

14 April 2008

Dr John Tamblyn
Chair
Australian Energy Market Commission
PO Box A2449
Sydney South NSW 1235

Dear Dr Tamblyn,

Re: Request for Changes to the National Electricity Rules

Please find attached two separate Rule change proposals relating to the AER's pending review of the Weighted Average Cost of Capital (WACC) parameters, as follows:

- 1) Alignment of the AER's review of the WACC parameters for transmission and distribution (Attachment A), and
- 2) Technical drafting issues (Attachment B).

The Rule change proposals have been prepared in accordance with Clause 8(1) of the NEL Regulations, and include the text of the AER's proposed Rule amendments. The AER proposes that both of the attached Rule change proposals be treated as non-controversial in nature and expedited under section 96 of the NEL.

Should you have any questions or queries regarding the attached proposals, please contact Mr Blair Burkitt on (03) 9290 1442.

Yours sincerely,



Michelle Groves
Chief Executive Officer

ATTACHMENT A

NATIONAL ELECTRICITY LAW

REQUEST FOR A NON-CONTROVERSIAL RULE CHANGE

RELATING TO

ALIGNMENT OF THE AER'S REVIEW OF THE WACC PARAMETERS FOR TRANSMISSION AND DISTRIBUTION

A. NAME AND ADDRESS OF PERSON MAKING THE REQUEST

Australian Energy Regulator
Level 38
360 Elizabeth Street
MELBOURNE VIC 3000

B. INTRODUCTION

In accordance with Chapter 6 of the National Electricity Rules (NER) the AER is about to commence its review of the Weighted Average Cost of Capital (WACC) parameters to apply for the purposes of a building block proposal submitted by an electricity Distribution Network Service Provider (DNSP). The 31 March 2009 completion date for the distribution WACC review in clause 6.5.4(b) was chosen so that the outcome of the review would apply to the upcoming Queensland and South Australian distribution resets. For electricity transmission, chapter 6A of the NER requires the AER to initiate its first review of the WACC parameters applicable to Transmission Network Service Providers (TNSPs) on 1 July 2009.

The AER considers there is merit in aligning the distribution and transmission WACC reviews so that the review and consultation for both sectors is undertaken concurrently. This will ensure consistency in approach and treatment of key issues (where appropriate).

Given the immediate requirement to have WACC parameters in place for the pending distribution resets, the AER considers that alignment is best achieved by bringing forward the completion date for the transmission WACC review to 31 March 2009. Accordingly, this Rule change proposal seeks an amendment to clause 6A.6.2(g) to effect the alignment.

C. REQUEST FOR EXPEDITED PROCESS

The AER proposes that this Rule change proposal be consulted and determined under an expedited process in accordance with section 96 of the NEL. Bringing forward the completion date for the transmission WACC review to 31 March 2009 will not change the first electricity TNSP covered by the AER's review. Accordingly, the

AER considers that the proposed Rule change is unlikely to have a significant effect on the national electricity market and therefore proposes that it be treated as non-controversial in nature.

C. STATEMENT OF ISSUES

i Current Rules

With respect to the timing of the AER's review of the electricity distribution WACC parameters, clause 6.5.4(b) of the NER requires that:

The first review is to be concluded by 31 March 2009 and further reviews are to follow at intervals not exceeding, in any case, 5 years.

For the equivalent review of the electricity transmission WACC parameters, clause 6A.6.2(g) of the NER requires that:

The AER must initiate its first review on 1 July 2009 and every five years thereafter.

ii The problem

Under the Rules as currently written, the timing of the AER's review of the distribution and transmission WACC parameters is not aligned.

The AER considers there is merit in aligning the distribution and transmission WACC reviews so that the review and consultation for both sectors is undertaken concurrently. Alignment will ensure consistency in approach and treatment of key issues (where appropriate). It appears to represent the original intent of the Standing Committee of Officials (SCO) of the Ministerial Council on Energy (MCE) in drafting Chapter 6 of the NER.

iii Proposed solution

Given the immediate requirement to have WACC parameters in place for the pending distribution resets, the AER considers that alignment is best achieved by bringing forward the completion date for the transmission WACC review. Accordingly, the AER proposes that clause 6A.6.2(g) of the NER be amended to read:

The AER must conclude the first review by 31 March 2009 and every five years thereafter.

