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**AUSTRALIAN COMPETITION TRIBUNAL**

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**Lodgment and Details**

Document Lodged:      Application for Leave and Application for Review

File Number:            ACT 2 of 2017

File Title:                Application under section 71B of the National Electricity Law for a review of a transmission determination made by the AER in relation to AusNet Transmission Group Pty Ltd pursuant to Rule 6A.13 of the National Electricity Rules

Registry:                 VICTORIA – AUSTRALIAN COMPETITION TRIBUNAL

Dated: 18/05/2017 at 4.10pm AEST



Registrar

**Important Information**

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**Commonwealth of Australia**

*National Electricity (Victoria) Act 2005*

**In the Australian Competition Tribunal**

**File No.**

**Re** Application under section 71B of the National Electricity Law for a review of a transmission determination made by the AER in relation to AusNet Transmission Group Pty Ltd pursuant to Rule 6A.13 of the National Electricity Rules

**Applicant:** AusNet Transmission Group Pty Ltd (ABN 78 079 798 173)

**Address of Applicant:** Level 31, 2 Southbank Boulevard, Southbank Victoria 3006

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

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## A. INTRODUCTION

### *AusNet Services*

1. AusNet Transmission Group Pty Ltd (**AusNet Services**) owns and operates the high voltage electricity transmission network in Victoria (**Network**). The Network, which is 6,754 kilometres long, serves Victoria, covering an area of approximately 227,600 square kilometres and supplying electricity to a population of over 5.9 million people, or more than 2.1 million households and businesses.
2. AusNet Services is registered as a transmission network service provider (**TNSP**) under cl 2.5.1 of the National Electricity Rules (**NER**). It provides prescribed transmission services<sup>1</sup> (which are a form of direct control network service<sup>2</sup>) by means of the Network.
3. This Application for Leave and Application for Review relates to the Network.

### *Legislative framework and its application to AusNet Services*

4. Section 6 of the *National Electricity (Victoria) Act 2005* (Vic) applies the National Electricity Law (**NEL**) as a law of Victoria. The NEL is set out as a Schedule to the *National Electricity (South Australia) Act 1996* (SA).
5. Section 9 of the NEL gives the NER the force of law in Victoria.
6. AusNet Services is a “network service provider” within the meaning of s 2 of the NEL because it:
  - (a) owns, controls or operates a transmission system that forms part of the interconnected national electricity system; and
  - (b) is so registered under the NER.
7. The Network is a “transmission system” within the meaning of s 2 of the NEL, in that it is “the apparatus, electric lines, equipment, plant and buildings used to convey or control the conveyance of electricity that the [National Electricity] Rules specify as, or forming part of, a transmission system.”

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<sup>1</sup> For a definition of “prescribed transmission services”, see NER, Chapter 10.

<sup>2</sup> National Electricity Law, s 2B.

*AER transmission determination process*

8. Section 15 of the NEL prescribes the functions and powers of the AER, which include “AER economic regulatory functions or powers”. In the context of electricity transmission, an AER economic regulatory function or power means a function or power performed or exercised by the AER under the NEL or the NER that relates to:

*the economic regulation of services provided by ... a regulated transmission system operator ... by means of, or in connection with, a transmission system.*<sup>3</sup>

9. AusNet Services is regulated in terms of the revenues it is permitted to earn from the provision of prescribed transmission services pursuant to the NEL and the NER.
10. Clause 6A.2.1(1) of the NER requires the Australian Energy Regulator (**AER**) to make a transmission determination for a TNSP in accordance with Chapter 6A in respect of prescribed transmission services. One component of the transmission determination is a revenue determination for the provider in respect of the prescribed transmission services it provides.<sup>4</sup>
11. Pursuant to cl 6A.10.1 of the NER, AusNet Services was required to submit, and on 30 October 2015 did submit, a revenue proposal and a proposed pricing methodology to the AER for its consideration in accordance with Chapter 6A (**Revenue Proposal**). The Revenue Proposal pertains to AusNet Services’ transmission regulatory control period which commenced on 1 April 2017 and concludes on 31 March 2022 (**2017-22 regulatory control period**).
12. Clause 6A.12.1 of the NER requires the AER to make a draft decision in relation to the Revenue Proposal. On 20 July 2016, the AER made such a decision entitled *Draft Decision, AusNet Services transmission determination 2017-18 to 2021-22* dated July 2016 (**Draft Decision**).
13. On 21 September 2016, in accordance with cl 6A.12.3 of the NER, AusNet Services submitted a revised revenue proposal entitled *AusNet Transmission Group Pty Ltd, Transmission Revenue Review 2017-2022, Revised Revenue Proposal* dated 21 September 2016 (**Revised Revenue Proposal**).

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<sup>3</sup> NEL, s 2(1).

<sup>4</sup> cl 6A2.2(1) of the NER.





