properly characterised as capital expenditure.

2 Nature of monitoring activities

2.1 The attached narrative document sets out in detail the nature of “monitoring” in the context of mine subsidence works. JGN would draw the AER’s attention in particular to the following:

- (a) Day-to-day “monitoring” of the pipeline does not involve excavating or exposing the pipeline, or monitoring the stress levels of the pipeline (done by strain gauges). Rather, it involves patrols along the pipeline easement by car or by helicopter on a rolling basis and there is no inspection of the pipeline itself which remains buried. The cost of these patrols is treated as operating expenditure. These patrols will continue in areas that have been identified as potentially being affected by mine subsidence and, again, the costs associated with this day-to-day monitoring are currently treated by JGN as operating expenditure.
- (b) “Monitoring” in the context of mine subsidence is only undertaken after the following steps have been completed:
 - (i) BHP Billiton (**BHPB**) notification to JGN of its intention to undertake long-wall coal mining in the vicinity of where the JGN pipeline is located;
 - (ii) Receipt of information from BHPB as to its ground movement predictions and preliminary stress analysis which shows if and how the proposed mining may lead to the pipeline being shifted or moved from its original position;

- (iii) Discussions between JGN, other pipeline owners in the potentially affected region (if relevant), and BHPB in relation to the mining activities and their potential impact;
- (iv) Analysis of the information provided by BHPB to decide whether it is necessary to commence any mitigation and monitoring work to deal with the anticipated stress of sections of the pipeline that are likely to be affected;
- (v) If it is determined that works may be needed to deal with the stress that the pipeline may come under as a result of the mining activity, technical representatives from each affected pipeline and BHPB will meet to develop specific engineering designs and technical solutions to deal with the potential subsidence (the **Technical Committee**); and
- (vi) The plans developed by the Technical Committee are then reviewed and subject to the approval of representatives from each pipeline owner (the **Steering Committee**). If JGN's pipeline is the only pipeline affected by BHPB's mining activities, this committee structure will not be used and JGN will develop and approve its own plans.

The costs incurred in undertaking the above steps are currently treated as operating expenditure by JGN (and therefore were not included in JGN's capital expenditure for the 2005-10 period, or in capital expenditure forecasts for the 2010-15 period).

- 2.2 Following the completion of the steps in 2.1(b)(i) to (v), and a decision to commence a mine subsidence project to deal with any potential stress and damage to the pipeline caused by mine subsidence, expenditure on activities undertaken as part of the mine subsidence project is treated as capital expenditure. Activities undertaken in a project include steps to put JGN in a position where it can "monitor" the stress that the pipeline is under prior to, during, and following the mining activity. This allows JGN to determine what, if any, mitigation work must be undertaken to prevent damage to the pipeline before and during mining, and what rehabilitation work is required to restore the pipeline once mining has ceased. In order to monitor the stress on the pipeline, parts of the pipeline must be excavated and exposed (i.e., dug out of the ground) and strain gauges installed. The strain gauges can only be installed directly on the steel pipeline once it has been excavated and the protective coating on the pipeline removed. JGN has included an illustrative photo of a strain gauge in the accompanying narrative document.
- 2.3 In the context of mine subsidence, JGN uses the term "monitoring" to cover the collection and analysis of information regarding the stress on parts of the pipeline and the movement of the pipeline and the ground during mining. This information is collected from strain gauges that are installed on the pipeline as well as from field surveys using survey prisms and other equipment. The information is then used to determine the necessity and scope of mitigation works prior to mining, further mitigation work during mining and rehabilitation of the pipeline after mining activity has stopped.
- 2.4 It should be clear from the above, that the only monitoring costs that are treated as capital expenditure by JGN are related to mine subsidence activity. This "monitoring" differs from day-to-day monitoring and only takes place in areas where the pipeline is likely to be affected by mining activity. These likely impacts are identified through the analysis of information provided by BHPB and continually monitored, identified and analysed during mining to determine the mitigation works that may need to be undertaken to ensure the pipeline is not damaged as a consequence of mining activity. Without such monitoring activity, JGN would not be able to determine the stress being placed on the pipeline due to mining and respond to that stress appropriately.

