



Australian Energy Market Commission

**Rule Determination**

**National Electricity Amendment (WACC,  
technical drafting issues) Rule 2008**

Rule Proponent  
Australian Energy Regulator

26 June 2008

Signed: .....

**John Tamblyn**  
**Chairman**  
For and on behalf of  
Australian Energy Market Commission

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## **About the AEMC**

The Council of Australian Governments, through its Ministerial Council on Energy, established the Australian Energy Market Commission (AEMC) in July 2005 to be the Rule maker for national energy markets. The AEMC is currently responsible for Rules and policy advice covering the National Electricity Market. It is a statutory authority. Our key responsibilities are to consider Rule change proposals, conduct energy market reviews and provide policy advice to the Ministerial Council as requested, or on AEMC initiative.

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## Abbreviations

AEMC	Australian Energy Market Commission
AER	Australian Energy Regulator
Commission	see AEMC
ENA	Energy Networks Association
NEL	National Electricity Law
NEM	National Electricity Market
NEO	National Electricity Objective
Rule Change Proposal	Australian Energy Regulator, <i>Request for Changes to the National Electricity Rules – Technical Drafting Issues</i> , 14 April 2008
Rules	National Electricity Rules
WACC	Weighted Average Cost of Capital

## Summary

The Australian Energy Market Commission (Commission) makes this Rule determination and attached Rule on a Rule change request from the Australian Energy Regulator (AER) relating to technical drafting issues in accordance with sections 102 and 103 of the National Electricity Law (NEL). The Rule, which is attached, will commence operation on 1 July 2008.

The Rule making process was expedited in accordance with section 96 of the NEL.

On 14 April 2008 the Commission received a Rule change proposals from the AER which related technical drafting issues in relation to the specification of the factors that the AER is required to consider in the context of its upcoming review of the rate of return and taxation parameters applying to distribution and transmission network determinations.

The specific drafting errors referred to by the AER were:

- debt risk premium: the restrictions contained in clauses 6A.6(2)(i)(2) and 6.5.4(d)(6) which limit the AER's review of the debt risk premium to the credit rating component;
- cost of debt: the terminology used to describe the return on debt required by debt holders in clauses 6A.6.2(j)(2) and 6.5.4(e)(2); and
- review of values and methodologies: the apparent limitation of the AER's revisions to previously adopted 'values' rather than previously adopted 'values or methodologies' contained in clauses 6A.6.2(j)(4)(ii) and 6.5.4(e)(ii).

As a result of the submissions received and the Commission's analysis of the proposed Rule, the Commission has generally accepted the AER's proposed Rule subject to a number of modifications made in relation to some specific matters such as the terminology used to describe the cost of debt and the scope of the AER's review of the debt risk premium.

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# 1 Australian Energy Regulator's Rule Change Proposal

## 1.1 Background

On 14 April 2008, the AER lodged a Rule change proposal with the Commission entitled 'Technical Drafting Issues'(Rule Change Proposal).<sup>1</sup>

In this Rule Change Proposal the AER seeks to address 'inadvertent drafting errors' that have been made in relation to the specification of the factors that the AER is required to consider in the context of its upcoming review of the rate of return and taxation parameters applying to distribution and transmission network determinations. The specific drafting errors referred to by the AER include:

- the restrictions contained in clauses 6A.6(2)(i)(2) and 6.5.4(d)(6) which limit the AER's review of the debt risk premium to the credit rating component;
- the terminology used to describe the return on debt required by debt holders in clauses 6A.6.2(j)(2) and 6.5.4(e)(2); and
- the apparent limitation of the AER's revisions to previously adopted 'values' rather than previously adopted 'values or methodologies' contained in clauses 6A.6.2(j)(4)(ii) and 6.5.4(e)(ii).