14. On 20 December 2017, AusNet Services submitted a further short submission to the AER addressing certain aspects of its Revised Revenue Proposal.
15. On 28 April 2017, the AER made its final decision under cl 6A.13.1 of the NEL, entitled *Final Decision, AusNet Services transmission determination 2017–2022* dated April 2017 (**final decision**). On the same day, in accordance with cl 6A.13.4 of the NEL, the AER made the transmission determination to which the final decision relates, entitled *AusNet Services, Transmission determination 2017–22* dated April 2017 (**Transmission Determination**). The Transmission Determination states that the AER’s reasons are included in the final decision which is to be read in conjunction with the Transmission Determination (page 3). In this application the final decision and Transmission Determination are referred to collectively as the **Final Decision**.

*Relevant regulatory regime*

16. Section 16 of the NEL prescribes the manner in which the AER must perform an AER economic regulatory function or power, which includes the making of a transmission determination. Section 16 requires that the AER must, in performing or exercising an AER economic regulatory function or power:
  - (a) under s 16(1)(a), perform or exercise that function or power in a manner that will or is likely to contribute to the achievement of the national electricity objective (**NEO**);
  - (b) under s 16(1)(c), in making a reviewable regulatory decision, specify the manner in which the constituent components of the decision relate to each other, and the manner in which the AER has taken that interrelationship into account in making the reviewable regulatory decision;
  - (c) under s 16(1)(d), if the AER is making a reviewable regulatory decision and there are two or more possible decisions that will or are likely to contribute to the achievement of the NEO, make the decision the AER is satisfied will or is likely to contribute to the achievement of the NEO to the greatest degree, and specify the reasons as to the basis on which the AER is so satisfied; and
  - (d) under s 16(2)(a), take into account the revenue and pricing principles in s 7A of the NEL when exercising a discretion in making those parts of a transmission determination relating to prescribed transmission services.
17. Section 7 of the NEL sets out the NEO. It provides that the objective of the NEL:



*... is to promote 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.*

18. Section 7A of the NEL sets out the revenue and pricing principles (**RPPs**), which relevantly include:

- (a) under s 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—
  - (i) providing direct control network services; and
  - (ii) complying with a regulatory obligation or requirement or making a regulatory payment;
- (b) under s 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;
- (c) under s 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;
- (d) under s 7A(6), 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 transmission system with which the operator provides direct control network services.

19. Clause 6A.14.1 sets out the contents of a final decision made by the AER pursuant to rule 6A.13 which, relevantly for the purposes of this application includes a decision by the AER to either approve or refuse to approve the total revenue cap for the provider for the regulatory control period and the maximum allowed revenue for the provider for each regulatory year of the regulatory control period (cl 6A.14.1(1)(i) and (ii)). Further, pursuant to cl 6A.14.1, a final decision is a decision by the AER, relevantly for



the purposes of this application, on the value of imputation credits as referred to in cl 6A.6.4 (cl 6A.14.1(5D)).

20. Clause 6A.14.2 requires the AER to give reasons for its final decision which set out the basis and rationale of its decision, including:

- (a) details of the qualitative and quantitative methodologies applied in any calculations and formulae made or used by the AER for the purposes of its decision;
- (b) the values adopted by the AER for each of the input variables in any calculations and formulae, including:
  - (i) whether those values have been taken or derived from the TNSP's current revenue proposal; and
  - (ii) if not, the rationale for the adoption of those values;
- (c) details of any assumptions made by the AER in undertaking any material qualitative and quantitative analyses for the purposes of the decision; and
- (d) reasons for the making of any decisions, the giving or withholding of any approvals, and the exercise of any discretion, as referred to in Chapter 6A of the NER, for the purposes of the decision.

## **B. APPLICATION FOR LEAVE AND APPLICATION FOR REVIEW OF TRANSMISSION DETERMINATION**

21. AusNet Services seeks the leave of the Australian Competition Tribunal (**Tribunal**) to apply to the Tribunal for a review of a reviewable regulatory decision pursuant to s 71B of the NEL. Subject to leave being granted by the Tribunal, an application is made under s 71C of the NEL for review of the Final Decision, being a reviewable regulatory decision of the AER.

22. The Final Decision is a reviewable regulatory decision for the purpose of s 71B(1) of the NEL as it is a network revenue or pricing determination that sets a regulatory period.<sup>5</sup> As mentioned in paragraph 15, above, the reasons for the Transmission

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<sup>5</sup> NEL, s 71A (definition of "reviewable regulatory decision") and s 2 (definitions of "network revenue or pricing determination" and "transmission determination").





Determination are set out in the AER's final decision, and those documents are to be read together (and are together referred to herein as the Final Decision).

23. AusNet Services is an affected or interested person or body (as that term is defined in s 71A of the NEL) for the purposes of s 71B(1) of the NEL, being the regulated network service provider to whom the reviewable regulatory decision applies.
24. For the reasons set out in Section C of this Application, AusNet Services applies for review of the Final Decision in respect of the following matter:
  - (a) *Value of imputation credits (gamma)*: the AER's decision to not approve AusNet Services' proposed value of imputation credits of 0.25 for use in the estimation of the cost of corporate income tax and to instead adopt a value of imputation credits of 0.4 (**Gamma Decision**).

