



Australian Energy Regulator Request for Changes to
the National Electricity Rules - WACC Parameters:
Technical Drafting Issues Consultation

TransGrid Submission to AEMC

13 June 2008

1 Introduction and Summary

This submission has been prepared by TransGrid in response to the Australian Energy Regulator's ('AER') request to the Australian Energy Market Commission ('AEMC') for a 'non-controversial rule change' to address 'a number of technical drafting issues' arising from the treatment in chapters 6A and 6 of the National Electricity Rules ('NER' or 'the Rules') as per the AER's letter to the AEMC of 14 April 2008. The AER's rule change request concerns elements of the Rules that govern its pending review of the parameters to be applied in determining the regulatory weighted average cost of capital ('WACC').

TransGrid is concerned that aspects of the AER's rule change request give rise to more significant implications for the AER's pending WACC review than intended. It follows that, in its current form, the AER's rule change request may *not* qualify for determination under an expedited process on the basis that it is 'non-controversial'. We attempt to explain the nature and potential consequences of these implications below, and suggest a number of amendments that could be made to the Rule change request in order for it to achieve the stated purpose of the AER's rule change proposal.

TransGrid also notes that the AER has lodged a Rule change proposal to align its review of the WACC parameters for electricity transmission and distribution services. TransGrid supports this aspect of the AER's proposal.

2 Discussion

The AER's rule change request involves three proposed changes to clauses arising under 6A.6.2 and 6.5.4 of the NER that govern the AER's forthcoming review of the regulatory WACC. The substance of these clauses involves:

- the scope of the AER's review of the debt risk premium;
- the terminology for the cost of debt, being a factor to which the AER must have regard; and
- the terminology for referring to the risk free rate and credit rating parameters.

TransGrid has concerns about the first and second elements of the AER's Rule change request in particular, as set out below.

3 Scope of Review of the Debt Risk Premium

The current provisions in the Rules 6A.6.2(e) and 6.5.2(e) for determining the *debt risk premium* (the margin to be applied over the risk free rate to reflect debt default risk) specify that it is to be calculated according to the difference between the annualised yield on a ten year Commonwealth government bond and that on a ten year corporate bond rate of BBB+ credit rating.

Consistent with this approach, the Rules 6A.6.2(c) and 6.5.2(c) for determining the *nominal risk free rate* specify that it is to be calculated on a moving average basis from the annualised yield on Commonwealth government bonds with a maturity of ten years.

The Rules provide 6A.6.2(i) and 6.54(d) that the AER may only review:

- 'the values of and methodologies used to calculate' the nominal risk free rate; and
- 'the credit rating level' used to calculate the debt risk premium.

The AER points out in its Rule change request that a review by reference to these provisions could give rise to potential inconsistency, and offers the (hypothetical) example of where it may conclude that there was 'persuasive evidence' that a different methodology for calculating the risk free rate was appropriate (say, the use of a five year maturity Commonwealth government bond). In that circumstance, the method prescribed in the Rules for calculating the debt risk premium would be inconsistent with the method for calculating the risk free rate – because the two components would involve using annualised yields from bonds of different maturities (five years and ten).

TransGrid agrees that such an outcome would involve inconsistency, and that the Rules effectively preclude the AER from making a review finding (other than retaining the status quo for determining the risk free rate) capable of resolving this inconsistency.

The AER proposes to address this inconsistency in a way that appears to widen the scope of its review to include 'all components of the "debt risk premium", and thereby encompass matters beyond the relatively narrow question of 'the credit rating level' to be adopted. It proposes to do this by adding the reference in 6A.6.2(i)(1) and 6.5.4(d) that defines the scope of its review to include:

Clause 6A.6.2(i)(1)

- 'the debt risk premium; and'

Clause 6.5.4(d)

- 'the debt risk premium as referred to in clause 6.5.2(e)'

However, the consequence of such a Rule change is that the AER's review would encompass the entire method for calculating the debt risk premium (irrespective of whether or not it sought to alter the method for deriving the risk free rate), rather than simply the choice of credit rating used to derive the debt risk premium, as is currently required by the Rules. Essentially, the AER would be able to rewrite the specification of the debt risk premium, as defined in clauses 6A.6.2(e) and 6.5.2(e). This in turn would allow the AER, say, to move away from the market-determined, credit rating based assessment of the debt margin that is currently prescribed in the Rules. For example (and hypothetically), the AER would have the ability to decide to fix the debt margin by reference to some specified percentage figure, with this locked in until its next review.