The AER has submitted that the Rule Change Proposal is non-controversial and has therefore requested that the Rule making process be expedited in accordance with section 96 of the NEL.<sup>2</sup>

## 1.2 Problem to be addressed by the Rule Change

### 1.2.1 Debt risk premium

The first issue raised by the AER relates to the parameters it is allowed to consider when reviewing the debt risk premium.<sup>3</sup> Clauses 6A.6.2(i)(2) and 6.5.4(d)(6) currently allow the AER to review the credit rating component of the debt risk premium but do not refer to the risk free rate component of the debt risk premium. The AER stated that while clauses 6A.6.2(i)(1)(i) and 6.5.4(d)(1) allow the AER to review the methodology used to calculate the nominal risk free rate, clauses 6A.6.2(e) and 6.5.2(e) have implicitly assumed that the nominal risk free rate will be calculated as the ten year Commonwealth annualised bond rate. The AER's concern is that if it were to conclude that a different methodology for calculating the risk free rate was appropriate, then continuing to use the ten year annualised Commonwealth bond rate for the purposes of calculating the debt risk premium could give rise to an internal inconsistency in the calculation of the cost of debt.

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<sup>1</sup> Australian Energy Regulator, *Request for Changes to the National Electricity Rules – Technical Drafting Issues*, 14 April 2008 (Rule Change Proposal).

<sup>2</sup> Rule Change Proposal, p 7.

<sup>3</sup> Rule Change Proposal, p 8.

The AER has submitted that if two alternative measures of the risk free rate were to be used in this formulation then this would give rise to a ‘theoretically inappropriate outcome’.<sup>4</sup>

### 1.2.2 Cost of debt

The second drafting issue that AER submitted needs to be addressed is the terminology adopted in clauses 6A.6.2(j)(2) and 6.5.4(e)(2) to describe the return on debt component of the weighted average cost of capital (WACC).<sup>5</sup> Clause 6A.6.2(j)(2) in its current form refers to this component of the WACC as the ‘market value of debt’ while clause 6.5.4(e)(2) uses the terminology ‘value of debt’ to describe this component of the overall WACC. Within the Rule Change Proposal, the AER observed that the term ‘market value of debt’ is a distinct concept and cannot be used to describe the return required by debt holders which, in its view, is the intent of the Rules.

### 1.2.3 Review of values and methodologies

The final issue raised in the Rule Change Proposal relates to clauses 6A.6.2(j)(4) and 6.5.4(e)(4).<sup>6</sup> These provisions set out the factors that the AER must consider if the parameters for review cannot be determined with certainty. The AER’s contention with these two Rules is that they both use the term ‘value’ rather than recognising that the task of the AER in some cases is to review the methodology used to calculate the parameter, rather than the parameter value itself.

## 1.3 Proponent’s proposed solution

### 1.3.1 Debt risk premium

On the debt risk premium issue, the AER has proposed that clauses 6A.6(2)(i)(2) and 6.5.4(d)(6) be amended to remove the apparent limitation of the AER’s review to the credit rating and to allow the AER to review both components of the debt risk premium, that is, both the credit rating and the methodology used to calculate the risk free rate.<sup>7</sup> The specific amendments proposed by the AER in this context entail inserting the following into clauses 6A.6.2(i)(2) and 6.5.4(d)(6) as follows:

clause 6A.6.2(i)(2): ~~the credit rating level~~ the debt risk premium as referred to in paragraph (e) or as subsequently revised under paragraph (h)

clause 6.5.4(d)(6): ~~credit rating levels~~ the debt risk premium referred to in clause 6.5.2(e)

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<sup>4</sup> Rule Change Proposal, p 2.

<sup>5</sup> Rule Change Proposal, p 9.

<sup>6</sup> Rule Change Proposal, p 10.

<sup>7</sup> Rule Change Proposal, p 8.



The Commission notes that the AER's explanation of its proposed changes and the actual drafting provided by the AER in Appendix B.1 in the Rule Change Proposal differ. The Commission has considered the substance of the AER's proposed changes as, under the NEL, providing a draft of a requested Rule to be made is optional.<sup>8</sup>

### 1.3.2 Cost of debt

To correct the terminology used to refer to the interest required by debt holders in clauses 6A.6.2(j)(2) and 6.5.4(e)(2), the AER has suggested replacing the terms 'market value of debt' and 'value of debt' with the term 'cost of debt'. Specifically, the AER has proposed amending clauses 6A.6.2(j)(2) and 6.5.4(e)(2) in the following manner:

clause 6A.6.2(j)(2): the need for the ~~market value~~ cost of debt to reflect the current cost of borrowings for comparable debt.

