Draft decision

Jemena Gas Networks

Mine subsidence expenditure

August 2011

AUSTRALIAN ENERGY REGULATOR

Request for submissions

This document sets out the Australian Energy Regulator's (AER) draft decision for the mine subsidence expenditure proposed by JGN Networks (NSW) Ltd (JGN) with respect to its NSW gas networks. Following an application to the Australian Competition Tribunal (Tribunal) by JGN for a review of AER's decision on 28 June 2010, the Tribunal remitted the decision in respect of mine subsidence expenditure to the AER to remake the decision.

Interested parties are invited to make written submissions on this draft decision by 26 August 2011. Submissions should be sent electronically to AERinquiry@aer.gov.au. with the subject title 'JGN Gas Networks – mine subsidence expenditure'.

The AER prefers that all submissions be made public to facilitate an informed and transparent consultative process. Submissions should be made with reference to the *ACCC–AER information policy: the collection, use and disclosure of information*. This document is available at www.aer.gov.au under 'Publications'. Submissions will be treated as public documents unless otherwise requested. Parties wishing to submit confidential information are requested to:

- clearly identify the information that is the subject of the confidentiality claim; and
- provide a non-confidential version of the submission.

All non-confidential submissions will be placed on the AER's website.

Copies of the Tribunal's order, additional information received from JGN, this draft decision and the AER's proposed access arrangement and access arrangement information are available on the AER's website.

Inquiries about this draft decision or how to make submissions can be made by email to AERinquiry@aer.gov.au or by phone on (02) 6243 1233.

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Shortened forms

access arrangement proposal	Jemena Gas Networks (NSW) Ltd, Access arrangement, August 2009
AER	Australian Energy Regulator
BHPB	BHP Billiton
gamma	Assumed utilisation of imputation credits
JGN	Jemena Gas Networks (NSW) Ltd
June 2010 final decision	AER, Final Decision: Jemena Gas Networks access arrangement proposal for the NSW gas networks 1 July 2010–30 June 2015, June 2010
NGL	National Gas Law
NGR	National Gas Rules
Tribunal	Australian Competition Tribunal
Tribunal's order	Australian Competition Tribunal, Jemena Gas Networks (NSW) Ltd (ACT File Number 10 of 2010), 30 June 2011

1 Introduction

In June 2010, the Australian Energy Regulator (AER) released its final decision on Jemena Gas Networks (NSW) Ltd's (JGN) access arrangement proposal for its NSW gas networks.[1] The AER did not approve JGN's proposal and proposed and approved its own access arrangement and access arrangement information.[2]

On 13 October 2010 the Australian Competition Tribunal (Tribunal) granted leave under s. 245 of the National Gas Law (NGL) to JGN to apply for a review of the AER's decision. Specifically, JGN sought review of the following matters:

- the debt risk premium
- the assumed utilisation of imputation credits (gamma)
- certain non-tariff terms and conditions
- the reduction in the opening capital base to remove the effect of the rate of return on the difference between estimated and actual capital expenditure in the 2005–2010 access period
- the AER's reclassification of mine subsidence expenditure as operating expenditure.[3]

In its determination on 30 June 2011, the Tribunal varied the AER's decision in respect of the first three matters mentioned above.

The Tribunal remitted the AER's decision to disallow an amount of $4.6 million ($2004–05) in the opening capital base and to reallocate $3.1 million forecast capital expenditure on mine subsidence to forecast operating expenditure to the AER to make the decision again in accordance with the following direction:

(a) mine subsidence expenditure other than monitoring expenditure that was incurred during the 2005–10 access arrangement period be included in the opening capital base for the 2010–15 access arrangement period;

(b) forecast mine subsidence expenditure in respect of the 2010–15 access arrangement period other than monitoring expenditure be allocated as forecast capital expenditure;

(c) the inclusion of the mine subsidence monitoring expenditure in the opening capital base for the 2010–15 access arrangement period and the allocation of forecast 'monitoring' expenditure in the forecast capital expenditure be reconsidered by the AER, taking into account the following issues:

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1 AER, *Final Decision, Jemena Gas Networks, Access arrangement proposal for the NSW gas networks, 1 July 2010-30 June 2015*, June 2010.

