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Gavin Fox
General Manager, Network Pricing
Australian Energy Regulator
GPO Box 3131
Canberra, ACT, 2601

By email: RateOfReturn@aer.gov.au

Dear Gavin

Ausgrid welcomes the opportunity to respond to the Australian Energy Regulator's (**AER**) discussion paper on the 2026 Rate of Return Instrument (**RORI**). Ausgrid generally supports the AER's decision to consider new approaches for the cost of debts and equity beta. However, implementation of the changes is key to maintaining an unbiased estimate of the cost of capital and we discuss the following points our submission:

- **Cost of equity:** Ausgrid supports expanding the equity beta methodology by adopting a robust set of international comparators, noting that actual or perceived implementation issues can be overcome without undue complexity.
- **Cross checks:** The AER has implemented a test for the Financeability Guideline which can be used as a cross-check for the RORI process which should be considered in the final assessment of the RORI.
- **Cost of debt:** While the capex weighted cost of debt will bring debt allowances closer to the underlying debt cash flows, we do not support the AER 10-tranche model because it is not implementable, and would impose undue transaction costs. Rather, we advocate for a simpler approach similar to the model developed by the Queensland Treasury Corporation (**QTC**).

The submission from Energy Networks Australia (**ENA**) provides more detail and expert analysis, and Ausgrid supports the ENA submission. The attached submission outlines these matters in greater detail.

If you have any questions, please contact Philippe Laspeyres, Economic Regulation Manager, at [redacted]

Yours sincerely,

[redacted]

Timothy Jarratt

Group Executive, External Affairs and Strategy

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Submission

This RORI comes at a time of rapid changes in the energy sector. The investment requirement for an orderly, affordable and safe energy transition is significant, and the capital required is global and highly mobile. Infrastructure investors, including pension funds and sovereign wealth funds, assess opportunities on a risk-adjusted return basis across jurisdictions. If the Australian regulatory framework offers returns that are structurally lower than comparable jurisdictions—or lower than the true cost of capital—capital will flow elsewhere, stalling the energy transition and ultimately increasing costs for consumers through delayed projects and disorderly transition dynamics.

1. Cost of equity

The estimation of equity beta is a key element of the 2026 RORI review due to the reliance on a domestic dataset that has effectively ceased to exist. The AER has historically relied on a small set of nine domestic energy network businesses to estimate the equity beta. However, due to mergers and de-listings, this sample has been reduced to only one firm from the original comparator set (APA Group). In its Discussion Paper, the AER acknowledges that APA is "not an optimal comparator" due to its high proportion of unregulated revenue. The data limitation has come to a point that incorporation of international comparators is not a matter of if, but how. We note the use of international comparators is standard regulatory and commercial practice when domestic samples are insufficient, and we can learn from methodologies of other regulators to apply to the RORI.

One concern about using international comparators is how to construct the most appropriate dataset. We suggest that the sample selection should be limited to countries belonging to the Organisation for Economic Co-operation and Development (**OECD**) to ensure similar political and economic stability, and should include firms with a high proportion of regulated assets. Applying these selection criteria will ensure that the fundamental drivers of systemic risk are consistent across developed economies. In its 2021 Rate of Return Review, the Queensland Commission Authority's conclusions on the use of international firms as comparators are: "Despite these differences, we would expect many of the international energy firms to have broadly similar operational risks as a regulated energy business operating in Australia, such as Jemena or Ausgrid."[1]

Other regulators facing similar data constraints have successfully integrated international comparators. For example, New Zealand Commerce Commission (**NZCC**) uses a comparator sample of 58 largely international firms. It acknowledges the small domestic market and prioritises the statistical robustness of a large, live sample. The Economic Regulation Authority (**ERA**) of Western Australia explicitly incorporates international comparators to supplement the sparse domestic data. Ofgem uses a sample of eight comparators, five of which are international.

The AER observes that international firms often have lower gearing levels than the Australian benchmark (60%). This difference creates a technical challenge when translating beta estimates from the international context to the Australian regulatory framework. Under the assumption that debt carries zero systematic risk, the process of removing the effects of the international firms' lower leverage ("de-levering") and then applying the higher Australian benchmark leverage ("re-levering") will produce an upward bias in the final

[1] Queensland Commission Authority, December 2021, *Rate of return review: Final report*, pp.71-72.

equity beta estimate. This occurs because the formula attributes all the risk associated with higher leverage to equity holders, overlooking the fact that debt holders also bear some systematic risk.

Options to overcome this include changing the benchmark gearing for the Australian firms to that of the international firms, and to include a debt beta which reflects that debt is not risk free. We do not think that changing the gearing of Australian firms is feasible due to the implications on other aspects of the RORI, particularly debt and the trailing average. On debt betas, the Eligible Experts Report observes that the debt risk premium cannot be estimated reliably.[2] Nonetheless, the prevailing view is that debt betas are small, meaning that re-levering using debt betas does not make a material difference.