clause 6.5.4(e)(2): the need for the ~~value~~ cost of debt to reflect the current cost of borrowings for comparable debt.<sup>9</sup>

### 1.3.3 Review of values and methodologies

To address the final issue, the AER has proposed an amendment that recognises that the task of the AER in some cases is to review the value of the parameters while in other cases it is to review the methodologies used in the calculation of parameter values. The specific amendments proposed by the AER are set out below:

clause 6A.6.2(j)(4)(ii): the need for persuasive evidence before adopting a value or methodology (as the case may be) for that parameter that differs from the value or methodology that has previously been adopted for it.

clause 6.5.4(e)(4)(ii): the need for persuasive evidence before adopting a value or the method for their calculation (as the case may be) for that parameter that differs from the value or the method for their calculation that has previously been adopted for it.<sup>10</sup>

## 1.4 Consultation

On 15 May 2008, the Commission published a notice under section 95 of the NEL advising of its intention to commence the Rule change process and initial consultation on the Rule Change Proposal.

The Commission considered that the Rule Change Proposal was a request for a non-controversial rule and, accordingly, intended to expedite the Rule Change Proposal under section 96 of the NEL, subject to any written objections. The Commission took the view that the Rule Change Proposal was unlikely to have a significant effect

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<sup>8</sup> See section 92(1)(b) of the NEL.

<sup>9</sup> Rule Change Proposal, p 13.

<sup>10</sup> *ibid.*

on the National Electricity Market (NEM) as the Rule Change Proposal sought to improve the clarity of WACC parameter reviews.

The closing date for written objections in relation to expediting the Rule Change Proposal under section 96 of the NEL was 29 May 2008. No written objections were received by this date. However, in a submission received on 13 June 2008, TransGrid stated that the Rule Change Proposal may not qualify for determination under an expedited process on the basis that it is non-controversial. TransGrid was of the view that ‘...aspects of the AER’s Rule change request give rise to more significant implications for the AER’s pending WACC review than intended’.<sup>11</sup> As the Commission did not receive this objection in relation to expediting the Rule Change Proposal by 29 May 2008 the Commission continued to expedite the Rule Change Proposal under section 96 of the NEL.

In its submission TransGrid suggested that some amendments could be made to the Rule change request so that that the AER’s purpose could be achieved. TransGrid’s suggested amendments are considered in the context of the Commission’s consideration of the Rule Change Proposal.

The closing date for submissions on the Rule Change Proposal was 13 June 2008. The Commission received three submissions in response to the Rule Change Proposal from:

- Energy Networks Association (ENA);
- EnergyAustralia; and
- TransGrid.

The ENA’s submission supported the proposed drafting amendments and noted that the suggested amendments would:

‘overcome a series of minor drafting deficiencies in the existing rules, allowing for clear and effective application of the rules by the AER’.<sup>12</sup>

TransGrid and EnergyAustralia commented on the debt risk premium and cost of debt issues.<sup>13</sup> While both TransGrid and EnergyAustralia agreed that the AER’s concerns regarding these issues are valid, they did not support the AER’s proposed drafting solutions. Appendix A sets out a summary of TransGrid’s and EnergyAustralia’s comments and alternative drafting on these issues. There were no detailed comments on the review of the values and methodologies issue other than TransGrid and EnergyAustralia supporting the AER’s proposed amendment.

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<sup>11</sup> TransGrid, *Submission – AER Request for Changes to the NEL - WACC Parameters: technical drafting issues*, 13 June 2008, p. 2.

<sup>12</sup> ENA, *AEMC Rule Change – Alignment of the AER’s Review of WACC Parameters for Transmission and Distribution and Technical Drafting Amendments*, 10 June 2008, p. 1.

<sup>13</sup> TransGrid, p 2 – 3. EnergyAustralia, *Submission on AER rule request for WACC review*, 13 June 2008, p 1 – 2.

## 2 Rule Determination

### 2.1 Commission's Determination

In accordance with section 102 of the NEL the Commission made and published this Rule determination. In accordance with section 103 of the NEL the Commission determined to make the *National Electricity Amendment (WACC parameters, technical drafting issues) Rule 2008 No 5* (Rule as Made).