2 AER, *Decision, Access arrangement, JGN's NSW gas distribution networks, 1 July 2010-30 June 2015*, June 2010.

3 Tribunal, *Application by Jemena Gas Networks (NSW) Ltd [2010] ACompT 8*, 13 October 2010.

- the nature of 'monitoring' and its costs

- the degree of connection between monitoring and mine subsidence expenditure that is of a capital nature for the purposes of rules 72(1), 77 and 79 of the NGR

- 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.

(d) in considering the above issues regarding mine subsidence monitoring expenditure the AER shall take into account additional information (if any) submitted by JGN provided the additional information relates only to the three issues mentioned in subparagraph 2(c).

(e) in making the decision on mine subsidence expenditure again, the AER may take into account relevant information relating to the amount of any reimbursement or compensation from the Mine Subsidence Compensation Fund that has been determined as payable to JGN by a Court (or otherwise by agreement between JGN and the Mine Subsidence Board) and quantified as at the date of the AER's re-made decision (the award amount), which is to be considered in light of any amounts that JGN is required to pay out of the award amount to any other party.[4]

The Tribunal's order requires the AER to use its best endeavours to make its decision again on mine subsidence expenditure within three months of the date of the Tribunal's determination (30 June 2011).[5]

The AER has reconsidered this matter and made this draft decision in accordance with the directions of the Tribunal.

The work undertaken by the AER in relation to mine subsidence has identified a number of small errors in the JGN access arrangement and access arrangement information that require correction. These corrections have been incorporated in the documents published with this draft decision.

The AER intends to make its final decision by 30 September 2011.

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4 Tribunal, *Jemena Gas Networks (NSW) Ltd (ACT File Number 10 of 2010)*, 30 June 2011 (Tribunal's Determination, 30 June 2011).

5 Tribunal's Determination, 30 June 2011, para 2(g).

2 Mine subsidence expenditure

2.1 The AER's June 2010 final decision

In its June 2010 final decision on JGN's proposed access arrangement the AER considered whether expenditure incurred by JGN as a result of mine subsidence should be classified as capital expenditure as proposed by JGN, or operating expenditure. The AER considered that the expenditure was not of a capital nature and therefore did not meet the definition of capital expenditure. Instead, the AER considered that the expenditure should be classified as operating expenditure.[6]

JGN proposed to roll into the opening capital base expenditure it incurred in the 2005–10 access arrangement period on mine subsidence. Because the AER considered that this expenditure did not represent capital expenditure, it removed an amount of $4.6 million ($2004–05) from the opening capital base.[7] Similarly, for the 2010–15 access arrangement period the AER reclassified $3.1 million ($2009–10) forecast expenditure on mine subsidence as operating expenditure.[8] JGN sought review of the AER's decision.

2.2 The Tribunal's determination

The Tribunal stated in its decision that mine subsidence expenditure (other than that incurred for monitoring) should be treated as capital expenditure.[9]

In relation to 'monitoring' expenditure, the Tribunal stated:[10]

> The 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 usually 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.

The Tribunal indicated that it had been unable to extract the cost of 'monitoring' from the overall mine subsidence costs. The Tribunal stated that it did not know when (if at all) the monitoring was followed by restoration works. The Tribunal also stated that it

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6 AER, *Final Decision, Jemena Gas Networks, Access arrangement proposal for the NSW gas networks, 1 July 2010–30 June 2015*, June 2010, p. 45.

7 AER, *Final Decision, Jemena Gas Networks, Access arrangement proposal for the NSW gas networks, 1 July 2010–30 June 2015*, June 2010, p. 45.

8 AER, *Final Decision, Jemena Gas Networks, Access arrangement proposal for the NSW gas networks, 1 July 2010–30 June 2015*, June 2010, p. 69–70.

