



13 June 2008

Dr John Tamblyn
Chairman
Australian Energy Markets Commission
PO Box A2449
Sydney South NSW 1235

570 George Street
Sydney NSW 2000
Telephone (+61) 2 9269 4171
Facsimile (+61) 2 9269 4696
Harry Colebourn
Executive Manager
Network Regulation & Pricing

Address all mail to
GPO Box 4009
Sydney NSW 2001
Australia

By email to submissions@aemc.gov.au

Dear Dr Tamblyn 

EnergyAustralia's submission on AER rule request for WACC review

EnergyAustralia welcomes the opportunity to respond to the Australian Energy Regulator's (AER) request for a rule change on the AER's review of WACC parameters. EnergyAustralia supports the AER's proposed rule changes in relation to:

- The alignment of the AER's review of the WACC parameters for transmission and distribution and the associated amendments to the NER.
- The AER's proposed amendment to clause 6.5.4(e)(4)(ii) of the NER to reflect that the AER's WACC values may also result in a revised methodology.

EnergyAustralia supports any improvements that ensure clarity in the scope of the AER's WACC review and also supports an expedited process to improve drafting where the current rules are inconsistent or unclear.

However, EnergyAustralia is concerned with the drafting of the proposed rule changes in relation to clause 6.5.4(d) and clause 6.5.4(e)(2) of the NER (and equivalent clauses in Chapter 6A). While we support the AER's intent to provide further clarity to the existing rules, the proposed drafting changes alter the scope of the existing clauses beyond technical drafting changes. We have outlined our concerns and suggested an alternative approach to addressing the AER's issues below.

Debt risk premium

EnergyAustralia agrees with the AER that the existing drafting could result in an inconsistency between the nominal risk free rate adopted following a review under clause 6.5.4(d)(1), and the nominal risk free rate used in the calculation of the debt risk premium under 6.5.2(e).

EnergyAustralia is concerned that the proposed introduction of clause 6.5.4(d)(8) goes beyond resolving technical drafting issues and involves separate consideration of the debt risk premium as part of the review (in addition to credit rating levels). This goes beyond what was originally intended in the Rules.

EnergyAustralia submits that the AER's drafting should be amended by the AEMC to ensure that the proposed rule change only addresses the technical issues identified by the AER. EnergyAustralia considers that the following suggested amendment to Clause 6.5.4(d)(8) is a more appropriate response to address the problem identified by the AER :

The debt risk premium referred to in Clause 6.5.2(e) but only to 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).

Substitution of 'value of debt' with 'cost of debt'

EnergyAustralia recognises the concerns raised by the AER in relation to clause 6.5.4(e)(2). However, we consider that:

- The use of the term 'value of debt' in clause 6.5.4(e)(2) is logical if read with the broader WACC provisions in the NER.
- If the AEMC intended to refer to the cost of debt in clause 6.5.4(e)(2), EnergyAustralia considers minor modifications are required to the AER's proposed rule change.

EnergyAustralia reviewed clause 6.5.4(e)(2) in the broader context of clauses 6.5.2 to 6.5.4. Based on this review, EnergyAustralia submits that it is likely that policy makers had not erred in referring to the 'value of debt' in clause 6.5.4(e)(2). This would mean that the AER's proposed technical amendment is not required.

In support of its view, EnergyAustralia notes that 'value of debt' is used repeatedly in the WACC section and forms part of the parameters that the AER is required to undertake. Further, the AER's substitute term, 'cost of debt', is seemingly addressed in the preceding clause 6.5.4(e)(1). This clause refers to both debt and equity when the definition of 'rate of return' is recognised as being the WACC formula in its entirety as set out in clause 6.5.2(b), and therefore applies to both the return on debt as well as equity. For these reasons, it is more likely that policy makers intended to use the term 'value of debt' for this provision.

EnergyAustralia contends that the existing clause provides that, when determining the value of debt for the gearing ratio, the AER must consider the same constraints that would apply to a benchmark efficient firm in changing its own gearing ratio. This is the impact on the firm's credit rating (comparable debt) and the subsequent impact on the cost of debt funds (current cost of borrowings) that would create a natural constraint on the use of debt as an efficient source of funds. Effectively this ensures that the AER does not review gearing decisions without considering their impact on other WACC parameters.

Moreover, EnergyAustralia contends that the underlying purpose of this clause is to ensure that the AER's WACC decisions preserve the dynamic relationships that exist between the gearing ratio, the credit rating and the market cost of debt, that but for the operation of the clause as written, would be absent from the list of considerations for the AER's WACC review. For instance, it would not be sensible to make separate decisions in relation to the value of debt and the credit rating which logically should be considered together to maintain consistency.

If on the other hand, clause 6.5.4(e)(2) was intended by policy makers to relate to the overall return payable on debt, EnergyAustralia notes that the AER's proposed drafting would require modification to ensure clarity and provide consistency with other WACC provisions in the NER. EnergyAustralia submits that minor modifications to the AER's proposed rule change are required including:

- The term 'cost of debt' should be substituted with the term 'return on debt'. Return on debt is more appropriate as it is defined in clause 6.5.2(b) of the NER. Removing cost of debt would also remove potential confusion over whether cost of debt refers to debt raising costs.
- The inclusion of 'market' before 'cost of borrowing' would be consistent with the existing provision in Chapter 6A and would also ensure clarity that the return on debt should be based on the market costs of securing debt.

Based on these views, EnergyAustralia's suggested amendment to the AER's proposed drafting for Clause 6.5.4(e)(2) is set out below:

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

In summary, EnergyAustralia seeks confirmation from the AEMC that the purpose of Clause 6.5.4(e)(2) is to ensure that the AER takes into account the dynamic inter-relationships between the elements of the WACC as they relate to debt and the ultimate cost of debt. This is to ensure that the AER has regard to linkages between parameters and does not undertake isolated reviews in Clause 6.5.4(d).

If you require any clarification of this matter, please do not hesitate to contact me or Mr. Jon Hocking on (02) 9269 2054.

Yours sincerely,



Harry Colebourn
Executive Manager Network Regulation & Pricing