*Requirements for leave*

25. The Tribunal may only grant AusNet Services leave to apply under s 71B(1) of the NEL if:
  - (a) pursuant to s 71E(a) of the NEL, it appears to the Tribunal that that there is a serious issue to be heard and determined as to whether a ground for review set out in s 71C(1) exists; and
  - (b) the provisions of s 71E(b) of the NEL, requiring that there be a *prima facie* case, are met as to which see paragraph 26 below; and
  - (c) pursuant to s 71F(2) of the NEL, the amount that is specified in or derived from the decision exceeds the lesser of \$5,000,000 or 2% of the average annual regulated revenue of the regulated network service provider.
26. Pursuant to s 71E(b) of the NEL, the Tribunal may also only grant leave to apply under s 71B(1) if it appears to the Tribunal that AusNet Services 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*".
27. A "*materially preferable NEO decision*" is defined in s 71P(2a)(c) of the NEL to mean a decision that is materially preferable to the reviewable regulatory decision in making



a contribution to the achievement of the NEO. This requirement for leave is addressed in Part D of this Application.

28. The requirements for leave are also addressed in the affidavit of Roxanne Kylie Smith sworn on 18 May 2017 in support of this application for leave.

### C. GROUNDS FOR REVIEW- VALUE OF IMPUTATION CREDITS (GAMMA)

#### *Background*

29. Clause 6A.6.4 of the NER states that the estimated cost of corporate income tax of a TNSP for each regulatory year ( $ETC_t$ ) must be estimated in accordance with the following formula (italicised terms are defined in Chapter 10 of the NER):

$$ETC_t = (ETI_t \times r_t) (1 - \gamma)$$

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 *prescribed transmission services* if such an entity, rather than the *Transmission Network Service Provider*, operated the business of the *Transmission 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

$\gamma$  is the value of imputation credits (gamma).

30. The Australian taxation system has a mechanism to avoid double imposition of income tax on company profits, by which companies may pay dividends grossed-up by the applicable company tax, accompanied by imputation credits generated by the company's payment of company tax on Australian earnings. The imputation credits permit Australian resident shareholders (subject to certain conditions) to offset the company tax component of the relevant dividends against their own income tax liabilities or (for dividends received after 1 July 2000) receive a refund to the extent that the credits exceed their own liabilities. 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 necessary because the regulated network service provider is to receive, as an element of its *annual building block revenue requirement* (provided for in clause 6A.5.4(a)), a building block under clause 6A.6.4 representing the cost of corporate income tax, yet some of the corporate



tax to be paid by the business will represent value to investors, in the form of imputation credits. If that value was not taken into account, the amount of revenue required to provide an appropriate return would be overstated. Mathematically, this value could be deducted from the required return or else deducted from the cost of corporate income tax. The NER adopts the latter approach.

31. It is common ground between the AER and AusNet Services that  $\gamma$  (gamma) in the above formula is to be calculated as the product of:

- (a) the distribution rate for imputation credits; and
- (b) the value of distributed imputation credits (theta),

(that is,  $\gamma = \text{distribution rate} \times \text{theta}$ ).

32. What is not common ground is:

- (a) the appropriate interpretation of the distribution rate and theta parameters (including what is meant by “value of imputation credits” in cl 6A.6.4 of the NER); and
- (b) the appropriate figures for each of the distribution rate and theta, and ultimately, the value for gamma.

33. The value for gamma of 0.25 proposed by AusNet Services and the AER’s Gamma Decision, including the method of its calculation, and the material relied on by the parties in support of their positions, are substantively similar as the equivalent gamma decisions considered in the following proceedings:

- (a) The merits review applications by the NSW and ACT network service providers the subject of the Australian Competition Tribunal’s decision in *Application by Public Interest Advocacy Centre Ltd and Ausgrid* [2016] ACompT1 (the **Ausgrid decision**); and
- (b) The merits review application by SA Power Networks the subject of the Australian Competition Tribunal’s decision in *Application by SA Power Networks* [2016] ACompT11 (the **SAPN decision**).

34. In the *Ausgrid* decision, the Tribunal determined that various decisions be remitted to the AER including with a direction that the AER is to make the constituent decision on the estimated cost of corporate income tax (gamma) in accordance with the Tribunal’s



reasons for decision and including by reference to an estimated cost of corporate income tax based on a gamma of 0.25 (the figure of 0.25 referred to in the Tribunal's determinations being based on a distribution rate of 0.7 and a theta of 0.35).<sup>6</sup>

35. In the *SAPN* decision, the Tribunal found no error in the AER's estimate of gamma<sup>7</sup>.
36. Both the *Ausgrid* decision and the *SAPN* decision are subject to applications for Judicial Review in the Full Federal Court. As at the date of this application, both Full Federal Court decisions are reserved.

*AusNet Services proposal*

37. In its Revenue Proposal and Revised Revenue Proposal, AusNet Services proposed a gamma of 0.25, based on a distribution rate of 0.7 and a theta of 0.35.<sup>8</sup>
38. AusNet Services' proposed distribution rate was based on analysis of the long-term distribution rate across Australian companies (referred to as "all equity") using the "cumulative payout ratio approach".
39. AusNet Services' estimate of theta was based on the market value of distributed imputation credits, as indicated by dividend drop-off analysis, 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. AusNet Services relied upon the study commissioned by the Tribunal in the *Energex* proceedings,<sup>9</sup> as well as two updates to that study which both confirmed the estimate of theta of 0.35:

- (a) SFG Consulting: *Updated dividend drop-off estimate of theta*, Report for the Energy Networks Association, 7 June 2013.

