From:
To:
Cc:
Subject: FW: Debt questions 1 [SEC=OFFICIAL]
Date: Friday, 28 January 2022 1:10:32 PM
Attachments:

OFFICIAL

Hi Glenn,

1. The ability to switch to the trailing average was permitted as a result of a National Electricity Rules (NER) rule change made in 2012. The final rule change gave the AER the power to set the cost of debt using a trailing average, using a current or 'on on-the-day' rate measured prior to the commencement of the regulatory control period, or using a combination of the two – this flexibility remains, although it is now allowed for in the National Electricity Law. The original Australian Energy Market Commission (AEMC) rule change material is all available here. The rule change on debt, which was considered as part of a package of broader rule changes submitted by the AER, was submitted by a group of major energy users on the grounds it would give a more stable return on debt through time and would avoid windfall gains and losses from the allowed return deviating from regulated businesses embedded/actual debt costs (I've attached the rule change request by the Energy Users Committee – see page 43 and CEPA's recommendations). There were consulting reports prepared for the AEMC by SFG consulting. These are all on the AEMC webpage for the rule change and I've attached probably most relevant 27 February 2012 report (done before the draft rule change was made). The Feb 2012 SFG report covers the pros and cons of a trailing average for debt (I think a later report by SFG also looked at the use of a trailing average for equity). The way the AER has looked at the trailing average, at least for a number of years, is as tranches of on-the-day debt and is explained in the attached 2016 AER ActewAGL decision. Our ActewAGL decision on the trailing average and its application was upheld on appeal to the Australian Competition Tribunal (ACT). Note the appeal was not on the use of the trailing average per se, as this was explicitly allowed in the NER, rather the appeal was on whether we should use a transition or not. I'll also note that in later decisions we focused on the principles for a full transition and dropped much of the simplified math explanation given the Australian Competition Tribunal was critical of this part of our decision in its reasoning.
2. We did touch on the difference between the promised yield and expect return on debt here. McKenzie and Partington also considered it briefly in a report they did for the AER here in the context of comparing the allowed return on equity to the observed promised yield on debt.

Please let me know if you need anything further, or if you have any questions.

Kind Regards, Esmond

Esmond Smith
Senior Financial Advisor
Australian Energy Regulator

From: Anderson, Warwick
Sent: Friday, 28 January 2022 8:19 AM
To: Smith, Esmond
Subject: FW: Debt questions 1 [SEC=OFFICIAL]

OFFICIAL

Hi Esmond

Can you please respond to Glenn. Point out that the original rule change request came from consumers looking for a more stable RoR

Warwick

From: Glenn Boyle
Sent: Friday, 28 January 2022 6:52 AM
To: Anderson, Warwick
Subject: Debt questions 1

Hi Warwick

A couple of questions about the cost of debt calculations.

1. I (vaguely) gather that the switch to a 10-year trailing average was motivated (at least in part) by a wish to recognise the empirical reality that firms don't do their n-year borrowing all in one year but instead tend to spread it over n years — and so the 'overall' cost reflects the cost in each of those n years, not just the cost today. Can you point me to something that analyses and discusses this point in detail? (the Dec 2021 omnibus paper has a good discussion of the options going forward, but doesn't say much about how the current situation was arrived at)
2. From what I can gather, the inputs to the trailing average calculation are ex ante bond yields (as opposed to ex post bond returns). But yields are promised returns, not expected returns, and it's the latter that are required for WACC computations. If default risk is positive (which it will be for BBB-rated bonds), then expected returns are strictly less than yields, and so the use of yields biases the estimated cost of debt upwards. Has this point been discussed by the AER, and if so can you point me to it?

Cheers

'Nothing is impossible if you don't have to do it yourself.'

Glenn Boyle

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