9 Tribunal, *Application by Jemena Gas Networks (NSW) Ltd (No 3) [2011] ACompT* 6, 25 February 2011, para 38.

10 Tribunal, *Application by Jemena Gas Networks (NSW) Ltd (No 3) [2011] ACompT* 6, 25 February 2011, para 39.

was not possible for it to determine which of the claimed capital expenditure is in fact properly classified as capital expenditure.[11]

2.2.1 Additional information from JGN

In relation to the above matters, the Tribunal's direction requires the AER to take into account any additional information submitted by JGN.[12] To this end the AER requested JGN to provide information for both expenditure incurred in the 2005–10 access arrangement period and forecast expenditure. This included:

- details of the nature of monitoring activities; and
- the amount of those costs of monitoring activities not connected with any subsequent capital works.

JGN responded to the AER's request on 15 July 2011.[13] JGN provided general information on the process involved with mine subsidence work. Initially this process begins with BHP Billiton (BHPB) notifying JGN of its intention to mine and sends JGN ground movement predictions and preliminary stress analysis. The stress analysis shows how the proposed mining may lead to the pipeline shifting from its original position. JGN then consults with BHPB to determine the potential impact on its pipeline. If it is determined that monitoring and mitigation are required, JGN will develop and approve appropriate plans either on its own, or as a member of a 'technical committee' if other pipeline owners are affected. JGN treats the costs it incurs at this preliminary stage as operating expenses.[14]

Once a decision is made to commence a project to deal with potential stress and damage to the pipeline caused by mine subsidence, a five-stage process is commenced. The first three stages are undertaken prior to mining commencing, the next stage during mining, and the fifth stage after mining. Briefly, the stages are:

- Stage 1: pipeline excavation and installation of strain gauges (a strain gauge is a monitoring device used to collect information regarding stress on parts of the pipeline and the movement of the pipeline and the ground during mining). This stage also involves the removal of the pipe coating so that the strain gauges can be installed, and then applying a temporary coating.
- Stage 2: mitigation. This phase involves moving sections of pipeline from its original position (realigning) to prevent or mitigate damage from anticipated mine subsidence. A pipeline is under most pressure where it has been bent or curved, which typically occurs in areas where there are creeks which lie in gullies or valleys.

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11 Tribunal, *Application by Jemena Gas Networks (NSW) Ltd (No 3) [2011] ACompT* 6, 25 February 2011, para 40.

12 Tribunal's Determination, 30 June 2011, para 2(d).

13 JGN, *Expenditure on mine subsidence activities – Submission to the Australian Energy Regulator*, 15 July 2011 (JGN's submission, 15 July 2011).

14 JGN's submission, 15 July 2011, pp. 2–3.

- Stage 3: confirmation sent to the NSW Department of Trade, Investment, Regional Infrastructure and Services that JGN has conducted the necessary pre-mining work and established plans to relieve and monitor stress on the pipeline during mining.

- Stage 4: ongoing monitoring and further mitigation (as necessary). While mining activity is undertaken, JGN monitors the pipeline using field surveys and the strain gauges. Data from the strain gauges is used to assess whether the anticipated stress levels on the pipeline are realised. If necessary, further work is carried out. This may include reducing the operating pressure of the pipeline, further excavation and realignment of the pipeline, repacking of pipeline supports, removing water from pipeline trenches, repairing strain gauges and fences, and removing excess vegetation.

- Stage 5: pre-rehabilitation stage decision and rehabilitation. Once mining activity ceases, JGN conducts further analysis to determine whether any rehabilitation work is required, such as further realignment before the pipeline is reburied. Rehabilitation also involves recoating of those sections of the pipeline that have been exposed to the elements.[15]

JGN uses the term 'monitoring' to cover the collection and analysis of information from the strain gauges and field surveys. The costs of these activities are treated by JGN as capital expenditure.[16]

2.2.1.1 Mine subsidence expenditure in the 2005–10 access arrangement period

JGN submitted that it undertook mine subsidence work at five sites during the 2005–10 access arrangement period along a stretch of about 8 kms of the Wilton to Newcastle trunk pipeline. These five sites are located in the Appin region, which is located southwest of Sydney, NSW, where BHP Billiton (BHPB) conducts coal mining. Three of those sites had reached rehabilitation stage (stage 5) in 2005.[17]

