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Debt risk premium proposals: Overview of key issues

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AEMC framework

- What would we observe in an ideal world?
  - Efficient operations => lowest possible prices.
  - Incentive to provide accurate forecast of CAPEX and to spend efficiently.
  - Fair return to debt and equity.
  - Stability/predictability of prices, returns, asset values.
- Examine different models to determine which gets us closest to the ideal.
- Need information from stakeholders to make a properly informed decision:
  - How would regulators implement a different set of Rules?
  - How would the behaviour and incentives of businesses change under a different set of Rules?

Issues raised in submissions

- Separately consider:
  - Whether some form of averaging approach should be adopted; and
  - The characteristics of the benchmark (Credit rating, tenor, data source).

What should be averaged?

- Cost of debt is sum of r_f and DRP. There is a range of views about what should be averaged:
  - Average both (total cost of debt).
  - Average neither.
  - Average DRP only.
  - Average r_f for cost of debt *and* equity.

How should the average be computed?

- 5-year or 10-year average?
- Does the averaging period have to match the assumed tenor of debt?
- Should the benchmark index (whatever it is) be observed daily or less frequently?

Are there updates during the regulatory period?

- Submissions suggest different approaches for the regulatory period:
  - Estimate r_d using some sort of trailing average approach, and then hold fixed for the 5-year regulatory period.
  - Update r_d mechanically each year during the regulatory period. But is this a "determination" and therefore reviewable?
  - Have a fixed r_d for the regulatory period calculated by applying 80% weight to the trailing average and 20% weight to the rate at the time of the determination.
  - Apply the trailing average to the existing asset base and the rate at the time of the determination to new CAPEX.

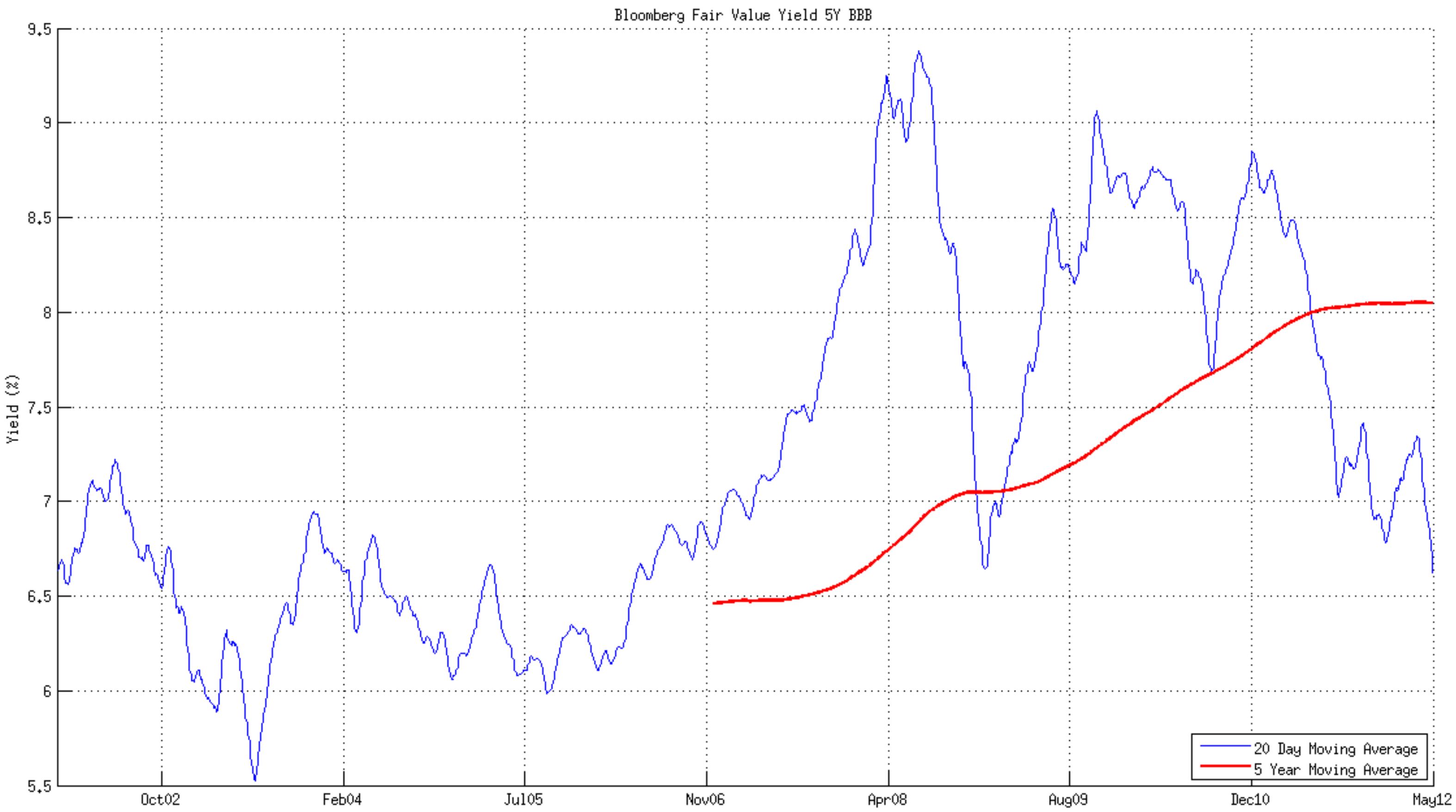
How would the trailing average be given effect?

