Addendum—Return on debt errata (June 2015)

Following the publication of this issues paper on 10 June 2015, correspondence with several Victorian businesses identified that the Issues Paper did not reflect all of the differences between the proposals in relation to the return on debt component of the rate of return. Specifically, there are further differences between the Victorian businesses' proposals in relation to:

- the choice of data series used to estimate the return on debt
- the nomination of averaging periods over which to estimate the return on debt, and the timing of annual return on debt updates.

This addendum is an errata to the original Issues Paper. It explains the differences between the Victorian businesses return on debt proposals that were not identified in the original version of the Issues Paper.

Choice of data series

The Issues Paper outlined that in recent AER determinations, we decided to use a simple average of the RBA and Bloomberg BVAL data series to estimate the return on debt. The Issues Paper also outlined that we made certain adjustments to the RBA and BVAL data series. These adjustments included to extrapolate the RBA and BVAL data series to a 10 year term, consistent with our benchmark debt term, where necessary. The Issues Paper (page 51) then stated:

> The Victorian distributors have proposed a variation on this approach. Specifically, the distributors have proposed to use:
>
> – For the first averaging period, a process that selects the data series (RBA or Bloomberg) which best fits the observed bond data for future averaging periods
>
> – For subsequent averaging periods, the averaging approach proposed by the AER unless there is a material (60 basis point) departure between the estimates from the two sources, in which case the "best fit" process in the first bullet point is used to select the best estimate.

This text incorrectly suggested the Victorian businesses have the same proposal in respect to this issue. However, there are differences between the proposals. These differences are summarised in the following table.

Table A- 1 Choice of data series—Summary of proposals

AusNet Services	CitiPower and Powercor	Jemena	United Energy
Proposed simple average of RBA and Bloomberg BVAL data series, consistent with recent AER decisions. However, departed from recent AER decisions on data series extrapolation. Proposed the SAPN method.	Proposed simple average of RBA and Bloomberg BVAL data series, consistent with recent AER decisions. However, departed from recent AER decisions on data series extrapolation. Proposed an annual process to select between the AER and SAPN methods.	Proposal is correctly described in original text of issues paper, except that Jemena's proposal is not limited to selecting between the RBA and BVAL data series. Rather, Jemena proposed that all BBB rated third party data series with published yields of seven years or greater, and a simple average of all such data series, be tested against observed bond yields using Jemena's proposed 'best fit' approach. Jemena also departed from recent AER decisions on data series extrapolation. Proposed an annual process to select between the AER and SAPN methods.	Proposed that a range of third party data series and other information be tested each year against observed bond yields using United Energy's proposed 'best fit' approach.[1] The data series that United Energy proposed be tested each year are the RBA data series, the Bloomberg BVAL data series, an empirically derived Nelson-Siegel yield curve estimated following United Energy's proposed method, an empirically derived par yield curve estimated following United Energy's proposed method, and any other sources of published yield information on A and BBB rated corporate bonds with yields of seven years and greater. United Energy also departed from recent AER decisions on data series extrapolation. Proposed an annual process to select between the AER and SAPN methods.

Source: Regulatory proposals.[2]

1 This information would include both aggregated yield information at different tenors, to the extent that such information is published, and data on the yields and spreads for individual bond issues.

2 AusNet Services, Regulatory proposal, April 2015, pp. 343–345; CitiPower, Regulatory proposal, April 2015, pp. 234–235;

Further, we note that United Energy's proposal departs from the Rate of Return Guideline (the Guideline) because it includes data series which are not independent third party published data series.

Averaging periods and timing of debt updates

The Issues Paper noted that, in regard to how the time-varying return on debt is reflected in the annual revenue allowance, the Guideline proposed that the averaging period should be 'as close as practical to the commencement of each regulatory year'. The return on debt for the first regulatory year of each regulatory period will typically be incorporated into the final decision of a revenue or price cap determination.[3] However, the return on debt for subsequent years of a regulatory period will typically occur after the regulatory period has commenced, and so will need to be incorporated through an annual update process.

For these subsequent regulatory years, in recent determinations we decided that the averaging period should end at least 25 business days before the annual pricing proposals are submitted, to give us 15 days in which to prepare the updates to the building block model (in particular, the X factor). The Issues Paper (p. 51) then stated:

> In their submissions the distributors have proposed a somewhat different approach. They propose that the return on debt be estimated as close as possible to the regulatory year to which it applies, but that any adjustment to tariffs not be made until the following year. The distributors argue that this provides them sufficient time to engage with retailers and other stakeholders on the annual tariff proposal before the update is reflected in tariffs.

The one year delay in the adjustment to tariffs correctly reflects Jemena's and United Energy's proposals.[4] However, AusNet Services, CitiPower and Powercor did not propose this delay.

On the nomination of averaging periods, each Victorian business nominated an averaging period confidentially in their proposal for the first regulatory year of the regulatory control period. However, for subsequent years, CitiPower, Jemena, Powercor and United Energy proposed to depart from the Guideline condition that the averaging period is nominated before the start of the regulatory period.[5] AusNet Services did not propose this departure, and has nominated averaging periods for all five years of the regulatory period.

Jemena, Regulatory proposal—Attachment 9.2—Rate of return proposal, April 2015, pp. 96–101, Powercor, Regulatory proposal, April 2015, pp. 242–243; and United Energy, Regulatory proposal—Rate of return on debt attachment, April 2015, pp. 24–30.

3 For the Victorian businesses, this means the mandatory revocation and substituion decision that the AER is required to publish by the end of April 2015.

4 Jemena, Regulatory proposal, April 2015, p. 104; and United Energy Regulatory proposal—Rate of return on debt attachment, April 2015, pp. 31–33. United Energy also considered that this process would provide United Energy with the flexibility to choose an averaging period which may occur at any time within the calendar year so as to better align with its debt management practices.

5 CitiPower, Regulatory proposal, April 2015, pp. 235–237; Jemena, Regulatory proposal—Attachment 9.2—Rate of return proposal, April 2015, pp. 101–102, Powercor, Regulatory proposal, April 2015, pp. 243–245; and United Energy, Regulatory proposal—Rate of return on debt attachment, April 2015, pp. 31–36. CitiPower, Jemena and Powercor departed from this Guideline condition for regulatory years 2017–20, whereas United Energy departed from this Guideline condition for regulatory years 2018–20.

However, AusNet Services has proposed to depart from the Guideline condition that each averaging period should be as close as practical to the commencement of each regulatory year in a regulatory control period.[6] AusNet Services identified this aspect of its proposal as a departure from the Guideline. CitiPower's, Jemena's, Powercor's and United Energy's proposals also appear to depart from this Guideline condition, but they do not identify their proposals as a departure from the Guideline.[7]

6 AusNet Services, Regulatory proposal, April 2015, p. 346.

7 The averaging period process proposed by these four Victorian businesses permit an averaging period of at least 10 consecutive business days to fall anywhere within a 12 month period. This means the proposed process permits averaging periods which are not as close as practical to the commencement of each regulatory year in a regulatory control period.