TransGrid

TransGrid Revenue Proposal
2018/19 – 2022/23

Appendix T

Frontier Economics:

Return on debt transition

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Dear Nicola

Return on debt transition

This letter is in response to your request for us to provide an opinion on the transition from a return on debt allowance based on the rate on the day approach to one based on the trailing average approach.

We have approached this task on the basis that the benchmark efficient entity (BEE) is not a regulated business, but rather a hypothetical efficient business operating in a competitive market for the relevant services – the approach taken by the Australian Competition Tribunal (Tribunal) in *PIAC-Ausgrid*.[1]

In our view, the framework for considering the question of the return on debt transition is straightforward, and the approach that should be adopted is as follows:

> Determine the efficient debt management approach that the BEE would have adopted under the previous National Electricity Rules (Rules). This determines the debt portfolio that the BEE has at the end of the last regulatory control period (RCP) under the previous Rules. Call this the "starting debt portfolio";

> Determine the efficient debt management approach that the BEE would adopt under the current Rules. This determines the debt portfolio that the BEE would construct under the current Rules. Call this the "target debt portfolio";

> Determine how, and over what period, the BEE would most efficiently convert the starting debt portfolio into the target debt portfolio. This involves determining the

[1] Applications by Public Interest Advocacy Centre Ltd and Ausgrid [2016] ACompT 1 [914].

efficient debt portfolio that the BEE would have in place in each year over the transition period;

> The regulatory allowance in each year should match the efficient cost of the efficient debt portfolio that the BEE would have in place in each year.

> This framework really suggests nothing more than that the regulatory allowance for each year of a RCP should equate to the efficient cost that would be borne by the BEE in that year. We note that equating the regulatory allowance with the efficient cost is consistent with the Rules in that:

  – Rule 6A.6.2(h) requires that the allowed return on debt for each regulatory year must be estimated such that it contributes to the achievement of the allowed rate of return objective; and

  – Rule 6A.6.2(c) defines the allowed rate of return objective, requiring that the allowed return must be commensurate with the efficient financing costs of the BEE.

> Thus, the combination of these two provisions in the Rules requires the allowed return on debt to be set so that it is commensurate with the efficient financing costs of the BEE every year. This is precisely the approach that we have set out above – determine what debt portfolio the BEE would have in place each year, and then determine the efficient cost of that debt portfolio for that year.[2]

The target portfolio

The AER has determined, and we agree, that the target debt portfolio is a "trailing average" portfolio. That is, under the current Rules, the BEE should be considered to issue 10% of its debt financing requirements each year in the form of 10-year fixed rate bonds.

The starting portfolio

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2 Appendix U: The AER's application of a transition to the trailing average approach

The *PLAC-Ausgrid* Tribunal[3] determined that the efficient debt management approach is determined without reference to the particular regulatory rules that may apply from time to time. Rather, the BEE should be considered to be an unregulated business operating in a competitive market. The evidence suggests that such businesses tend to adopt an approach of issuing long-term fixed rate debt on a staggered maturity basis – consistent with the trailing average regulatory allowance.

The appropriate transition approach

In the case where the BEE begins with a trailing average debt portfolio and where the target is a trailing average debt portfolio, no transition is required – the BEE would maintain the same trailing average debt management approach throughout. Thus, in every year the BEE's efficient cost of debt would be the 10-year trailing average cost of debt.

Yours sincerely,

Stephen Gray

Director

[3] Applications by Public Interest Advocacy Service Ltd and Ausgrid Distribution [2016] ACompT 1 (26 February 2016).

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