<sup>6</sup> *Applications by Public Interest Advocacy Centre Ltd and Ausgrid* [2016] ACompT 1; *Applications by Public Interest Advocacy Centre Ltd and Endeavour Energy* [2016] ACompT 2; *Applications by Public Interest Advocacy Centre Ltd and Essential Energy* [2016] ACompT 3; *Application by ActewAGL Distribution* [2016] ACompT 4; *Application by Jemena Gas Networks (NSW) Ltd* [2016] ACompT 5.

<sup>7</sup> At [196]

<sup>8</sup> AusNet Services: *Regulatory Proposal*, p 287; *Revised Regulatory Proposal*, pp 198, 199.

<sup>9</sup> SFG Consulting: *"Dividend drop-off estimate of theta" Final Report, re Application by Energex Limited (No 2)* [2010] ACompT 21 March 2011.



- (b) Frontier Economics: *An updated dividend drop-off estimate of theta*, Report prepared for AGN, Multinet Gas, AusNet Transmission, AusNet Gas Distribution and Transgrid, September 2016.

(In this application the original SFG study commissioned by the Tribunal in *Energex* and the updates referred to above are together referred to as the **SFG Studies**)

*AER decision*

40. In the Final Decision the AER did not accept AusNet Services' proposed gamma of 0.25. The AER instead adopted a gamma of 0.4, selected from within a range of 0.3 to 0.5.<sup>10</sup>

*Errors in the Gamma Decision*

41. The Gamma Decision was based on an incorrect construction and application of the NER (especially the words "value of imputation credits") and thus the exercise of the AER's discretion was incorrect and/or its Final Decision unreasonable. In particular:
- (a) the AER misconstrued and misapplied cl 6A.6.4 of the NER by concluding that the term "value of imputation credits" means the proportion of company tax returned to investors through the utilisation of imputation credits (where Australian resident investors are assumed to fully utilise distributed credits, and thus theta is 1 for those investors), including because such a measure is a post-company tax pre-personal tax measure of the utilisation rate;
  - (b) the AER erred in determining that theta should reflect the before-personal-tax and before-personal-costs value of imputation credits distributed to investors, whereas the correct approach is to estimate theta as the value to investors of distributed imputation credits, which may be affected by the extent of utilisation of those credits by investors and by 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);
  - (c) the AER's interpretation of "value of imputation credits" is not in accordance with its proper meaning. Clause 6A.6.4 of the NER refers to "value" and this

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<sup>10</sup> AER Final Decision, AusNet Services transmission determination 2017-2022, Attachment 4- Value of Imputation Credits, 4-9 to 4-10.





means the amount that investors value the imputation credit, or its “worth” to investors;

- (d) at a conceptual level, the AER’s approach overstates the discount to the required return for the 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. This is consistent with the estimation of all other relevant parameters in the building block framework, which 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 measured by reference to traded bond prices). The value of imputation credits is informed by how shareholders act in the market;
- (e) the AER (incorrectly) found that its conceptual approach to the value of gamma was consistent with the Officer framework and, on that basis, concluded that its conception of gamma best promotes the NEO and other requirements of the NER, whereas an interpretation of the “value of imputation credits” that looks to the value that investors place on imputation credits (as a market value, such as that measured by dividend drop-off studies) is the interpretation that best achieves the NEO;
- (f) this error in the AER’s construction and approach caused the AER to give weight to measures that could only ever be a theoretical upper bound (or above an upper bound) for the value of imputation credits (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 (relevantly represented in the material that was before the AER by the SFG Studies);
- (g) in calculating theta, the AER erred in giving any weight, or alternatively in giving greatest weight, to “equity ownership” measurements, including because:
  - (i) such measurements do not measure the “value” of distributed credits;
  - (ii) such measurements could only ever be a theoretical upper bound for theta (or above an upper bound). 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

- (iii) such measurements do not take account of actual rates of utilisation, matters that prevent a domestic investor from utilising imputation credits (such as the “45 day rule”), or matters that affect whether a domestic investor will give full value to imputation credits (such as transactions costs), and therefore will overstate theta;
- (h) the AER erred in giving weight to imputation credit redemption rates from tax statistics in preference to market value results from the SFG Studies, including because:
- (i) such measurements do not measure the “value” of distributed credits;
  - (ii) such measurements could only ever be an upper bound for theta. Imputation credit redemption rates from tax statistics only indicate the proportion of investors who redeem imputation credits and who may therefore place some value on imputation credits; and
  - (iii) such measurements do not take account of matters that affect whether a domestic investor will give full value to imputation credits (such as transactions costs), and therefore will overstate theta;
- (i) the AER erred in placing limited reliance on market value studies when appropriately constructed market value studies provide direct evidence as to the value of theta and the “value of imputation credits” required under clause 6A.6.4 of the NER;
- (j) the AER erred in concluding that the output of a market value study (e.g. the 0.35 estimate from the SFG Studies) had to be adjusted so as to capture the utilisation rate of imputation credits, 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 Studies should in fact be interpreted as an estimate of around 0.4 (after adjustment). The AER erred in making this adjustment, including because it is inconsistent with the meaning of “value of imputation credits” in clause





6A.6.4 of the NER, in circumstances where the SFG Studies properly measured the value of theta.