Of the two remaining sites, one site, [c-i-c], had reached stages 4 and 5 during the 2005–10 access arrangement period, whereas the remaining site, [c-i-c] reached stages 2 to 4. For those two sites, JGN estimated the monitoring costs for these projects at [c-i-c] respectively.[18]

JGN submitted that the monitoring costs were connected with works of a capital nature and should therefore be treated as capital expenditure.[19] JGN submitted that a total of $4.6 million ($2004–05) should be included in the opening capital base for the 2010–15 access arrangement period, representing mine subsidence expenditure incurred during the 2005–10 access arrangement period.[20]

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15 JGN's submission, 15 July 2011, p. 4, Attachment A, pp. 3–6.
16 JGN's submission, 15 July 2011, p. 3.
17 JGN's submission, 15 July 2011, Attachment A, p. 6.
18 JGN, *Expenditure on mine subsidence activities – Confidential submission to the Australian Energy Regulator*, 15 July 2011, p. 4 (JGN's confidential submission, 15 July 2011).
19 JGN's submission, 15 July 2011, p. 4.
20 JGN's submission, 15 July 2011, p. 7.

2.2.1.2 Forecast mine subsidence in the 2010–15 access arrangement period

JGN forecasts mine subsidence expenditure during the 2010–15 access arrangement period for two sites, [c-i-c] . The [c-i-c] site is currently at stage 5, while the [c-i-c] site is at stage 4 and is expected to be completed during the period. Monitoring costs for the [c-i-c] site are forecast at [c-i-c] ($2009–10).[21] No monitoring costs are forecast for the [c-i-c] site.

JGN submitted that once mining ceases at [c-i-c] , the site is likely to require significant rehabilitation work (stage 5) as mining in the area has caused significant ground movement.[22] Therefore, JGN submitted all forecast mine subsidence expenditure in the 2010–15 access arrangement period should be treated as capital expenditure. JGN submitted that a total amount of $2.95 million ($2010) (including monitoring expenditure) should be included as capital expenditure.[23]

2.2.2 AER's consideration

The Tribunal determined that expenditure on mine subsidence, other than 'monitoring' expenditure, should be treated as capital expenditure instead of operating expenditure.[24] In accordance with the Tribunal's determination, certain activities undertaken by JGN at the mine subsidence sites constitute capital works. These include, for example, excavation of the site, realignment of sections of the pipeline, recoating of the pipeline, reburying of the pipeline and restoration of the site. Accordingly, the costs associated with these activities represent capital expenditure for the purposes of JGN's access arrangement.

The Tribunal also determined that the AER should take into account the nature of 'monitoring' and its costs and the degree of connection with mine subsidence expenditure that is of a capital nature. If there is no connection, the AER is also to take account of whether the cost of 'monitoring' can be sufficiently determined so that it can be separated from mine subsidence capital expenditure.

In this instance the AER agrees with JGN's submission that its costs of monitoring activities associated with mine subsidence should be treated as capital expenditure. The monitoring activities undertaken by JGN are closely connected with the capital works. Therefore, the costs associated with those monitoring activities should also be classified as capital expenditure. The AER considers that this assessment is consistent with the Tribunal's determination.

For one site, [c-i-c] , the total costs at stage 4 were monitoring costs only. As JGN did not carry out any capital works during that stage, there was no capital works associated with the monitoring activities.[25] However, the project should be viewed as a whole, rather than each stage being looked at individually, as each stage is interconnected. Stage 5 involves work of a capital nature. As the project as a whole involved capital works, it can be said that the monitoring activities were closely

21 JGN's confidential submission, 15 July 2011, p. 5.
22 JGN's confidential submission, 15 July 2011, Attachment A, p. 11.
23 JGN's submission, 15 July 2011, p. 7.
24 Tribunal' Determination, 30 June 2011, paras 2(a) and 2(b).
25 JGN's submission, 15 July 2011, Attachment A, p. 7.

connected with capital works and the monitoring costs should be classified as capital expenditure.

Consequently, the AER agrees with JGN that $4.6 million ($2004–05) should be included in the opening capital base for the 2010–15 access arrangement period.