The AER's proposed Rule change will result in alignment of the transmission and distribution WACC reviews, with no adverse consequences.

iv How the proposed solution will contribute to the achievement of the National Electricity Objective

The National Electricity Objective (NEO) as stated in section 7 of the NEL is:

...to promote the 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,

reliability and security of supply of electricity and the reliability, safety and security of the national electricity system.

Given that, in the AER's view, the proposed Rule change is non-controversial in nature, it is not expected to have a significant effect on the national electricity market. Despite this obvious corollary, the AER considers that the proposed Rule change will contribute to the NEO by promoting efficient investment in electricity networks across the NEM. In particular, alignment of the transmission and distribution WACC reviews will enhance regulatory certainty by:

- ensuring consistency in the AER's approach and treatment of WACC issues (where appropriate) for the electricity network sector as a whole, and
- allowing interested parties to contribute to the consultation process for both industries simultaneously.

v *Benefits and costs and potential impact on those likely to be affected by Rule change*

The most significant benefit of the Rule change proposal is that it is likely to enhance regulatory certainty for the electricity network sector as a whole. In addition, given that many of the WACC issues are consistent across both industries, there are obvious synergies for the AER and interested parties in undertaking a holistic sector-wide review as a single five-yearly process.

The benefits of alignment have been acknowledged by the policy-makers in drafting the Chapter 6 distribution Rules. In the early drafts of Chapter 6 the AER was required to initiate its first review of the distribution WACC parameters on 1 July 2009.¹ The SCO selected this date so as to align the timing of the AER's Chapter 6 review of the WACC parameters for distribution with that specified in Chapter 6A for transmission.² In the final version of Chapter 6 however, the AER's review of the distribution WACC parameters was brought forward to conclude by 31 March 2009 so as to assist the transition to the first distribution resets for Queensland and South Australia. In its communiqué the MCE acknowledged merit in re-aligning the timing of the distribution and transmission WACC reviews, but noted that this was a matter for the AEMC.³

The Rule change proposal is not expected to impose any costs on TNSPs or electricity consumers. Clause 6A.6.2(h) of the NER provides that the outcome of a review only applies to resets where the revenue proposal is submitted after the completion of the AER's WACC review. Therefore regardless of whether the timeframe for the transmission WACC review is brought forward to 31 March 2009 or not, the first TNSP to submit a revenue proposal under the AER's first completed WACC review

¹ For example, see *National Electricity (Economic Regulation of Distribution Services) Amendment Rule 2007*, April 2007, clause 6.5.2(g).

² Standing Committee of Officials of the Ministerial Council on Energy, *Changes to the National Electricity Rules to establish a national regulatory framework for the economic regulation for electricity distribution – Explanatory Material*, April 2007, p.14.

³ Ministerial Council on Energy, 14th Meeting Communique, Perth, 13 December 2007, p.2.

is Powerlink (due to submit 31 May 2011). For clarity, Transend, Transgrid and EA will remain subject to the existing transmission WACC parameters in chapter 6A for the next regulatory period, as they are due to submit revenue proposals before 31 March 2009.

APPENDIX A.1 – PROPOSED AMENDMENTS

RULE CHANGE REQUEST – ALIGNMENT OF THE AER’S REVIEW OF THE WACC PARAMETERS FOR TRANSMISSION AND DISTRIBUTION

TEXT OF PROPOSED AMENDMENTS

Rule change — aligning the distribution and transmission WACC reviews

Clause 6A.6.2(g) be amended to read:

- (g) The *AER* must ~~initiate~~**conclude** the first review ~~on 1 July 2009~~**by 31 March 2009** and every five years thereafter.

Clause 6A.6.4(c) be amended to read:

- (c) The *AER* must ~~initiate~~**conclude** the first review ~~on 1 July 2009~~**by 31 March 2009** and every five years thereafter.