3 Opening capital base: costs associated with “monitoring” activities

- 3.1 The AER has requested information on the nature of “monitoring” activities and the associated costs for mine subsidence expenses proposed to be included in the opening capital base.
- 3.2 The narrative sets out that during the period 1 July 2005 to 30 June 2010, JGN undertook mine subsidence works at five sites.
- 3.3 At three of those sites ({c-i-c} Simpsons Creek), the only work undertaken during the 2005 – 2010 regulatory period related to rehabilitation works (Stage 5). All other work (Stage 1 to Stage 4) occurred in the period prior to 1 July 2005 and included mitigation works. The nature of the “monitoring” activities during the rehabilitation stage include using strain gauges readings to detect residual stress and determine whether the pipeline requires further realignment before being buried. Monitoring during this stage is typically followed by capital works, including the recoating and reburying of the pipeline and in some cases the further realignment of the pipeline.
- 3.4 Mine subsidence related activities at the other two sites (Unnamed Creek and {c-i-c}) during the 2005-2010 regulatory period involved stages prior to, and in the case of Unnamed Creek including, rehabilitation:
- (a) At Unnamed Creek the activities involved ongoing monitoring and further mitigation (Stage 4) and rehabilitation (Stage 5). JGN has done the best it can to identify the monitoring costs associated with Stage 4 as it related to Unnamed Creek and considers that the costs incurred {c-i-c} ;
- (b) At {c-i-c} , the activities undertaken in the 2005-2010 regulatory period included mitigation (Stage 2) and ongoing monitoring and further mitigation (Stage 4). JGN has done the best it can to identify the monitoring costs associated with Stage 4 as it related to {c-i-c} and considers that the costs incurred {c-i-c} .
- 3.5 The AER has asked for information as to any “monitoring” costs in the 2005-2010 regulatory period that are not connected with any subsequent capital works.
- 3.6 JGN submits that it is clear that the works undertaken at {c-i-c} were capital works – including the mitigation and further mitigation works and the rehabilitation of the pipeline. As set out in the narrative document, the mitigation stage (Stage 2) involved full excavation and realignment of 200m of the pipeline. Further realignment of the pipeline was also necessary as part of Stage 4 as a consequence of the ground subsidence in {c-i-c} . Therefore, any “monitoring” costs associated with the activities and {c-i-c} are clearly connected with capital works.
- 3.7 JGN also submits that the works undertaken at Unnamed Creek were capital works, despite separate mitigation works not being required. As noted in the narrative document, Stage 4 involves collecting strain gauge readings and analysis of those readings. Field surveys were also undertaken. Following some anomalies in the data being reported by the strain gauges, it was found that a number of the strain gauges had been damaged and required repair. The rehabilitation of the pipeline that occurred at Stage 5, which involved the removal of a temporary epoxy coating and strain gauges, and the recoating and reburying of the pipeline, should properly be characterised as capital works, and therefore the costs associated with “monitoring” activities should also be properly treated as capital expenditure.

4 Forecast mine subsidence expenses: costs associated with “monitoring” activities

- 4.1 The AER has requested information on the nature of “monitoring” activities and the associated forecast costs for mine subsidence expenses for the 2010-2015 regulatory period.
- 4.2 As set out in the narrative document, the forecast for the 2010-2015 regulatory period includes monitoring expenses only in respect of {c-i-c}. {c-i-c} is at Stage 4 (ongoing monitoring and further mitigation) as long-wall mining has not been completed. Once the mining has ceased, the mine subsidence activities will move to Stage 5, rehabilitation. The forecast expenditure amount for ongoing monitoring and further mitigation at {c-i-c} during the 2010-2015 regulatory period {c-i-c}.
- 4.3 The AER has also asked JGN to identify any forecast “monitoring” costs that are not connected with any subsequent capital works. JGN submits that the Stage 4 and Stage 5 activities undertaken at {c-i-c} and included in the forecast are capital works. Therefore, forecast expenditure for any “monitoring” works undertaken with respect to the activities at {c-i-c} should properly be characterised as forecast capital expenditure.

5 Treatment of “monitoring” costs

- 5.1 JGN submits that to the extent “monitoring” costs have been included in the opening capital base or the forecasts for capital expenditure for the 2010-2015 regulatory period, these costs should properly be treated as capital expenditure.
- 5.2 The case law dealing with whether expenditure is of a capital nature indicates that if a total expenditure is of a capital nature, so is very part of it.¹ In *Federal Commissioner of Taxation v Western Suburbs Cinemas Limited* [1952] 86 CLR 102 (**Western Suburbs Cinemas**), the work done consisted of the replacement of the entire ceiling of the cinema with a new and better ceiling.² Amongst other submissions, the taxpayer submitted that if the work actually involved in the replacement of the ceiling was considered in detail, it would be found that some things that were done would have had to be done even for the purpose of repair and that those amounts should properly be treated as not being of a capital nature and therefore an allowable deduction.³
- 5.3 Kitto J found that if expenditure is properly characterised as being of a capital nature, the totality of that expenditure is to be treated as capital expenditure – even if some of the same activities would have been performed in respect of expenditure of an income rather than a capital character.