Similarly, the AER also accepts JGN's submission that the forecast monitoring expenditure for the 2010–15 access arrangement period should be classified as forecast capital expenditure as it is closely connected with capital works. Therefore, the AER agrees that $2.95 million ($2010) (including monitoring expenditure) should be reclassified as forecast capital expenditure.

2.3 Mine Subsidence Compensation Fund

2.3.1 JGN's appeal to the High Court

The Tribunal's order also provides that the AER may take into account relevant information relating to the amount of any reimbursement or compensation from the Mine Subsidence Compensation Fund to which JGN is entitled.[26]

This issue arose following a recent decision by the High Court of Australia in relation to a claim for $2.77 million that JGN made against the Mine Subsidence Board. JGN's claim was originally rejected by the Mine Subsidence Board and the Land and Environment Court of NSW, and subsequently by the Court of Appeal of the Supreme Court of NSW. JGN then appealed to the High Court of Australia, which allowed the appeal. However, the High Court judgment did not determine the amount of compensation which JGN is entitled to receive from the Mine Subsidence Compensation Fund.[27]

2.3.2 AER's consideration

As JGN's claim for compensation from the Mine Subsidence Compensation Fund relates to capital expenditure incurred in the 2005–10 access arrangement period, the normal approach for dealing with the compensation would be to subtract it from JGN's capital expenditure. The net amount would be rolled into the capital base to establish the opening capital base for the 2010–15 access arrangement period. This is to prevent JGN being reimbursed twice, first through reference tariffs and again through compensation payments. However, in this instance the amount of compensation is unlikely to be known for some time. Accordingly, the AER considers that this matter should be dealt with at the next review of the access arrangement.

Rule 77(2)(a) of the NGR states that the opening capital base at the commencement of the earlier access arrangement period may be adjusted for any difference between estimated and actual capital expenditure included in that opening capital base. Given that the amount of compensation to which JGN is entitled and the net capital expenditure are unknown at this stage, the amount of capital expenditure in the 2005–10 access arrangement period which is included in the opening capital base as at

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[26] Tribunal's Determination, 30 June 2011, para 2(e).

[27] High Court of Australia, *Jemena Gas Networks (NSW) Limited v Mine Subsidence Board [2011] HCA 19*, 1 June 2011.

1 July 2010 is only an estimate. The actual amount will not be known until the matter of compensation is resolved. Therefore, at the next review of the access arrangement, the $4.6 million ($2004–05) of mine subsidence expenditure included in the opening capital base as at 1 July 2010 can be adjusted by the amount of any compensation received by JGN from the Mine Subsidence Compensation Fund (net of any amount that JGN is required to pay to any other party).

Also, in establishing the opening capital base at the next review of the access arrangement, the AER can take into account any compensation that JGN might receive during the 2005–10 access arrangement period with respect to forecast mine subsidence expenditure.

2.4 Conclusion

The AER has reconsidered its final decision regarding mine subsidence expenditure as directed by the Tribunal. In accordance with the Tribunal's determination, in this instance the monitoring activities undertaken by JGN with respect to mine subsidence are closely connected to capital works and the associated costs should be treated as capital expenditure.

Adding $4.6 million ($2004–05) to the opening capital base increases the opening capital base to $2312.7 million ($2010). Reclassifying $2.95 million ($2010) of forecast mine subsidence expenditure as capital expenditure increases total forecast capital expenditure over the 2010–15 access arrangement period to $740.2 million ($2010). Total operating expenditure decreases to $702.8 million ($2010).

The overall effect of the AER's draft decision on mine subsidence is to increase total revenue across the access arrangement period by $0.1 million ($2010). This minimal overall impact results from the two mine subsidence adjustments offsetting each other. These are:

- Adding to the opening capital base increases total revenue during this access arrangement period.
- Movement from operating expenditure to capital expenditure decreases total revenue during this access arrangement period.[28]

Tariffs will change very slightly:

- For the haulage reference service, the X factor for years 3, 4 and 5 remains at -8.33 per cent.
- For the meter reference service, the X factor for years 3, 4 and 5 changes from -0.71 per cent to -0.83 per cent.