42. The AER erred in concluding that its utilisation rate estimate from tax statistics of 0.48 is a point estimate, and not an upper bound, for theta, and thus failing to conclude that its figure from tax statistics provided an upper bound for gamma of approximately 0.34. The AER erred in the following respects:

- (a) the AER made an error of fact in its findings of fact in concluding that its tax statistics figure may be affected by unreliability associated with tax statistics, when the concern about unreliability had been raised only about an Australian Taxation Office (ATO) database (recording the ATO's data as to the amounts of credits distributed) that is not required to estimate gamma directly, and that error of fact was material to the making of the Final Decision. This is demonstrated by the fact that the two factors which produce the upper bound for gamma, distribution rate and the redemption rate, are to be represented as:

$$\frac{\text{Credits Distributed}}{\text{Credits Created}} \times \frac{\text{Credits Redeemed}}{\text{Credits Distributed}}$$

where the "Credits Distributed" term, which is the only term about which any reliability concerns have been raised, cancels out during the multiplication, leaving:

$$\frac{\text{Credits Redeemed}}{\text{Credits Created}}$$

- (b) the AER's decision was based on a failure to recognise as a matter of logic:
- (i) that its figure for tax statistics was a prevailing utilisation rate of distributed credits and thus must be an upper bound for the value of theta;
  - (ii) that any uncertainty as to the tax statistics estimate of theta has no bearing on what that estimate is measuring; and
  - (iii) that its figure for tax statistics must, when combined with a distribution rate that is an appropriate proxy for the distribution rate for the benchmark efficient entity, supply an upper bound for gamma



of approximately 0.34 (in that the value of imputation credits could not be above 0.34 but could be lower).

- (c) The AER's decision in this regard was illogical and unreasonable and the Gamma Decision thus involved an incorrect exercise of discretion and/or was unreasonable.

43. The AER erred in concluding that the evidence from tax statistics can support a gamma estimate of at least 0.4 because:

- (a) that conclusion is premised on values for gamma (of 0.40 to 0.51) produced by the AER using Dr Lally's preferred distribution rate for listed equity from the financial reports for the top 20 ASX listed firms (0.83) in combination with tax statistics estimates of theta; and
- (b) that distribution rate is not an appropriate proxy for the distribution rate of benchmark efficient entity.

The AER's reasoning in this regard was illogical and unreasonable and the Gamma Decision thus involved an incorrect exercise of discretion and/or was unreasonable.

44. The AER erred in concluding that it was appropriate to have regard to a range of equity ownership figures for listed equity of 0.38 to 0.55 and for all equity of 0.56 to 0.68. The AER erred in the following respects:

- (a) the Gamma Decision was based on a conclusion that the AER should have regard to equity ownership figures from prior periods, rather than the prevailing equity ownership figures as at the date of the Final Decision; and
- (b) the Gamma Decision was based on a conclusion that the AER should have regard to equity ownership figures for all equity rather than merely listed equity, in circumstances where listed equity provided an appropriate proxy for the benchmark efficient entity and all equity did not.

The AER's reasoning in this regard was illogical and unreasonable and the Gamma Decision thus involved an incorrect exercise of discretion and/or was unreasonable.

45. The Gamma Decision was illogical and unreasonable in that it was based on the AER's conclusion that it should have regard to the distribution rate for listed equity, in circumstances where the distribution rate for listed equity is significantly influenced by

the distribution of foreign earnings and where the benchmark efficient entity, by the AER's definition, has no foreign earnings, such that the distribution rate for listed equity is a poor proxy for the distribution rate of the benchmark efficient entity and the distribution rate for all equity is a much better proxy. Because imputation credits are only generated from the company income tax payable on Australian earnings, but imputation credits may be attached to dividends at the company tax rate irrespective of the presence of foreign earnings in the profits earned by the company, the presence of foreign earnings in the company's profits biases the calculation of the distribution rate upward by comparison with a company that has only Australian earnings. The Gamma Decision, therefore, involved an error of discretion and/or was unreasonable.