If a total expenditure is of a capital nature, so is every part of it; you cannot take a portion of the work done, such as the erection of a scaffolding and, closing your eyes to the purpose of which it was in fact erected, attribute to the cost of that portion an income nature for no better reason than that the same scaffolding would have been erected in order to serve a purpose which, if it had existed, would have made the total expenditure an income charge.⁴

- 5.4 JGN submits that monitoring activities undertaken as part of a program of works designed to preserve the capital asset, which is not work that arises from causes associated with

¹ *Federal Commissioner of Taxation v Western Suburbs Cinemas Limited* [1952] 86 CLR 102, 109.

² *Federal Commissioner of Taxation v Western Suburbs Cinemas Limited* [1952] 86 CLR 102, 106.

³ *Federal Commissioner of Taxation v Western Suburbs Cinemas Limited* [1952] 86 CLR 102, 107.

⁴ *Federal Commissioner of Taxation v Western Suburbs Cinemas Limited* [1952] 86 CLR 102, 109.

the operation of the pipeline, should be treated as capital expenditure. The monitoring activities that are currently capitalised by JGN are only undertaken in areas where it has been identified that mitigation works may need to be undertaken to preserve the capital asset. The expenditure is large, non-recurrent⁵ and made for the purpose of obtaining an advantage for the enduring benefit of JGN's business.

- 5.5 Further, properly understood, the character of the monitoring expenditure is such that it should be treated as capital expenditure regardless of whether or not it is followed up by preservation or remediation works. Monitoring expenditure can and should be distinguished from repair work that is “a stitch in time which saves nine” as it either:
- (a) makes good defects and also prevents defects from developing (see *W Thomas & Co Pty Ltd v Commissioner of Taxation (Cth)* (1965) 115 CLR 58, 72); or
 - (b) is done to a large extent in anticipation of forthcoming defects and executed in combination with work of rectification (see *Day v Harland & Wolff Ltd* [1953] 1 WLR 906, 909).

Repair work in both contexts would not be considered capital expenditure according to the High Court in *BP Oil Refinery (Bulwer Island) Ltd v Federal Commissioner of Taxation*, the case referred to by the Tribunal in paragraph 29 of its reasons for decision.

- 5.6 In *BP Oil Refinery*, the High Court held that expenditure incurred on encasement in concrete of wooden wharf piles that had been damaged by marine organisms for the sole purpose of preventing damage by those organisms was *not* expenditure incurred for repairs. According to Jenkinson J, “work will not be considered repair unless it includes some restoration of something lost or damaged, whether function or substance or some other quality or characteristic”. The concrete encasement “added something...an improvement, not a repair” and was therefore of a capital nature.
- 5.7 The preservation and remediation work undertaken to restore the pipeline clearly falls within the same category as the concrete encasement considered in *BP Oil Refinery*, as does the monitoring expenditure which is directed to the immediate and future preservation of the pipeline by ensuring ground pressure changes and other effects of mining activity are noticed and responded to appropriately. It is clearly not of the same nature and does have the same characteristics as repair work considered in *W Thomas & Co Pty Ltd v Commissioner of Taxation*, which was work “done to make good a deterioration that had occurred by ordinary wear and tear or by the operation of natural causes during the passage of time” (at 72).

6 Conclusion

- 6.1 For the reasons set out in these submissions, JGN considers that:

- JGN's mine subsidence “monitoring” activities do not arise from the everyday, ordinary operation of the pipeline. It is required as a result of a third party decision (i.e., BHPB) to commence mining activity in the vicinity of the JGN pipeline.
- There is a high degree of interconnectedness between mine subsidence “monitoring” and mine subsidence capital works that would support a conclusion that “monitoring” expenditure is of a capital nature. The monitoring is required to determine if any action needs to be taken to preserve the capital asset, that is, the pipeline.

⁵ In the terms discussed in *Associated Newspapers Limited v Federal Commissioner of Taxation* [1938] 61 CLR 337.

- The following mine subsidence monitoring expenditure incurred during the 2005-10 regulatory period is therefore of a capital nature and should be allowed in the opening capital base for the regulatory period 2010-2015:

- For Unnamed Creek - {c-i-c} ;

- For {c-i-c} - {c-i-c} .

In total, {c-i-c} should be allowed in the opening capital base for the 2010-2015 regulatory period, representing all mine subsidence expenditure incurred during the 2005-2010 regulatory period.

- JGN's forecast expenditure on mine subsidence activities to be undertaken in the 2010-2015 regulatory period should be treated as forecast capital expenditure (including the monitoring costs identified in respect of {c-i-c}). This would be given effect by transferring {c-i-c} from forecast direct operating expenditure to net direct mine subsidence capital expenditure.