With respect to the amount of compensation to which JGN is entitled from the Mine Subsidence Compensation Fund, this issue will be dealt with at the next review of JGN's access arrangement, as the actual amount is unknown at this stage.

[28] However, this movement will increase revenue in subsequent access arrangement periods.

3 Correction of errors

In the process of updating the JGN access arrangement and access arrangement information the AER has identified a number of errors in those documents that require correction. Under r. 68(1)(a) of the NGR the AER may vary an access arrangement during an access arrangement period if it appears to the AER that the determination is affected by a material error, or deficiency that is a clerical mistake, an accidental slip or omission. These errors are material and may cause confusion as to the basis and derivation of the elements of the access arrangement.

3.1 Wilton – Wollongong redundant pipeline

The June 2010 final decision indicates that the opening capital base of the Wilton-Wollongong pipeline should be reduced to reflect capital redundancy ($2.1m, $2004–05) in line with a previous IPART decision.[29] However, in the June 2010 final decision, the capital base tables for the earlier access arrangement period incorrectly remove $2.1m from the Wilton-Newcastle trunk pipeline instead of the Wilton-Wollongong trunk pipeline.[30] The wrong values were then incorporated in the access arrangement and access arrangement information released at the end of June 2010.

Since the Wilton-Wollongong trunk pipeline is valued at $8.5m (but incorrectly listed in the Final Decision at $10.6m at the beginning of the earlier access arrangement period) this error has a material impact, in proportional terms, on the value of the asset. Further, the error has been caused by a clerical mistake as referred to in r. 68(1)(a) of the NGR. Therefore, the AER has corrected the error in the access arrangement and the access arrangement information attached to this draft decision.

3.2 Equity raising costs

The Tribunal's recent determination relating to gamma and Debt Risk Premium (DRP) resulted in lower equity raising costs.[31] The impact of this change was correctly modelled by JGN and AER staff in June 2010 and is correctly reflected in the June 2011 access arrangement (as amended by the Tribunal), but the capital base tables of the June 2011 access arrangement information (as amended by the Tribunal) were not updated to take into account the lower costs.

The AER has therefore corrected the error in the capital base tables of the access arrangement information attached to this draft decision.

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29 AER, *Final Decision, Jemena Gas Networks – Access Arrangement Proposal for the NSW gas networks*, June 2010, p. 46.

30 AER, *Final Decision, Jemena Gas Networks – Access Arrangement Proposal for the NSW gas networks*, June 2010, p. 95.

31 This happens because the change to gamma incorporated a change to the imputation credit payout ratio, which lowered the required dividends, which increased the retained earnings available to fund new equity, which reduced the need for external equity, which reduced equity raising costs.

3.3 Contract administration operating expenditure step change

In its Final Decision the AER allowed a contract management step change in relation to JGN's Asset Management Agreement.[32] This approval was not reflected in the forecast operating expenditure tables in section 9.6 of the final decision but was reflected in the annual total revenue tables in section 10.4 of the decision.[33] This omission understated forecast operating expenditure of $1.5m ($2010) over five years.

The AER has therefore corrected the error in the access arrangement information attached to this draft decision. While this error was reflected in the access arrangement information, it was not reflected in the access arrangement itself.

[32] AER, *Final Decision, Jemena Gas Networks – Access Arrangement Proposal for the NSW gas networks*, June 2010, pp. 262–263.

[33] AER, *Final Decision, Jemena Gas Networks – Access Arrangement Proposal for the NSW gas networks*, June 2010, pp. 283–284 and p. 288.

4 The AER's draft decision

In accordance with r. 72(1), r. 77(2)(b), r. 78(b) and r. 79 of the NGR, the AER amends the access arrangement and access arrangement information as varied by the Tribunal by:

- increasing the opening capital base as at 1 July 2010 by $4.6 million ($2004–05)
- removing mine subsidence expenditure from operating expenditure and adding $2.95 million ($2010) to forecast capital expenditure.
- making all consequential amendments to the access arrangement and access arrangement information. (A marked up version of the access arrangement and access arrangement information has been released in conjunction with this draft decision.)

In accordance with r. 68(1)(a) of the NGR, the AER amends the access arrangement and access arrangement information to correct material errors.