The Rule as Made will commence on 1 July 2008.

The Rule as Made, which is different from the proposed Rule in the Rule Change Proposal, is published with this determination.<sup>14</sup>

### 2.2 Commission's considerations

In coming to its decision in favour of the Rule as Made, the Commission has taken into account:

- the Commission's powers under the NEL to make the Rule as Made;
- the Rule Change Proposal, including the proposed provisions originally put forward by the AER;
- the submissions received from ENA, TransGrid and EnergyAustralia; and
- the Commission's analysis as to the ways in which the Rule Change Proposal will, or is likely to, contribute to the National Electricity Objective (NEO) so that the rule making test is satisfied.

For the reasons set out in section 3 the Rule as Made satisfies the Rule making test. In brief the Commission considers that the Rule as Made will, or is likely to better, contribute to the achievement of the NEO than the proponent's proposed Rule because it ensures a greater level of clarity and consistency across the Rules than the proponent's proposal. The key differences between the AER proposed Rule and the Rule as Made are explained in the analysis in section 3.

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<sup>14</sup> See section 103(3) of the NEL. It provides, amongst other things, that the Rule that is made need not be the same as the draft of the proposed Rule to which a notice under section 95 relates.

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## **3 Commission's assessment against NEL criteria**

### **3.1 Methodology**

This section sets out the Commission's reasons for its Rule determination. In assessing any proposed Rule change against the NEL criteria the first step is to consider the relevant counterfactual arrangements to which the change is being compared. In the present case, the appropriate counterfactual would be the continuation of present arrangements under which the AER would be undertaking a review of the relevant parameters; uncertain of precisely which aspects of those parameters should be subject to review.

### **3.2 Commission's power to make the Rule**

The Commission is satisfied that the Rule as Made falls within the subject matter for which the Commission may make Rules, as set out in section 34 of the NEL and schedule 1 to the NEL. The Rule as Made falls within the matters set out in section 34 of the NEL as it relates to the activities of persons participating in the NEM or involved in the operation of the NEM. Further, item 33 of schedule 1 to the NEL covers reviews by, or on behalf of, the AER, amongst other entities.

### **3.3 Rule making test and the National Electricity Objective**

The Rule making test states that the 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.<sup>15</sup> The overarching 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:

- price, quality, safety, reliability and security of supply of electricity; and
- the reliability, safety and security of the national electricity system.<sup>16</sup>

The NEO is founded on the concepts of economic efficiency (including productive, allocative and dynamic dimensions of efficiency), good regulatory practice (which refers to the means by which regulatory arrangements are designed and operated) as well as reliability, safety and security priorities.

In the Rule Change Proposal the AER explained why it considered that its proposed Rule would promote the NEO. According to the AER '...the proposed Rule change will improve the clarity and consistency of the NEL...In particular, the proposed

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<sup>15</sup> See section 88(1) of the NEL.

<sup>16</sup> See section 7 of the NEL.

Rule change is likely to enhance regulatory certainty and thus promote an environment where efficient investment is facilitated'.<sup>17</sup>

The ENA was also of the view that the Rule Change Proposal would promote the NEO. Specifically, the ENA stated that:

'...rule changes promote the National Electricity Law objective by making regulatory process associated with establishing important cost of capital parameters and methodologies efficient, and by addressing a number of technical drafting issues that have the potential to result in unintended consequences if left uncorrected'.<sup>18</sup>

Clear and consistent use of the concepts around the economic regulation of transmission and distribution networks will promote efficient investment in electricity services and regulatory certainty for the benefit of consumers. Therefore, the Commission considers the Rule as Made will or is likely to promote the NEO and, accordingly, satisfies the Rule making test. The Commission's more detailed assessment is set out below.

As the Rule Change Proposal:

- is not related to specifying direct control network services or negotiated network services, section 88A of the NEL (form of regulation factors) is not relevant to this analysis; and
- does not fall within items 15-24 and 25-26J of Schedule 1 to the NEL, section 88B of the NEL (revenue and pricing principles) is not relevant to this analysis.