- The details of how the trailing average is to be implemented could be codified in the Rules.
- The regulator could be given the option of considering the use of a trailing average approach.
  - Would this have to be an all-or-nothing decision, or could the regulator give some weight to the trailing average and some weight to the rate on the day?
  - How would the regulator determine whether or not to use the trailing average approach? Should some principles be set out in the Rules?
  - Would transition arrangements be required if a change of approach was to be made?

How would the trailing average be given effect?

- The regulated business could be given the option of choosing a trailing average or the rate on the day.
  - How long would the choice have to stay in effect?
    - Need to avoid gaming;
    - But need to recognise that market conditions can change materially over a relatively short period.
- In general, would transition arrangements be required to allow businesses to unwind existing hedges etc.?

Current market situation: Total BBB yield



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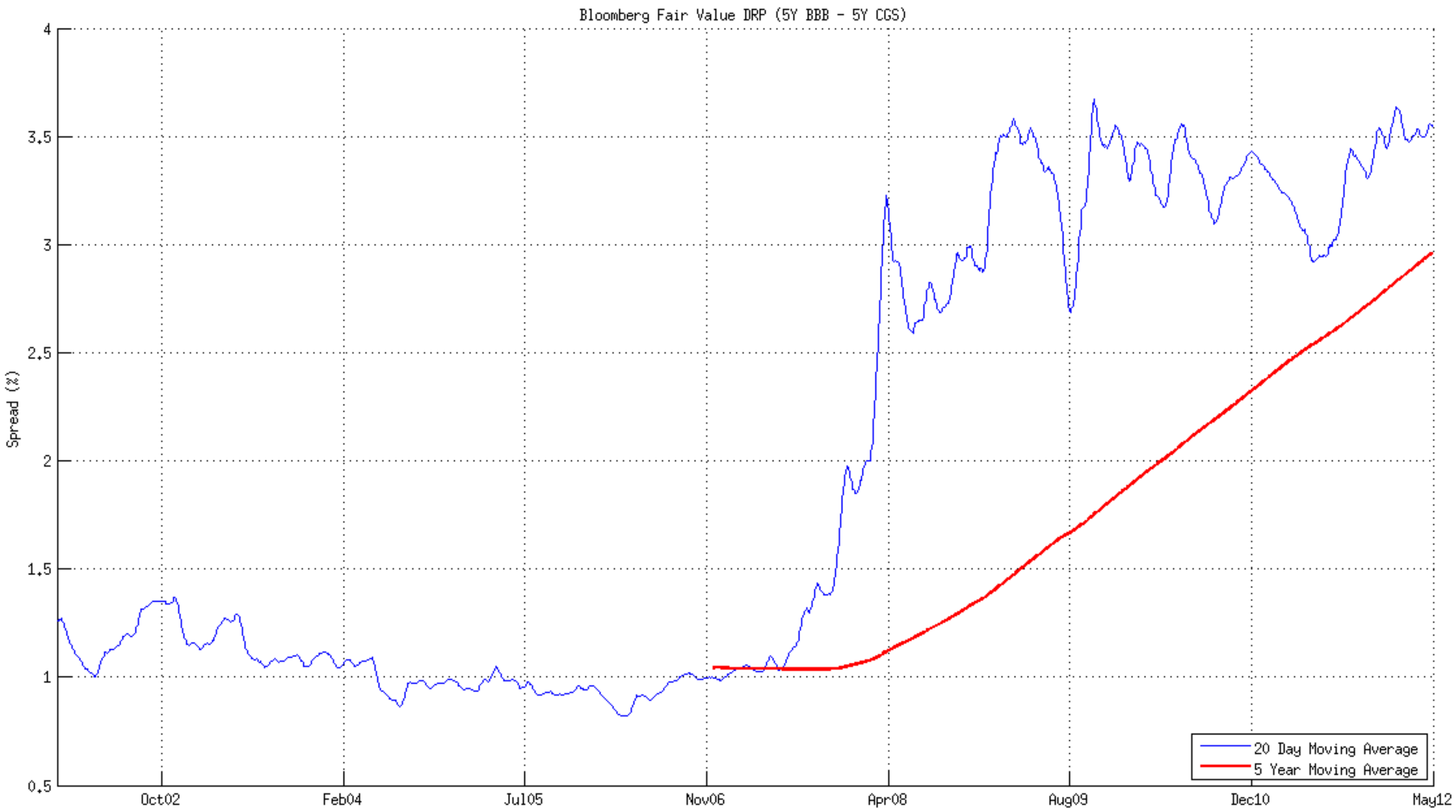
Current market situation: BBB DRP



Proposed work plan

- Examine a range of scenarios:
  - Rising interest rates/DRP;
  - Falling interest rates/DRP.
- Examine a range of regulatory approaches:
  - Current Rules;
  - Averaging approaches.
- Consider the effect that different approaches have on:
  - Volatility of cash flows;
  - Volatility of asset and equity values;
  - Incentives in relation to CAPEX.

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