ATTACHMENT B

NATIONAL ELECTRICITY LAW

REQUEST FOR A NON-CONTROVERSIAL RULE CHANGE

RELATING TO

TECHNICAL DRAFTING ISSUES

A. NAME AND ADDRESS OF PERSON MAKING THE REQUEST

Australian Energy Regulator
Level 38
360 Elizabeth Street
MELBOURNE VIC 3000

B. INTRODUCTION

In accordance with the National Electricity Rules (NER) the AER is about to commence its five-yearly review of the Weighted Average Cost of Capital (WACC) parameters to apply in electricity distribution and transmission determinations.⁴

The AER has identified a number of technical drafting issues in Chapters 6A and 6 of the NER with respect to the pending WACC review. The AER considers that a rule change appears to be the only sensible means of addressing what appear to be inadvertent drafting errors on the part of the policymakers.

This Rule change proposal merely seeks to restore an outcome which reflects the intent of the policymakers in drafting Chapters 6A and 6 of the NER.

C. REQUEST FOR EXPEDITED PROCESS

The AER proposes that this Rule change proposal be consulted and determined under an expedited process in accordance with section 96 of the NEL. The AER considers that the changes proposed are unlikely to have a significant effect on the national electricity market and therefore proposes that the AEMC treat it as non-controversial in nature.

D. STATEMENT OF ISSUES

1. Debt risk premium

⁴ Under the Rules as currently written, the timing of the AER's review of the distribution and transmission WACC parameters is not aligned. The AER's proposal to align the timing of the reviews is the subject of a separate Rule change proposal to the AEMC.

i Current Rules

Clauses 6A.6.2(e) and 6.5.2(e) of the NER initially lock in the methodology for determining the debt risk premium, as follows:

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 and the observed annualised Australian benchmark corporate bond rate for corporate bonds which have a maturity of 10 years and [in the case of Chapter 6A] a BBB+ credit rating from Standard and Poors or [in the case of Chapter 6] a credit rating from a recognised credit rating agency.

Clauses 6A.6.2(i), 6A.6.4(d) and 6.5.4(d) set out the matters that the AER may review as part of its five-yearly transmission and distribution WACC review.

Clauses 6A.6.2(i)(2) and 6.5.4(d)(6) only allow the AER to review the credit rating component of these clauses as part of its WACC review. However, the credit rating is only one component of the debt risk premium. The reference in the above clause to the '10 year Commonwealth annualised bond rate' is a reference to the risk free rate. All components of the risk free rate are open for review for both transmission and distribution [ie. under clauses 6A.6.2(i)(1)(i) and 6.5.4(d)(1) respectively].

ii The problem

A literal interpretation of the NER means that even if (hypothetically), at the conclusion of its WACC review, the AER determined that there was 'persuasive evidence' to change the methodology for calculating the risk free rate [as allowed under clauses 6A.6.2(i)(1)(i) and 6.5.4(d)(1) of the NER], the AER would still be required to apply the initial methodology to calculate the risk free rate for the purposes of calculating the debt risk premium. This would clearly lead to an internally inconsistent and theoretically inappropriate outcome.

Given that the NER provides clear discretion for the AER to review the methodology for calculating the risk free rate in one area, such an outcome for the debt risk premium is arguably inconsistent with the intent of the policymakers, and may inadvertently limit the scope of the AER's WACC review.

iii Proposed solution

The AER considers that clauses 6A.6.2(i)(2) and 6.5.4(d)(6) of the transmission and distribution Rules (respectively) need to be amended so as to allow the AER to review all components of the 'debt risk premium', rather than solely the 'credit rating level' component thereof.

For transmission, the AER proposes that clause 6A.6.2(i)(2) of the NER be amended to read:

the debt risk premium as referred to in paragraph (e) or as subsequently revised under paragraph (h).

Equivalently, for distribution the AER proposes that clause 6.5.4(d)(6) of the NER be amended to read:

the debt risk premium referred to in clause 6.5.2(e);

The AER's proposed Rule change will result in correction of the internal inconsistency identified, and in doing so will provide clarity on the scope of the AER's WACC review.

2. Cost of debt

i. Current Rules

Clause 6A.6.2(j)(2) states that one of the factors the AER must have regard to in undertaking a transmission WACC review is:

the need for the market value of debt to reflect the current cost of borrowings for comparable debt

The equivalent distribution provision [clause 6.5.4(e)(2)] uses the exact same wording but with the word 'market' deleted.

ii. The problem

The terminology '(market) value of debt' does not seem to make much sense in this context. The (market) value of debt is a distinct concept from the 'cost of debt' under the specified WACC equation, and therefore it does not make sense to suggest that the (market) value of debt needs to reflect the current cost of borrowings for comparable debt. On this basis it would be difficult for the AER to have regard to such a matter in reviewing the cost of debt or the WACC more generally.

iii. Proposed solution

The accompanying determination to the transmission rules more logically includes the principle that:

the cost of debt should reflect the current cost of borrowings for comparable debt;⁵

In other words, the correct wording appears to have been used in the accompanying Chapter 6A explanatory document [with direct reference to clause 6A.6.2(j)(2)], but when this was inserted into the NER, an inadvertent drafting error appears to have been made.