### **3.4 Commission's assessment**

The Commission's assessment of the Rule Change Proposal has involved a separate consideration of the issues surrounding:

- debt risk premium;
- cost of debt; and
- review of values and methodologies.

The remainder of this section provides an overview of the Commission's assessment of each of these issues.

#### **3.4.1 Debt risk premium**

The first issue raised by the AER relates to the scope of its review of the debt risk premium and the apparent limitation of its review to the credit rating used in the derivation of the debt risk premium. Clauses 6A.6.2(i)(2) and 6.5.4(d)(6) in their

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<sup>17</sup> Rule Change Proposal, p 9.

<sup>18</sup> ENA, p. 1-2.

current form allow the AER to review the credit rating component of the debt risk premium but do not refer to the ability of the AER to consider the risk free rate used in the measurement of the debt risk premium. Although clauses 6A.6.2(i)(1)(i) and 6.5.4(d)(1) allow the AER to review the methodology used to calculate the nominal risk free rate, clauses 6A.6.2(e) and 6.5.2(e) have specified that the nominal risk free rate is to be based on the ten year Commonwealth annualised bond rate.

The Commission accepts that, by limiting its review of the debt risk premium to the credit rating component, there is a risk that there will be an internal inconsistency in the calculation of the return on debt component of the WACC. Such an inconsistency could arise if the AER were to conclude that an alternative to the ten year Commonwealth bond rate should be used for the calculation of the risk free rate. Clauses 6A.6.2(e) and 6.5.2(e) would require the AER to continue to use the ten year annualised Commonwealth bond rate for the purposes of calculating the debt risk premium. This outcome would, as the AER has pointed out, give rise to a theoretically inappropriate measure of the return on debt and may also result in a return on debt that fails to reflect the current cost of borrowings for comparable debt as required by clauses 6A.6.2(j)(2) and 6.5.4(e)(2).

EnergyAustralia and TransGrid agreed with the issue concerning, and rationale for, the AER's Rule change request but did not agree with the solution proposed. In their view, the solution proposed would allow the AER to review the entire method for calculating the debt risk premium, rather than simply an element used to derive the debt risk premium (which is currently required in the Rules). The Commission accepts the points made by EnergyAustralia and TransGrid. Any amendments should limit the review to the credit rating.

EnergyAustralia and TransGrid have suggested alternative drafting which is contained in Appendix A. Both alternatives seek to confine the review of the debt risk premium to the extent required for changes to the risk free rate. EnergyAustralia retained the drafting proposed by the AER but added a proviso limiting the review to consistency with changes to the risk free rate. TransGrid's proposal sought to address the overarching issue, being the meaning of the debt risk premium in clauses 6A.6.2(e) and 6.5.2(e). Under TransGrid approach's, clauses 6A.6.2(i)(2) and 6.5.4(d)(6) would not be amended.

The alternative solution proposed by TransGrid is preferable to the original drafting proposed by the AER. This alternative ensures that any changes to the risk free rate flowing from the AER's review will automatically flow through to the meaning of debt risk premium. At the same time this alternative will preserve the methodology used to calculate the debt risk premium.<sup>19</sup> The Commission would make one modification to the drafting proposed by TransGrid. It would add the term 'nominal' when referring to the risk free rate, to ensure consistency in terminology across the Rules.

In view of the foregoing, the Commission accepts that an amendment of the form proposed by TransGrid, with one modification, is appropriate. Incorporating this

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<sup>19</sup> That is, it is calculated as the margin between the risk free rate and the corporate bond rate for a specified credit rating.

change into the Rules would result in the following amendments to Chapter 6A and Chapter 6 of the Rules:

Clause 6A.6.2(e): The debt risk premium for a regulatory control period is the premium determined for that regulatory control period by the AER as the margin between the ~~10-year Commonwealth annualised bond rate~~ annualised nominal risk free rate and the observed annualised Australian benchmark corporate bond rate for corporate bonds which have a BBB+ credit rating from Standard and Poors and a maturity equal to that used to derive the nominal risk free rate ~~of 10 years~~.