46. The Gamma Decision was illogical and unreasonable in that it was based on the AER's conclusion that it should have regard to Dr Lally's preferred distribution rate for listed equity from the financial reports for the top 20 ASX listed firms of 0.83, in circumstances where those top 20 ASX listed firms have significant foreign earnings that significantly influence their distribution rate and where the benchmark efficient entity by definition has no foreign earnings, such that Dr Lally's preferred distribution rate is a poorer proxy for the distribution rate of the benchmark efficient entity than both the distribution rate for all equity and a distribution rate for listed equity from ATO data of 0.75. The Gamma Decision therefore involved an incorrect exercise of discretion and/or was unreasonable.
47. The AER made errors of fact in its findings of fact, each of which was material to the making of its Final Decision:
  - (a) in concluding that the value of imputation credits is 0.4, when in fact the correct figure is 0.25;
  - (b) in concluding that it is estimating the value of imputation credits consistently with other rate of return parameters;
  - (c) in concluding that the figure for Australian equity ownership could be higher than 0.47 (within a range of 0.38 to 0.55 based on listed equity data, or 0.56 to 0.68 based on all equity data), when in fact the correct value was approximately 0.47;
  - (d) in determining that the relevant range of estimates from market value studies is from 0 to 1.0;





- (e) in concluding that the SFG Studies were affected by the weaknesses affecting other market value studies, when in fact the methodology used by SFG was designed specifically to overcome shortcomings of earlier studies; and
  - (f) in concluding that the distribution rate for the benchmark efficient entity could be as high as 0.83, when in fact the correct figure is 0.7.
- 48. In reaching a conclusion that gamma is 0.4, the AER's Gamma Decision was illogical and unreasonable because it gave primary weight to equity ownership rates as a measure of theta in circumstances where:
  - (a) the rate of equity ownership is, of its nature, above even an upper bound for theta;
  - (b) the redemption rate from tax statistics, which itself must be an upper bound for theta, was lower than the figures used by the AER from equity ownership; and
  - (c) the SFG Studies provided better information as to theta, since the SFG Studies took into account factors which lead to imputation credits being less than fully valued by domestic investors,and the Gamma Decision thus involved an incorrect exercise of discretion and/or was unreasonable.
- 49. The AER erred in finding itself not convinced that transaction costs are likely to dissuade a material number of investors from redeeming imputation credits and that in estimating the utilisation rate, it did not need to adjust for transaction costs. Similarly, the AER erred in finding it did not need to adjust its estimates of the utilisation rate for other factors affecting investors valuation of imputation credits, specifically the time value of money (the impact of the delay between the distribution of an imputation credit and the time at which it is redeemed) and portfolio effects (where investors shift their portfolio away from the optimal portfolio towards a local portfolio in order to utilise more imputation credits, resulting in a loss in value and therefore a lower value of imputation credits). The AER's Gamma Decision thus involved an incorrect exercise of discretion and/or was unreasonable.
- 50. The AER erred in finding that to the extent investors value redeemed imputation credits at less than their face value due to personal costs, this will be picked up in the market value of the stock which drives the difference between the pre and post personal cost

return on equity and that empirical estimates of the market risk premium (**MRP**) will reflect the existence of any such costs. This finding fails to acknowledge that:

- (a) The AER's MRP estimates are based on data which includes dividends and capital gains only and not the benefit of imputation credits.
- (b) The AER's post tax revenue model (**PTRM**) requires an estimate of the total required return on equity. However, the observed returns used by the AER to estimate MRP (which quantify dividends and capital gains only) will reflect the market value to investors of imputation credits. That is, investors will reduce the return that they require in the form of dividends and capital gains in relation to the value that they receive from imputation credits. This results in the observed returns having to be grossed up for the value to investors of imputation credits to obtain an estimate of the total required return on equity.
- (c) It is logical that the market value of imputation credits must be added back to the observed returns in order to estimate the total required return on equity because the observed returns used by the AER to estimate the MRP are market data that reflect the market value that investors place on imputation credits. To add back anything other than the market value of credits to market returns that have been reduced by the market value of credits would be illogical.
- (d) Further and in any event, the AER's estimate of the MRP is based primarily on historic excess returns, most of which relate to the period prior to the introduction of imputation in 1987. The data used to estimate MRP prior to 1987 cannot reflect the existence of personal costs on the value of imputation credits.
- (e) The AER's Gamma Decision thus involved an error or errors of fact (being the findings set out in this paragraph 50) which were material to the making of its Final Decision, alternatively the AER's Gamma Decision involved an incorrect exercise of discretion and/or was unreasonable.

51. The AER erred in placing primary weight on its range of overlap in the ranges for gamma produced using "matched" distribution rates and theta estimates for each of all equity and listed equity (of 0.40 to 0.41) in circumstances where this was arbitrary and unreasonable. The Gamma Decision thus involved an incorrect exercise of discretion and/or was unreasonable.



52. It was illogical or unreasonable for the AER to accord any weight to Dr Lally's recommended value for gamma of at least 0.5, based on his preferred approach of combining a distribution rate for listed equity from the financial reports of the top 20 ASX listed firms with an all equity estimate of theta using the equity ownership approach, in circumstances where:
- (a) Dr Lally's preferred equity ownership figure was for all equity rather than merely listed equity, in circumstances where listed equity provided an appropriate proxy for the benchmark efficient entity and all equity did not;
  - (b) Dr Lally's preferred distribution rate is a poor proxy for the distribution rate of the benchmark efficient entity; and
  - (c) Dr Lally's approach is inconsistent with the requirements of the NER.

The Gamma Decision thus involved an incorrect exercise of discretion and/or was unreasonable.