2. Financeability

The AER has signalled a desire to limit the scope of the 2026 review, suggesting that the current instrument is "performing well and continues to support the long-term interest of consumers" and that many issues were "largely settled in the 2022 RORI review".[3] The example of high capex proposals is cited as evidence that the RORI is working well. We caution against making this link due to the many complex inputs behind capex proposals, noting that all networks submit regulatory proposals based on their best estimate of managing the network based on safety, reliability and adherence to the National Electricity Rules (**NER**). Similar conclusions have not been drawn in the past when the opposite has occurred, so we suggest that this should not feature in the AER's decision making.

We suggest that the financeability test under the new *Financeability Guideline*[4] could be used as a cross check for the adequacy of the RORI.

As noted by Ausgrid in previous RORIs, the WACC should provide cash flows sufficient to maintain the benchmark credit rating for a benchmark efficient entity based on the parameters used in formulating the WACC. This provides for internal consistency of the RORI assumptions, and the AER could leverage the financeability test set out in the *Financeability Guideline* to do this.

We note that analysis commissioned by the ENA applied the AER's new financeability test to the post tax revenue models (**PTRM**) of 22 recent regulatory determinations. The results of this analysis found that most of the regulated networks tested failed the financeability test and that the allowed revenues missed the BBB+ target and often reflected a credit rating below investment grade.

This is not isolated to a single metric, with the analysis showing:

- FFO Interest Coverage: 18 of 22 determinations (81.8%) had interest coverage ratios worse than the Baa1/BBB+ benchmark.
- FFO to Net Debt Ratio: 22 of the 22 determinations (100%) had ratios corresponding to ratings worse than Baa1/BBB+.

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[2] Eligible Experts Report, December 2025, paragraphs 249-250.

[3] AER, Rate of Return Instrument – Review discussion paper, August 2025, p.7 & p.12

[4] Australian Energy Regulator, *Financeability Guideline,* November 2024

- Retained Cash Flows (RCF) to Net Debt: 18 of 22 determinations (81.8%) also failed to meet the benchmark for this metric.

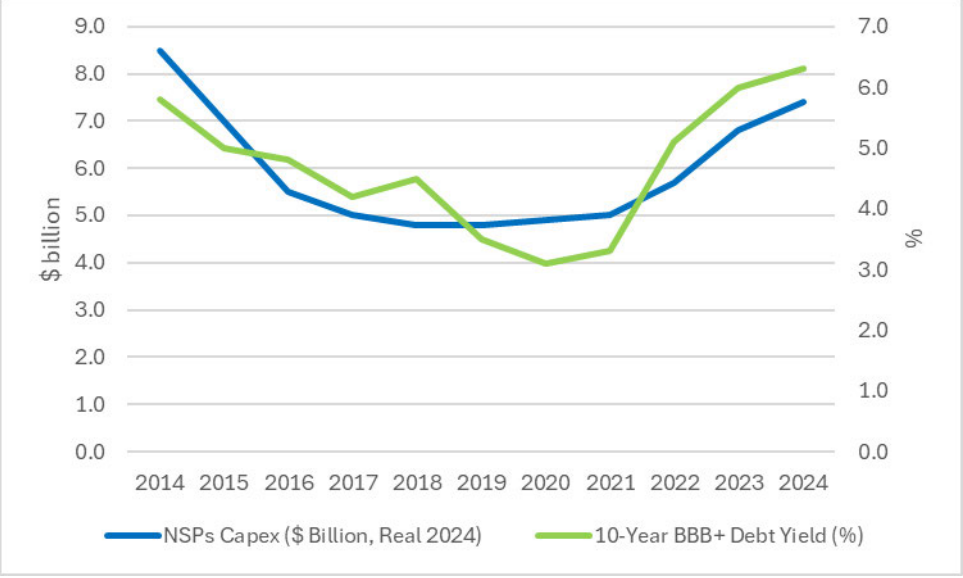
While this is confined to the credit metrics and does not take into account the qualitative indicators that generally improve credit ratings for regulated networks, it does indicate that the WACC may not be internally consistent with its own assumptions. If a cross check using the financeability test indicates that a majority of businesses would not be able to support the benchmark credit rating, we suggest that the AER reconsider how regulatory judgement has been used in the equity assumptions and whether they are appropriate. If no change is made, we request that the AER explain how the RORI is appropriate in that context.