Clause 6.5.2(e): The debt risk premium for a regulatory control period is the premium determined for that regulatory control period by the AER as the margin between the ~~10-year Commonwealth annualised bond rate~~ annualised nominal risk free rate and the observed annualised Australian benchmark corporate bond rate for corporate bonds which have a maturity equal to that used to derive the nominal risk free rate ~~of 10 years~~ and a credit rating from a recognised credit rating agency.

An amendment of this form will ensure that the return on debt continues to reflect the cost of borrowing for comparable debt in the event that the methodology used to calculate the risk free rate changes over time. This will, in turn, ensure that the appropriate investment signals are delivered to network owners and in so doing promote economic efficiency.

### 3.4.2 Cost of debt

The second issue raised by the AER relates to the terminology adopted in clauses 6A.6.2(j)(2) and 6.5.4(e)(2).

While appreciating the AER's concerns on this issue, EnergyAustralia did not agree that the use of the term 'value of debt' in clause 6.5.4(2) was not intended on the basis that it is logical if read with the broader WACC provisions in the Rules. TransGrid agreed with the AER that the terminology 'market value' and 'value of debt' were incorrect. However, TransGrid stated that the AER's proposed solution did not provide adequate guidance because the 'cost of debt' is not a defined WACC parameter and not a term to be reviewed by the AER. TransGrid has proposed amending clauses 6A.6.2(j)(2) and 6.5.4(e)(2) to state that in undertaking a review the AER must have regard to the need for the debt risk premium to reflect the current cost of borrowings for comparable debt.

The Commission agrees that the terms 'market value of debt' and 'value of debt' do not reflect the underlying intention of these provisions, which is to refer to the interest required by debt holders component of the WACC.<sup>20</sup> The cost of debt should reflect the current cost of borrowings for comparable debt. The interest

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<sup>20</sup> This is consistent with the original criteria for assessing the WACC parameters and methodology. Refer to AEMC 2006, *National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006 No 18*, p 83.



required by debt holders incorporates both the risk free rate and the debt risk premium. To be reflective of the current cost of borrowings, both aspects would need to be taken into account. Accordingly, the restriction suggested by TransGrid is unnecessary.

Along with the submissions from EnergyAustralia and TransGrid, the Commission has considered the AER's proposal to amend these provisions by replacing the terms 'market value of debt' and 'value of debt' with the term 'cost of debt'. While the Commission agrees that the term 'cost of debt' reflects the intention of the Rules, the term 'return on debt' has been used elsewhere in the Rules to describe the same concept. For example, both clause 6A.6.2(b) and 6.5.2(b) state that " $k_d$  is the return on debt". EnergyAustralia has suggested similar drafting, adding further that the term 'market' should be included when referring to the current cost of borrowing. This addition is not required since the preceding provisions (clauses 6A.6.2(i)(1) and 6.5.4(e)(1)), which refer to the rate of return more generally, require the AER to ensure that the overall rate of return is to be forward looking and commensurate with prevailing conditions in the markets for funds.

For consistency with other provisions, the Commission has therefore concluded that the terms 'market value of debt' and 'value of debt' should be replaced with the term 'return on debt'. Incorporating this change would result in the following amendments to Chapter 6A and Chapter 6 of the Rules:

clause 6A.6.2(j)(2): the need for the ~~market value of~~ return on debt to reflect the current cost of borrowings for comparable debt.

clause 6.5.4(e)(2): the need for the ~~value of~~ return on debt to reflect the current cost of borrowings for comparable debt.

Having applied the Rule making test, the Commission is satisfied that this Rule will or is likely to contribute to the attainment of the NEO. It will provide greater clarity and consistency in the scope of the AER's task and, in so doing, enhance the regulatory practice in this area.

