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**Submission to the *AER's Rate of Return Instrument (RORI) – Review Discussion Paper***

Thank you for the opportunity to make a submission to the Australian Energy Regulator's (**AER**) *Rate of Return Instrument – Review Discussion Paper*.

The Clean Energy Finance Corporation (**CEFC**) is a specialist investor in Australia's transition to net zero emissions by 2050. With access to more than $33 billion from the Australian Government, we work with co-investors, industry and government to drive economy-wide investment in decarbonisation. The CEFC supports the development of a secure, reliable and affordable electricity system while lowering emissions through its investment activities. The Australian Government has allocated $19.65 billion to the CEFC under its Rewiring the Nation (**RTN**) program to help spearhead the necessary transformation of Australia's electricity grid infrastructure.

In making this submission we wish to advise the CEFC has and will continue to invest in electricity network projects that will be affected by this review. This submission has not been developed for the purpose or intent of de-risking existing CEFC investments that may be affected by the review's outcome but rather from the perspective of our role in delivering RTN fund objectives which are to:

- Increase renewables in the grid to fast-track decarbonisation of the Australian economy.
- Ensure consumers benefit from the grid transformation.
- Build investor confidence in Australia's energy transition.

## A. Equity Beta

We note that financing risk may be one of the factors influencing the beta, though we are not in a position to comment on the methodology used to determine it.

Where the AER adopts a cost of debt that reduces the basis risk between cost and recovery, we expect this will reduce the risk faced by a Network Service Provider.

## B. Weighted Trailing Average for the return on debt calculation

### *Simple Trailing Average (STA)*

The Simple Trailing Average (**STA**) may reasonably reflect the cost of debt in stable interest rate environments. However, in periods of volatility such as the sharp fluctuations seen during the COVID-19 pandemic, STA can misrepresent actual borrowing costs. This mismatch arises because STA smooths debt costs over time, failing to account for concentrated borrowing during short windows of significant rate movement. As a result, it may lead to either under- or over-compensation.

This averaging approach is particularly misaligned with the funding realities of large, lumpy capital expenditure programs (e.g., Integrated System Plan (**ISP**) projects), which typically require substantial debt to be raised over brief periods (e.g., 1–3 years), rather than gradually over a decade. If STA diverges significantly from prevailing interest rates at the time of investment, it can result in materially inaccurate compensation. For example, the AER's 2024 RORI update estimates benchmark cost of debt for 2024 at 5.53% vs. 4.36% on a trailing average basis (using indicative averaging periods in August each year), leading to a difference of 117 bps, which is a significant difference for investors.

The CEFC considers STA inefficient for such projects due to its inability to reflect the timing and scale of actual debt raising. Under-compensation may discourage timely final investment decisions (FID) by Network Service Providers (NSPs), potentially delaying critical infrastructure. Conversely, over-compensation can lead to unnecessary costs for energy consumers.

### *Weighted Trailing Average (WTA) – AER Approach*

The WTA model better reflects the timing and size of new capital expenditure, aligning the return on debt allowance more closely with efficient financing costs. The return on debt continues to be calculated using a 10-year trailing average, but the weights applied to each year's debt are adjusted to reflect the yearly timing and amount of new debt raised, rather than assuming a fixed 10% refinancing profile. The CEFC considers that the AER's proposed approach raises several challenges:

- The increased complexity due to the overlapping debt tranches (up to 55 overlapping debt tranches at any given time) and use of 10 different debt maturities resulting in an increase in administration for both the AER and NSPs for both implementation and ongoing management, noting that tenors of 1 and 2 year durations are not typical given investor treasury/risk management practices;
- Data reliance: depends on accurate forecast and actual capital expenditure data; and
- Interaction with incentive schemes: may overlap with the CESS, requiring adjustments to avoid double counting.

### *CEFC's Preferred WTA Approach*

Timely delivery of key transmission projects is critical to improve outcomes and maintain reliability and security. A simple and transparent cost of debt approach is preferable so as to provide confidence to NSPs to take FID. This in turn requires that large projects be allowed to recover a regulated cost of debt that is more representative of the actual cost of debt for a benchmark capital structure during the delivery phase.

The CEFC supports the Queensland Treasury Corporation's (**QTC**) proposed method of splitting debt into "old" and "new" components, each with distinct rates. This approach blends historical rates for "old" debt with prevailing market rates for "new" debt raised annually. Transitional rates apply to new debt up to nine years old, ultimately converging to a simple 10-year trailing average.

- This method is relatively simple, transparent and imposes a lower administrative burden on both the AER and NSPs for implementation and ongoing management.
- The 10-year cost of debt is already an accepted benchmark by the AER and NSPs for determining the return on debt, aligning with past AER decisions. The key consideration is whether to apply the prevailing or historical cost of debt to new debt.
- Applying the prevailing cost of debt to new borrowings more accurately reflects the actual financing costs of new investments. It also mirrors how businesses typically finance new versus existing assets, helping to avoid under- or over-compensation due to interest rate fluctuations.
- In volatile markets, where interest rates can shift sharply over short periods, a simple trailing average may fail to capture the true cost of debt incurred during concentrated borrowing periods, leading to misaligned compensation.
- QTC's approach is consistent with the *Electricity Infrastructure Investment Act 2020* (NSW), which outlines a transition to a 10-year trailing average return on debt. For example, in the Transgrid Waratah Super Battery project (a transmission asset), a 100% weighting is initially applied to the return on debt at the time of the first revenue determination. The asset base then transitions into a full trailing average portfolio over 10 years through annual updates.
- Retaining historical rates for "old" debt also smooths out price volatility to consumers.

  In addition, the CEFC agrees with the QTC allocation for weightings.

## C. Other Considerations

*Transitional arrangements*

The change in RORI methodology should be implemented which does not provide NSPs optionality to select existing or impending changes to methodology. The CEFC considers that any RORI changes should not impact any projects that have already obtained an AER determination or reached financial close (i.e. capex reopeners). The timing for implementation should be as short as possible with clarification as to what RORI framework would apply to any contingent project applications *before* future regulatory resets for NSPs to avoid optionality of RORI regimes. Any transitional arrangements should consider the impact a revised methodology will have on the incentive for the timely delivery of critical infrastructure.

*Opt-in / Optionality*

Interest rate cycles will impact the NSPs' willingness to invest; the potential asymmetry is not in consumers' interests and therefore the framework should not allow for optionality. The CEFC does not consider that NSPs should have the ability to optionally choose which RORI framework applies.

*True up mechanism*

Implementing a true-up mechanism to reconcile differences between forecasted and actual capital expenditure is appropriate, particularly when delays are beyond the control of NSPs. This approach ensures that financing costs more accurately reflect the realities of new investments and helps discourage overly aggressive capex forecasting during the contingent project application stage. Therefore, inclusion of a true-up mechanism should be carefully balanced to address both objectives.

We value the opportunity to provide input into this process and look forward to the opportunity to engage further with the AER. Should you wish to discuss this submission further, please contact Bobby Vidakovic, Executive Director - RTN, [redacted]

Yours sincerely,

[redacted]

Ian Learmonth
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