3. Cost of Debt

The Weighted Trailing Average Cost of Debt

For much of the past decade, the Simple Trailing Average (**STA**) has generally provided a stable and sufficient allowance. However, the electricity network sector is now confronting a double challenge: a rapid escalation in global bond yields coinciding with a requirement to expand asset bases. **Figure 1** below shows NSPs' capex has followed a "U-shaped" trajectory. After peaking around 2014, investment declined significantly, stabilising at lower levels between 2016 and 2021 (averaging around $4.8–$5.0 billion annually). However, there has been a sharp increase recently, with capex rising to $6.8 billion in 2023 (a 20% increase on 2022) and further to $7.4 billion in 2024. The 10-year BBB+ debt yield (a key benchmark for network regulation) hit historical lows during the 2020–2021 period (around 3%), reducing the cost of financing for networks. Since 2022, yields have risen sharply to approximately 6.0–6.3%, driven by broader inflationary pressures and RBA cash rate increases.

Figure 1: Australian NSPs Capex and 10-Year BBB+ Debt Yields (2014–2024)



Source: AER's State of the Energy Market reports, & Reserve Bank of Australia.

As the National Electricity Market (**NEM**) enters a significant step change in its investment cycle driven by the Integrated System Plan (**ISP**) and jurisdictional Renewable Energy Zone (**REZ**) projects, network businesses are required to mobilise significant volumes of debt capital to network augmentations. By compensating new, high-cost debt at a lower historical average rate, the STA risks not allowing an appropriate allowance for debt that may result in cash flow issues. The opposite is also true, that in periods when the prevailing rate is lower than the STA businesses could be over compensated.

Ausgrid sees the adoption of the Weighted Trailing Average Cost of Debt (**WTA**) approach as a positive step. However, we have concerns about the 10-tranche model provided as part of the AER's consultation process.

Firstly, the model does not align with operational practices by business treasuries. Large infrastructure projects are not funded by ten different bonds of varying maturities. Such a strategy would fragment liquidity and increase execution risk. The complexity of such an approach would likely result in prohibitive transaction costs. Arranging ten separate bond issuances or swaps for every capital injection would multiply legal, underwriting, and administrative fees. These additional costs are not compensated under the current cost of debt calculation of debt raising cost allowances.

Secondly, the AER's proposed model is, in our view, overly complex to administer. Our analysis indicates that the model would require tracking multiple overlapping debt tranches at any one time, necessitating significant numbers of new calculations in the revenue model. This complexity reduces transparency and increases the risk of modelling errors without delivering a commensurate increase in accuracy.

Our strong preference is to adopt the methodology proposed by QTC. This approach achieves the objective of weighting new debt at the prevailing rate while maintaining administrative simplicity. The model applies the standard transition logic for growing debt and simply sets the weighting on "new" debt to zero for declining debt scenarios. This effectively defaults a declining business back to the STA, providing a robust methodology that works across both electricity and gas sectors without requiring bespoke models or introducing mathematical instability.

We support the introduction of a capex weighted trailing average to provide improved cost recovery to support efficient investment in significantly expanded capex programs in the future. However, it must be balanced against a framework which:

i) preserves certainty in cashflows and attractiveness to capital investors,

ii) provides a simple and easily replicable methodology, and

iii) reflects actual constraints and limitation of raising debt in funding markets.

Application of a threshold

The AER has queried whether the WTA should apply to all networks or only those exceeding specific capital expenditure thresholds. Ausgrid supports universal application of the simplified QTC model.

Applying thresholds could create perverse incentives for networks close to the threshold to artificially accelerate or defer capex with the view to trigger or avoid the WTA based on whether the prevailing rate is higher or lower than the trailing average. Furthermore, thresholds introduce arbitrary discrimination, creating a two-tier regulatory regime where some networks are compensated on a portfolio basis and others on a marginal basis. Given the relatively low administrative burden of the QTC model, there is no practical barrier to applying it universally to all networks, ensuring consistency across the sector.

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Role of a True-Up Mechanism

Regulatory allowances are set upfront based on forecasts. However, the delivery of major projects is subject to uncertainty impacting timeframes and costings. Changes from forecast capex to actual will create variances in the capex weights that are used to calculate the WTA. Regulatory revenue allowances could have been higher or lower if actual weights based on actual capex had been known at the time of setting the allowances. Therefore, some form of true-up is appropriate. The true-up we envisage maintains the incentives embedded in the existing framework, and does not move towards cost of service regulation.

The CESS model already performs a true-up through the financing benefit mechanism which is based on actual capex, not forecast capex. An amendment to the CESS model would be required to capture the effect of changes in the WTA. One approach is to estimate financing benefits under a WTA framework by recalculating the real WACC using actual capex to derive debt weights. This includes identifying financing benefits attributable to both **capex differences** and **differences in the opening RAB's cost of capital** due to changes in weighting.

We are of the view that this is the most appropriate and practical approach, as it avoids double counting and maintains the integrity of the AER's incentive framework.

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