### 3.4.3 Review of values and methodologies

The final issue raised in the AER's Rule Change Proposal relates to clauses 6A.6.2(j)(4)(ii) and 6.5.4(e)(4)(ii). In their current form these clauses only refer to the potential for the AER's review to result in a departure from previously adopted 'values' rather than recognising that the AER's review may result in a departure from previously adopted values or methodologies. TransGrid and EnergyAustralia supported the changes requested by the AER on this issue. The Commission acknowledges that the intention of the rate of return review provisions is to allow the AER to review either the value of a parameter or the methodology underlying the derivation of the parameter. For example, clause 6A.6.2(i)(1) states that:

(i) The AER may only review:

(1) the *values of and methodologies* [emphasis added] used to calculate:

(i) the nominal risk free rate;

- (ii) the equity beta;
- (iii) the market risk premium;
- (iv) the maturity period and bond rates referred to in paragraph (d); and
- (v) the ratio of the market value of debt to the market value of equity and debt.

Similarly clause 6.5.4(d) states that:

- (d) The following *matters (and the method of their calculation)* [emphasis added] may form the subject of a review:
  - (1) The nominal risk free rate referred to in clause 6.5.2(f);
  - (2) The equity beta referred to in clause 6.5.2(b);
  - (3) The market risk premium referred to in clause 6.5.2(b);
  - (4) The maturity period and bond rates referred to in clause 6.5.2(d);
  - (5) The ratio of the value of debt to the value of equity and debt referred to in clause 6.5.2(b);
  - (6) Credit rating levels referred to in clause 6.5.2(d);
  - (7) The assumed utilisation of imputation credits referred to in clause 6.5.3.

The Commission therefore broadly accepts this aspect of the AER's Rule Change Proposal subject to some additional modifications. The AER has proposed amendments to clauses 6A.6.2(j)(4)(ii) and 6.5.4(e)(4)(ii) only. For consistency, similar amendments are required to clauses 6A.6.2(j)(3), 6A.6.2(j)(4), 6.5.4(e)(3) and 6.5.4(e)(4). Given the changes discussed above, the Commission considers that for completeness, references to credit rating levels should also be included. Incorporating this into the Rules results in the following amendments to Chapter 6A and Chapter 6 of the Rules:

Clause 6A.6.2(j)(3): the need for the credit rating levels or the values attributable to, or methodologies used to calculate, the parameters referred to in paragraphs (i)(1)(ii), (iv), (v) and (i)(2) to be based on a benchmark efficient *Transmission Network Service Provider*

Clause 6A.6.2(j)(4): where the credit rating levels or the values that are attributable to, or methodologies used to calculate, the parameters referred to in paragraph (i) cannot be determined with certainty:

Clause 6A.6.2(j)(4)(ii): the need for persuasive evidence before adopting a credit rating level or a value for, or methodology used to calculate, that parameter that differs from the credit rating level, value or methodology that has previously been adopted for it.

Clause 6.5.4(e)(3): the need for the credit rating levels or the values attributable to, or the methods of calculating, the parameters referred to in paragraph (d) that vary according to the efficiency of the *Distribution Network Service Provider* to be based on a benchmark efficient *Distribution Network Service Provider*; and

Clause 6.5.4 (e)(4): where the credit rating levels or the values attributable to, or the method of calculating, parameters referred to in paragraph (d) cannot be determined with certainty:

Clause 6.5.4(e)(4)(ii): the need for persuasive evidence before adopting a credit rating level or a value for, or the method of calculating, that parameter that differs from the credit rating level, value or the method of calculation that has previously been adopted for it.

Having applied the Rule making test the Commission is satisfied that this Rule change is likely to contribute to the attainment of the NEO. It will provide greater clarity and consistency in the scope of the AER's task and, in so doing, enhance the regulatory practice in this area.

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## A Summary of Submissions

### Debt risk premium

EnergyAustralia stated that the AER's proposed drafting goes beyond resolving the technical drafting issues raised by the AER and the original intention of the Rules. The AER's proposal involves a separate consideration of the debt risk premium as part of the review (in addition to the credit ratings). EnergyAustralia would limit the review of the debt risk premium to the extent required to ensure consistency with any changes to the risk free rate.<sup>21</sup> EnergyAustralia proposed the following amendment to the AER's drafting for clause 6.5.4(d)(8) as more appropriate:

The debt risk premium referred to in clause 6.5.2(e) but only the extent necessary to ensure consistency with a value or method adopted following the AER's review of the nominal risk free rate in 6.5.2(c).<sup>22</sup>

