Consultation Notice – 21 June 2012

Additional round of consultation on cost of debt issues for the Economic Regulation of Network Service Providers Rule Change Requests

1 Background

The AEMC held a workshop on cost of debt 18 May 2012. The purpose of the workshop was to further explore issues raised by one part of the Energy Users Rule Change Committee's (EURCC) rule change request, being the proposed trailing averaging approach to estimating the cost of debt allowance. This rule change request is currently being considered as a consolidated rule request in conjunction with the Australian Energy Regulator's (AER) rule change request on the economic regulation of Network Service Providers (NSPs).

The cost of debt workshop generated constructive debate on new ideas and issues both for stakeholders and the AEMC to consider. There is support from a range of stakeholders for the overall concept of using a historical trailing average approach to the cost of debt. However, stakeholders' views and approaches regarding detailed design features and implementation differ.

Some stakeholders have further developed their thinking on the details subsequent to their submission to the Directions paper and the workshop. On 8 June 2012, the AEMC received a supplementary submission from the Queensland Treasury Corporation (QTC) that proposes an alternative trailing average approach to estimating cost of debt allowance. This proposal is a revision of the approach QTC advocated in its submission to the Directions Paper. In particular, QTC's revised proposal seeks to address some of the matters raised at the workshop about different re-financing approaches of NSPs and potential transitional issues associated with moving to an averaging approach to determining the cost of debt allowance.

In light of the cost of debt workshop outcomes and QTC's supplementary submission, the AEMC has decided to hold a further short round of stakeholder consultation prior to publishing its draft rule determinations. **The AEMC invites further submissions from stakeholders by 5 July 2012**.

This consultation is limited to the trailing average approach aspect of estimating the cost of debt allowance. The AEMC strongly encourages stakeholders to direct their responses to the questions noted below and the QTC's supplementary submission more generally.

2 Summary of QTC's supplementary submission

Under QTC's revised proposal, the benchmark cost of debt would equal a ten-year weighted moving average of the ten-year total corporate cost of debt. The moving average would be re-calculated quarterly based on the prevailing ten-year corporate cost of debt and updated annually.

According to QTC, these parameters are consistent with an efficient diversified debt funding strategy that would be used by a benchmark NSP in the absence of regulatory distortions.
All increases in the benchmark debt balance would be weight-averaged into the benchmark cost of debt allowance using the prevailing ten-year corporate cost of debt. The size and timing of the debt increases would be based on the benchmark debt profile in the NSP's post-tax revenue model (PTRM).

In the spreadsheet model provided by QTC with its supplementary submission, the benchmark cost of debt can be expressed as a simple weighted moving average or as an internal rate of return (IRR). QTC states that the IRR approach would be more consistent with the effective interest rate calculation that is used under the current Accounting Standards.

An important aspect of QTC's revised approach is that the benchmark credit rating, data source and methodology used to estimate the prevailing value of the ten-year total corporate cost of debt would continue to be determined as part of the revenue/pricing determinations by the AER.

QTC's proposal contains two transitional arrangements to support a potential move to the new calculation methodology:

- A NSP could transition to the new methodology during its next regulatory period. The timing would effectively coincide with the maturity of existing swap hedges that may have been used by NSPs to lock in a fixed base interest rate until the end of the current regulatory period.

- The starting value for the benchmark cost of debt would equal the average ten-year total corporate cost of debt during the reset period. QTC states that by using prevailing rates rather than historical rates, this approach would avoid the potential for investment distortions on NSPs' existing debt and remove the opportunity for potential gaming by NSPs.

QTC's proposal also provides details on how NSPs could align their base interest rate with a benchmark cost of debt that is calculated using a ten-year moving average.

QTC's supplementary submission, including its illustrative spreadsheet model is available on the AEMC's website at www.aemc.gov.au.

