AEMC

Economic Regulation of Network Service Providers
Cost of Debt Workshop

Agenda

18 May 2012

Radisson Blu Hotel Sydney, 27 O'Connell St Sydney

This workshop is being held by the AEMC to further explore the issues raised by the Energy Users Rule Change Committee's (EURCC) rule change request on the determination of the cost of debt allowance under the National Electricity Rules (NER). This rule change request is being considered in conjunction with the Australian Energy Regulator's (AER) rule change request on the economic regulation of Network Service Providers (NSPs). The purpose of this workshop is two-fold.

The first is to inform stakeholders of an empirical study on cost of debt methodologies the AEMC has commissioned SFG Consulting (SFG) to undertake as part of the Commission's assessment of the rule change requests. This study is primarily focussed on assessing the merit of the EURCC's proposal to determine the cost of debt allowance for regulated NSPs using a historical trailing average approach. At the workshop, SFG will outline its approach to the study and identify issues for stakeholders to comment on. In particular, participants will be asked to comment on and discuss scenarios for a historical trailing averaging methodology they consider should be tested by SFG in its empirical study.

The second purpose of this workshop is for the AEMC to understand the key issues where there is broad stakeholder agreement and areas where there is disagreement on the EURCC's proposed historical trailing average approach. The AEMC is assessing the historical trailing average approach to estimating the cost of debt allowance. As part of that assessment the AEMC will consider whether the approach is an option that should be available to the AER under the NER or should be prescribed as the appropriate approach in the NER. Even if the AEMC ultimately concluded that a historical trailing average approach should not be prescribed as the appropriate approach in the NER, the work being undertaken as part of the rule change process may be helpful for stakeholders if this option is considered by the AER in the future.

The AEMC is not proposing to discuss the EURCC's proposal to determine the cost of debt differently for government-owned NSPs from privately-owned NSPs at the workshop. The AEMC is reviewing the responses to the Directions Paper on this issue.

To help attendees contribute effectively to the workshop, the AEMC has prepared some questions for discussion. The workshop will not necessarily work through each question sequentially, but it would be helpful if attendees came prepared to discuss the range of issues covered by the questions. The agenda for the workshop and discussion questions follow.

Order of Workshop Proceedings

Time	Item	Speaker/Chair
8.30am	**Registration - tea/coffee**	
9.00am	Introduction and overview of objectives	Paul Smith, Senior Director AEMC
9.05am	**Part 1 Cost of debt methodologies**	
	Overview by Professor Stephen Gray and discussion questions and comments/views from participants	Chair: Paul Smith, Senior Director AEMC Presentation: Professor Stephen Gray, SFG Consulting
10.15am	Morning-tea break	
10.30am	**Part 2 – Detailed consideration of historical trailing average approach**	
	Discussion questions and comments/views from participants on implementation of a historical trailing average approach to cost of debt	Chair: Paul Smith, Senior Director AEMC
12:00pm	**End of workshop - followed by light lunch**	

Discussion Questions – Part 1

1. Do you agree that the proposal to use a historical average (rather than the prevailing cost of debt at the time of the determination) is independent of the choice of credit rating, tenor, and data source?
2. What are the possible variations of the averaging approach?
    a. What is to be averaged (tenor, rating, etc.)?
    b. Does the averaging period have to match the benchmark tenor?
    c. Will the average apply to the cost of debt or just the debt risk premium (DRP) component?
    d. How is the average to be computed (daily, monthly, and annually)?
    e. What data will be used? How will the index/benchmark be formed?
    f. Would the historical average rate or the current rate be applied to new debt financing to be raised over the regulatory period?
    g. Would the DRP be fixed for the regulatory period, or would there be periodic updates?
3. If the rules relating to the estimation of DRP are materially changed, this is likely to lead to a material change in the way NSPs manage their debt portfolios, and may affect incentives in relation to new capital expenditure (capex).
    a. Are these relevant considerations?
    b. If so, how do NSPs currently manage their debt portfolios and how might this change under an averaging approach?
    c. What are the current incentives in relation to capex, and how might this change under an averaging approach? If the prevailing cost of debt at the time of a determination is materially different from the trailing average, will this alter the business's proposed capex program submitted to the regulator? Also, in this scenario, would there be an incentive to over- or under-spend on capex during the regulatory period?

Discussion Questions – Part 2

1. Is the EURCC's proposal of establishing the cost of debt using historical trailing average compatible with the overall framework for estimating a forward-looking rate of return?

2. Should the historical trailing approach only apply to the DRP component or the overall cost of debt allowance (including the risk free rate)?

3. What are the other key features that stakeholders consider should form part of a historical trailing average approach, e.g. time period, credit rating, etc?

4. If a historical averaging approach is to be adopted, what details should be inserted into the rules and what should be left to the discretion of the regulator?

5. Is it feasible for a regulator (with sufficient discretion under the rules) to give partial weight to an historical average or is it an all-or-nothing proposition? How would a regulator determine whether and when to use an historical average?

6. The introduction of a trailing average approach appears to necessitate some ex post adjustments to NSP revenue allowances and then tariffs. Should this be done annually or through an end of period “true up”? What is the nature of the changes to the NER that would be required for these revenue and tariff adjustments?

7. Some NSPs have argued that transitional arrangements would be needed before a historical trailing average approach could be introduced because of the financing approaches adopted by NSPs under the current NER. What aspects of NSPs financing approaches would lead to transitional arrangements being required? Do the same issues apply for all NSPs?