TransGrid, like EnergyAustralia, expressed the view that the AER's proposed drafting goes beyond resolving the technical drafting issue; being that of a potential inconsistency. The AER's proposed change could facilitate a review that would encompass the entire method for calculating the debt risk premium.<sup>23</sup> TransGrid has proposed an alternative approach. Rather than amending clauses 6A.6.2(i)(2) and 6.5.4(d)(6), TransGrid would amend clauses 6A.6.2(e) and 6.5.2(e) to ensure that the methodology used to calculate the debt risk premium is maintained.<sup>24</sup> The clauses would be amended as follows:

Clause 6.5.4(d)(6): The debt risk premium for a regulatory control period is the premium determined for that regulatory control period by the AER as the margin between the ~~10-year Commonwealth annualised bond risk free~~ rate and the observed annualised Australian benchmark corporate bond rate for corporate bonds which have a maturity equal to that used to derive the risk free rate of 10 years and a credit rating from a recognised credit rating agency.

Clause 6A.6.2(e): The debt risk premium for a regulatory control period is the premium determined for that regulatory control period by the AER as the margin between the ~~10-year Commonwealth annualised bond risk free~~ rate and the observed annualised Australian benchmark corporate bond rate for corporate bonds which have a BBB+ credit rating from Standard and Poors and a maturity equal to that used to derive the risk free rate of 10 years.

### Cost of debt

While appreciating the AER's concerns, in relation to clause 6.5.4(e)(2) EnergyAustralia considered that:

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<sup>21</sup> EnergyAustralia, p 1.

<sup>22</sup> EnergyAustralia, p 2.

<sup>23</sup> TransGrid, p 3.

<sup>24</sup> That is, calculated as the margin between the risk free rate and the corporate bond rate for a specified credit rating.

- The use of the term ‘value of debt’ was intended. The provision is logical if read with the broader WACC provisions in the Rules; but
- If the Commission intended to refer to the cost of debt, minor modifications are required to the AER’s Rule change request.<sup>25</sup>

In support of the first point, EnergyAustralia noted that the term ‘value of debt’ is used repeatedly in the WACC provisions. EnergyAustralia is of the view that the underlying purpose of the clause is to ensure that the AER’s WACC decisions preserve the existing dynamic relationships between the gearing ratio, the credit rating and the market cost of debt. On this basis no change is required.

If, however the Commission did intend that clause 6.5.4(e)(2) relates to the overall return payable on debt, EnergyAustralia would make some modifications to ensure clarity and consistency with other WACC provisions:

The need for the return on debt ~~cost of debt~~ to reflect the current market cost of borrowing for comparable debt.

In EnergyAustralia’s view, the term ‘return on debt’ is preferable to cost of debt because it is defined in clause 6.5.2(b). Use of this alternative would also avoid potential confusion as to whether cost of debt refers to debt raising costs. ‘Market’ should be included to ensure that the return on debt should be based on the market costs of securing debt.

In its submission TransGrid agreed with the AER that the terminology ‘market value’ and ‘value of debt’ are incorrect. Further TransGrid agreed that the AER’s proposed Rule change does clarify the way in which the current cost of borrowing might be discerned. However, TransGrid is of the view that the AER’s proposed solution does not provide adequate guidance because ‘the cost of debt’ is not a defined WACC parameter and not a term to be reviewed by the AER. Trans Grid has proposed amending clauses 6A.6.2(j)(2) and 6.5.4(e)(2) to state that in undertaking a review the AER must have regard to the need for the debt risk premium to reflect the current cost of borrowings for comparable debt:

clause 6A.6.2(j)(2): the need for the ~~market value of debt~~ observed margin between the annualised risk free rate and the observed annualised Australian benchmark corporate bond rate for corporate bonds of equal maturity to reflect the current cost of borrowings for comparable debt.

clause 6.5.4(e)(2): the need for the ~~value of debt~~ observed margin between the annualised risk free rate and the observed annualised Australian benchmark corporate bond rate for corporate bonds of equal maturity to reflect the current cost of borrowings for comparable debt.<sup>26</sup>

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<sup>25</sup> EnergyAustralia, p 3.

<sup>26</sup> TransGrid, p 4.