The AER proposes that clauses 6A.6.2(j)(2) and 6.5.4(e)(2) be amended to properly reflect the intent of the AEMC.

⁵ AEMC, Rule Determination – National Electricity Amendment (Economic Regulation of Transmission Services) Rule 2006 No.18, 16 November 2006, p.83.

3. Departure from previously adopted 'values' and/or 'methodologies'

i. Current Rules

For transmission, the NER locks in initial values for the equity beta, market risk premium, gearing ratio and gamma. The NER then allows the AER to review these initially locked in values, however where these parameters cannot be determined with certainty, clause 6A.6.2(j)(4)(ii) requires:

the need for persuasive evidence before adopting a value for that parameter that differs from the value that has previously been adopted for it.

For distribution, clause 6.5.4(e)(4)(ii) reiterates the transmission clause, with the only difference being that the NER did not lock in any initial WACC values for distribution.

ii. The problem

Clauses 6A.6.2(j)(4)(ii) and 6.5.4(e)(4)(ii) only refer to departing from previously adopted 'values', however for the risk free rate and debt risk premium it is a 'methodology' or a 'credit rating level' rather than a value that is initially locked in.

iii. Proposed solution

The AER proposes that these two clauses be amended to reflect the fact that the AER's WACC review may also result in a revised methodology or credit rating level for the purposes of calculating a particular parameter or set of parameters.

4. How the proposed solution will contribute to the achievement of the National Electricity Objective

The National Electricity Objective (NEO) as stated in section 7 of the NEL is:

...to promote the 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, reliability and security of supply of electricity and the reliability, safety and security of the national electricity system.

Given that, in the AER's view, the proposed Rule change is non-controversial in nature, it is not expected to have a significant effect on the national electricity market. The proposed changes merely seek to give effect to the original intent of the policymakers.

Despite this, the AER considers that the proposed Rule change will improve the clarity and consistency of the NER, and is therefore likely to contribute to the NEO. In particular, the proposed Rule change is likely to enhance regulatory certainty and thus promote an environment where efficient investment is facilitated.

5. Benefits and costs and potential impact on those likely to be affected by Rule change

As the AER's proposed Rule changes merely seek to reflect the intent of the policymakers, there is not expected to be any substantive benefits or costs as a result. Notwithstanding this, improvements to the clarity and consistency of the NER are likely to enhance regulatory certainty for the electricity network sector as a whole.

APPENDIX B.1 – PROPOSED AMENDMENTS

RULE CHANGE REQUEST – TECHNICAL DRAFTING ISSUES

TEXT OF PROPOSED AMENDMENTS

Rule change 1— to allow the AER to review all components of the debt risk premium

Clause 6A.6.2(i)(1) be amended to read:

- (1) the values of and methodologies 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, as set out in this clause 6A.6.2 or as subsequently revised under paragraph (h); and
 - (vi) **the debt risk premium; and**

Clause 6.5.4(d) be amended to read:

- (d) The following matters (and the method of their calculation) may form the subject of a review:
 - (1) the nominal risk free rate referred to in clause 6.5.2(c);
 - (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(e);
 - (7) the assumed utilisation of imputation credits referred to in clause 6.5.3;
 - (8) **the debt risk premium referred to in clause 6.5.2(e)**

Rule change 2 — replacing the '(market) value of debt' with the 'cost of debt'

Clause 6A.6.2(j)(2) be amended to read:

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) be amended to read:

the need for the ~~value~~ **cost** of debt to reflect the current cost of borrowings for comparable debt;

Rule change 3 — including 'methodology' in addition to 'values'

Clause 6.5.4(e)(4)(ii) be amended to read:

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.

Clause 6A.6.2(j)(4)(ii) be amended to read:

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.