53. It was illogical and unreasonable for the AER to treat market value studies in a general manner and to conclude that these studies indicate a value for theta between 0 and 1, without proper regard to the relative merits of each study, and to the particular studies relied on by AusNet Services (the SFG Studies). The Gamma Decision was based on this approach, and therefore involved and incorrect exercise of discretion and/or was unreasonable.
54. The AER incorrectly exercised its discretion or alternatively was unreasonable, in determining that market value studies should be given limited weight (and less weight than equity ownership rates and tax statistics) in estimating theta. The AER's Gamma Decision was based on this approach, and the Gamma Decision therefore involved an incorrect exercise of discretion and/or was unreasonable.
55. The AER incorrectly exercised its discretion or alternatively was unreasonable insofar as a reason it gave for adopting a value for imputation credits of 0.4 was that it is consistent with providing regulatory certainty (as the AER had adopted this value for decisions made by it in 2015 and 2016) in circumstances where:
- (a) there is considerable uncertainty as to the gamma parameter in any case arising from the AER's conception of the value for imputation credits first adopted in the Rate of Return Guidelines, which was a departure from previous regulatory practice, as well as from the *Ausgrid* decision and *SAPN*



decision, and the applications for judicial review made in respect of those decisions;

- (b) to the extent regulatory certainty is an issue, it was not a proper basis for adopting a value for imputation credits based on an incorrect construction of the NER.
56. The AER incorrectly exercised its discretion or alternatively was unreasonable in finding that if dividend drop off studies can be used, specifically the SFG Studies, they should be paired with estimates of the distribution rate for only listed equity, giving rise to a value for imputation credits of at least 0.30 rather than 0.25. A listed equity only distribution rate is not consistent with the benchmark efficient entity.
57. The AER made an illogical and unreasonable decision in concluding that gamma was 0.4 in circumstances where:
- (a) equity ownership figures indicated an upper bound for theta of 0.47, and thus an upper bound for gamma of approximately 0.3 (when combined with a distribution rate of 0.7);
  - (b) tax statistics also indicated an upper bound for theta of 0.48, and thus an upper bound for gamma of approximately 0.3 (when combined with a distribution rate of 0.7); and
  - (c) the SFG Studies indicated a value for theta of 0.35, and thus value for gamma of 0.25 (when combined with a distribution rate of 0.7).
58. The Gamma Decision thus involved an incorrect exercise of discretion and/or was unreasonable.

#### *Conclusion – Gamma Decision*

59. For the reasons set out in this application, in making the Gamma Decision:
- (a) the AER made an error of fact in its findings of fact, and that error of fact was material to the making of the Final Decision;
  - (b) 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 Final Decision;
  - (c) the exercise of the AER's discretion was incorrect, having regard to all the circumstances; and/or

- (d) the AER's Gamma Decision and Final Decision was unreasonable, having regard to all the circumstances.

*Amount specified in or derived from decision*

60. The estimate of the cost of corporate income tax to AusNet Services during the 2017-2022 regulatory control period forecast by the PTRM where the value of gamma is 0.25 is \$78.7 million (\$nominal).
61. The Final Decision adopted a value of gamma of 0.4. Using that value, the PTRM calculated that the estimated cost of cost of corporate income tax to AusNet Services during the 2017-2022 regulatory control period forecast by the PTRM is \$59.5million (\$nominal).
62. If the amount derived by the calculation in paragraph 60 were added to AusNet Services' total revenue allowance, and the amount derived by the calculation in paragraph 61 was subtracted, AusNet Services' total revenue allowance would rise by \$78.7 million - \$59.5 million = \$19.2 million (\$nominal) over the regulatory control period.
63. Therefore, \$19.2 million (\$nominal) is, within the meaning of s 71F(2) of the NEL, the amount "specified in or derived from" the decision to adopt a value of gamma of 0.4.

**D. MATERIALLY PREFERABLE DESIGNATED NEO DECISION**

64. By reason of the grounds for review set out in Part C of this application (or any of them), AusNet Services seeks a determination as set out in Part E of this application varying the Final Decision under s 71P(2)(b) of the NEL, or setting it aside and remitting the matter to the AER under s 71P(2)(c) of the NEL.
65. A determination by the Tribunal as sought in Part E of this application will, or is likely to, result in a decision that is materially preferable to the Final Decision in making a contribution to the achievement of the NEO (a **materially preferable NEO decision**) within the meaning of s 71P(2a) of the NEL for the reasons identified in this Part D.
66. The NEO set out in s 7 of the NEL is to promote efficient investment in, and efficient operation and use of, electricity services for the long term interests of consumers with respect to price, quality, safety, reliability and security of supply of electricity, and the reliability, safety and security of the national electricity system.