TransGrid submits that, as drafted, this is *not* a non-controversial change, because it allows the AER's review to extend beyond the scope for the debt premium parameter, as currently defined in the Rules. In so doing, it alters the level of discretion afforded to the AER in a context where the scope of its existing discretion was the product of a comprehensive and consultative process that reached a conscious decision on those elements of the regulatory WACC that should be subject to AER review and those that should not.

TransGrid recognises that this is most likely an unintended consequence of the drafting of the proposal. Furthermore, TransGrid recognises that the stated rationale for the Rule change has merit. As currently drafted, the scope of the AER's discretion in reviewing the methodology and value of the risk free rate may give rise to inconsistency between the value of or methodologies used to derive the risk free rate and the debt premium, TransGrid believes that this should be addressed by modifying the requested Rule change so as to make it less expansive and to bring the revised Rule more closely into line with its original intent. Specifically, TransGrid proposes that clauses 6A.6.2(e) and 6.5.2(e) should be amended as follows:

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 annualised risk free rate ~~the 10-year Commonwealth annualised bond 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.~~

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 annualised risk free rate ~~10 year Commonwealth annualised bond 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.

These suggested amendments to the AER's requested Rule change would ensure consistency in the methodology for determining the risk free rate and debt premium parameters of the WACC, without extending the scope of the AER's review beyond that which is presently specified in the Rules.

4 Terminology for the Cost of Debt

The Rules currently set out a number of considerations to which the AER must have regard when it is undertaking its review of WACC parameters. These include a reference to the need for the 'market value' [Rule 6A.6.2(j)(2)] or 'value' [Rule 6.5.4(e)(2)] of debt 'to reflect the current cost of borrowings for comparable debt'.

The AER makes the valid observation that the terminology - being either 'market value' or 'value' of debt - does not seem to make sense in the context of the AER's review. The AER's rule change request proposes to address this by clarifying that this clause should refer to the 'cost' of debt (which implies a reference to the relevant rate of interest) rather than its 'value' or 'market value', where the latter involves an implied reference to the capital value of debt (which changes with but is different from the relevant rate of interest).

TransGrid agrees that the AER's rule change request does clarify the reference in the Rules to the way in which the current cost of borrowings might be discerned from market observations of debt instruments. However, these suggested changes appear to stop short of providing relevant and clear guidance to the AER in undertaking its review because 'the cost of debt' is not a defined WACC parameter, and is not a term to be reviewed by the AER.

In addition, as they presently appear in the Rules, clauses 6A.6.2(j)(2) and 6.5.4(e)(2) would be consistent with the AER reviewing the debt premium directly, with this reflecting the current cost of borrowing for corporate debt (ie, the margin at the time of the review). However, Rules 6A.6.2(i) and 6.5.4(d) only entitle the AER to review 'the credit rating level' element of the methodology for determining the debt risk premium.

TransGrid submits that clauses 6A.6.2(j)(2) and 6.5.4(e)(2), which effectively instruct the AER to have regard to the current cost of borrowings, should be amended to read as follows:

Clause 6A.6.2(j)(2)

the need for the observed margin between the annualised risk free rate and the observed annualised Australian benchmark corporate bond rate for corporate bonds of equal maturity ~~the market value of debt~~ to reflect the current cost of borrowings for comparable debt

Clause 6.5.4(e)(2)

the need for the observed margin between the annualised risk free rate and the observed annualised Australian benchmark corporate bond rate for corporate bonds of equal maturity ~~the value of debt~~ to reflect the current cost of debt of borrowings for comparable debt

These suggested amendments to the AER's requested Rule change would clarify the existing ambiguity in those clauses that guide the AER as to how it should approach the review as well as bringing that guidance into line with the scope of the AER's review as currently provided for in the Rules. The distinction between this suggested amendment and that requested by the AER is that this amendment does not inadvertently imply a scope for the AER's review beyond that which is presently specified in the Rules.

5 Clarifying the distinction between 'values' and 'methodologies'

The AER has correctly highlighted that the 'risk free rate' is a methodology not a value, and so it therefore seeks to change 6A.6.2(j)(4) & 6.5.4(e)(4) to allow value and/or methodologies to be changed. TransGrid agrees that this requested Rule change is sensible and non-controversial.