3 Consultation questions for stakeholders – QTC's proposal

This consultation is a further opportunity for stakeholders to comment on the issues raised by the trailing average aspect of the EURCC's proposal, and the range of submissions and suggestions on this issue during the AEMC's consideration of the rule change proposal. We have set out below a number of questions relating to QTC's updated proposal on which we would particularly welcome comments. Stakeholders may also want to have regard to the questions raised in the slides presented by Professor Stephen Gray from SFG Consulting at the cost of debt forum. These slides are available on the AEMC's website.

1. As compared to the proposal put forward by the EURCC in the rule change proposal and ETSA/ Citipower/ Powercor's proposal in response to the Directions Paper, what are the advantages and disadvantages of QTC's proposal?

2. If QTC's proposal was to be implemented, how would such a move affect a NSP's current financing practices? What impact would it have on its risk management practices?

3. Would QTC's approach reduce the overall level of risk associated with debt financing for NSPs? If so, are there any implications for cost of equity?

4. What changes (if any) should be made to the approach to calculation of the cost of equity if this moving average approach is applied to debt to ensure a consistency of approach?

5. If the moving average approach is adopted, should the average be calculated based on dollar-weighted average of the rates or by calculating the effective interest rate (the IRR of all future payments on the debt) or some other method?

6. Is the proposal for re-calculating the cost of debt on a quarterly basis reasonable? What other frequency of data points (to the proposed quarterly basis) could be used in calculating the cost of debt and why would this be an improvement?

7. Should this approach be an option under the rules? If so, should the regulator or the NSP have the discretion to exercise the option and why?

4 Revised timetable for the rule change process

On 21 June2012, the AEMC gave notices under gave notices under section 107 of the National Electricity Law (NEL) and section 317 of the National Gas Law (NGL) to extend the period of time for the making of the Draft Rule Determinations for the Economic Regulation of Network Service Providers rule change requests to 23 August 2012. Accordingly, the revised timetable for the remaining stages of the rule change process is set out below.

Milestone	Date
Consultation Notice published on additional round of consultation on cost of debt issues	21 June 2012
Notice to extend the time period for making of the draft rule determinations under section 107 of the NEL and section 317 of the NGL issued	21 June 2012
Submissions close on additional round of consultation on cost of debt issues	5 July 2012
Release of Draft Rule Determinations	By 23 August 2012
Submissions on Draft Rule Determinations close (at least 6 weeks from release of Draft Rule Determinations)	4 October 2012
Release Final Rule Determinations by (within 6 weeks from close of submissions on Draft Rule Determinations)	By 15 November 2012

5 Lodging Submissions

Submissions are to be lodged online or by mail by 5 July 2012 in accordance with the requirements set out below. In order to be given full consideration, submissions must be received by the AEMC by the close of this consultation period. Submissions that are received after this time may not be given full weight. Where practicable, submissions should be prepared in accordance with the Commission's guidelines for making written submissions on rule change requests. The Commission publishes all submissions on its website subject to a claim of confidentiality.

All enquiries on this project should be addressed to Richard Khoe on (02) 8296 7800.

5.1 Lodging a submission electronically

Electronic submissions must be lodged online via the Commission's website, www.aemc.gov.au, using the "lodge a submission" function and selecting the project reference code ["ERC0134"]. The submission must be on letterhead (if submitted on behalf of an organisation), signed and dated.

Upon receipt of the electronic submission, the Commission will issue a confirmation email. If this confirmation email is not received within 3 business days, it is the submitter's responsibility to ensure the submission has been delivered successfully.

5.2 Lodging a submission by mail

The submission must be on letterhead (if submitted on behalf of an organisation), signed and dated. The submission should be sent by mail to:

Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Or by Fax to (02) 8296 7899.

The envelope must be clearly marked with the project reference code: ERC0134.

Except in circumstances where the submission has been received electronically, upon receipt of the hardcopy submission the Commission will issue a confirmation letter. If this confirmation letter is not received within 3 business days, it is the submitter's responsibility to ensure successful delivery of the submission has occurred.