67. Under section 88 of the NEL the Australian Energy Market Commission may only make a Rule if it is satisfied that the Rule will or is likely to contribute to the achievement of the NEO. Chapter 6A of the NER (Economic Regulation of Transmission Services) has been made in accordance with those requirements. It follows that adherence to the provisions of Chapter 6A of the NER will contribute to the achievement of the NEO.
68. The grounds for review set out in Part C of this application identify that the Gamma Decision materially deviates from the NER and/or from the outcomes most aligned with adherence to the NER, the RPPs, and the NEO. A determination pursuant to s 71P of the NEL correcting, or providing for the correction of, those matters (or any of them) will be a materially preferable NEO decision.
69. AusNet Services' primary contention is that, on the grounds for review described in paragraphs 41 to 58 above, and on the material that was before the AER, a value of 0.4 for gamma was not reasonably open to be adopted, and that the Tribunal should, in lieu of the AER's erroneous Gamma Decision, on the material that was before the AER, adopt a value for gamma of 0.25. On this basis, the Final Decision denies AusNet Services \$19.2 million (\$nominal) in revenue necessary to meet AusNet Services' estimated cost of corporate income tax. The addition of that amount of AusNet Services' regulated revenue requirement over the regulatory control period would materially contribute to the advancement of the NEO, for the reasons that follow:
- (a) The Gamma Decision involves the construction of a new rule in the NER which, if the AER has applied incorrectly (as AusNet Services contends), will result in a permanent overstatement of the value of imputation credits, and thus an understatement of the cost of corporate income tax.
  - (b) The correct application of the building block approach in the NER involves providing AusNet Services with a reasonable opportunity to recover at least its efficient costs (through the building blocks) of providing prescribed transmission services and complying with regulatory obligations or requirements as contemplated by the RPPs in the NER. Calibrating the total revenue allowed to AusNet Services for the efficient costs of providing the prescribed transmission services and complying with regulatory obligations or requirements is in the long term interest of consumers with respect to the three facets of the NEO:
    - (i) investment in;



- (ii) operation of; and
  - (iii) use of,

electricity services.
- (c) Allowing AusNet Services to recover at least its efficient costs, including in relation to the cost of corporate income tax, is necessary to ensure that AusNet Services can attract the necessary investment to allow it to invest efficiently in its transmission network, and that there are appropriate incentives on it to invest efficiently in the network in the long term interest of consumers with respect to price, safety, quality, reliability and security of supply of electricity.
- (d) Understatement of the cost of corporate income tax therefore results in an inadequate return for investors in regulated businesses. If the overall return to investors is depressed to a material amount due to an overstatement of the value of imputation credits, AusNet Services may not be able to attract or retain sufficient funds to make the required investments in its network, which are necessary to promote the long term interests of consumers, because investors will be undercompensated and reliability and service standards may decline. The quantum in issue here is material enough to have the above effect.
- (e) Further, the impacts of the shortfalls in AusNet Services' ability to recover at least its efficient costs if the errors in the AER's Gamma Decision are left uncorrected are that:
  - (i) the dimensions of efficiency (productive, allocative and dynamic) recognised and sought in the NEO, namely the promotion of efficient investment in, and efficient operation and use of electricity services for the long term interests of consumers, will be unrealised;
  - (ii) investment in the network may be delayed;
  - (iii) to that extent, there may be adverse impacts on the quality, safety, security and reliability of electricity supplied to consumers over the long term, which is contrary to the achievement of the NEO;
  - (iv) the weighting required by the NEO in favour of the long term interests of consumers will have been disturbed by the undue weight given to short term price reduction by reason of the errors made by the AER.





70. Thus, if the Final Decision were varied to substitute the adoption of a gamma value of 0.4 with one of 0.25, on the grounds for review described in paragraphs 41 to 58, above, the resultant decision would be a “materially preferable NEO decision”, within the meaning of s 71P(2a)(c) of the NEL.
71. In the event that, rather than varying the Final Decision, the Tribunal opted to set it aside and remit for redetermination by reference to grounds of review in respect of the Gamma Decision, then in that event too, on the currently available material, the Tribunal can be reasonably satisfied that a materially preferable designated NEO decision would result from the remitter, for the same reasons as outlined above.
72. Further, the perpetuation of error is itself a matter that impairs “regulatory certainty”, and thus the correction of error is itself conducive to the achievement of the NEO.
73. A decision correcting one or more of the errors identified in Part C of this Application would be more conducive to the avoidance of the above impacts and to the promotion of efficient investment in the AusNet Services transmission network. That efficient investment effect would, in turn, be more conducive to the efficient operation and use of the prescribed transmission services than if the Final Decision is left uncorrected.

**E. ORDERS SOUGHT**

74. AusNet Services seeks a determination under s 71P(2)(b) of the NEL that the Tribunal vary the Final Decision to calculate the estimated cost of corporate income tax using a value of 0.25 for gamma, the value of imputation credits;
75. Alternatively, in the event that the Tribunal is satisfied that one or more grounds and the criterion in s 71P(2a) of the NEL is made out but decides that the variation sought in paragraph 74 above is insufficient or inappropriate, AusNet Services seeks such other determination varying the Final Decision pursuant to s 71P(2)(b) of the NEL as the Tribunal thinks fit.
76. In the further alternative, AusNet Services seeks a determination under s 71P(2)(c) of the NEL that the Final Decision be set aside and remitted to the AER to make the decision again in accordance with such directions or recommendations as the Tribunal deems fit.

**Address for Service**

Address for Service of Documents:

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Dated 18 May 2017

Signed on behalf of the Applicant

Roxanne Smith  
Johnson Winter & Slattery  
Solicitor for the Applicant

