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2026 Rate of Return Instrument (RORI) Review Discussion Paper

Endeavour Energy appreciates the opportunity to provide feedback to the AER's 2026 RORI Discussion Paper. We recognise the material impact the RORI can have on customer outcomes with respect to both the cost of energy and ensuring the necessary investment occurs to deliver safe, reliable and sustainable energy services. This importance is amplified by the energy transition as networks manage the growing demands associated with electrification, integrating renewables and meeting changing customer needs.

Objectives and scope of review

We support the AER's objective to promote efficient investment in, and efficient operation and use of, energy services in the long-term interest of consumers. The RORI can contribute to this by targeting an unbiased estimate of the required returns of a private long-term investor.

We welcome the more streamlined approach that the AER is undertaking and support the two priority areas that the AER has identified for more comprehensive review, being estimating beta and a capex weighted trailing average cost of debt. We have set out later in our submission our observations regarding these topics.

We note that we had concerns in relation to the 2022 RORI and its ability to meet the challenges of the energy transition and, in particular, the level of investment required to deliver Australia's energy transition and decarbonation goals.

In assessing the 2022 RORI, we caution against relying on recent capex trends as reliable indicators of performance. This is because capex is materially driven by non-discretionary factors; there are no counterfactual investment trends under alternate WACC estimates, or perfect knowledge of what the efficient level should be.

More specifically, the AER notes that networks proposing innovation allowances could be considered evidence of the adequacy of the 2022 RORI. However, innovation is viewed by many firms as non-discretionary given the criticality of identifying future solutions and efficiency opportunities. In the context of Australian energy networks, this innovation may be to pursue incentive benefits, reputational benefits or simply necessary to manage growing and changing needs within a capex allowance rather than an implied endorsement of the prevailing WACC. We also note the demand management innovation allowance is opex in nature (i.e., it does not attract a 'return on' allowance), and a mere fraction of overall expenditure allowances (by way of illustration, it represents 0.15% of Endeavour Energy's totex for the 2024-29 period).

To assess performance of the RORI we see more value in investor views, financeability tests and international benchmarks to see how other regulators have exercised their discretion in managing similar circumstances and considerations. We note analysis commissioned by Energy Networks Australia (ENA) which highlights a clear deficiency in the 2022 RORI whereby 20 of 22 regulatory decisions made under it fail to meet the credit rating assumption underpinning the RORI. It is not a tenable or practicable position to rely on qualitative assessment factors from credit rating agencies to maintain the investment grade of Australian networks. We recommend regard is had to these financeability assessments and targeting RORI outcomes which support the benchmark credit ratings underlying it on a quantitative basis.

Estimating Beta

The most pressing aspect of the review is developing a new approach to estimating beta given no 'live' domestic comparator firms remain. We recommend the approach to estimating this parameter is set wholly anew without having any regard to the existing estimate of 0.6, given that this relied solely on an ever-dwindling domestic set of firms that were not appropriately comparable, had volatile results and, consequently, produced an equity beta estimate that gave rise to inaccurate outcomes and was out of step with peer regulators.

We therefore support an approach that has regard to international comparator firms per the AER's suggested selection 'filters', rather than those suggested by Associate Professor Partington in the Expert Panel report, noting the objective of identifying comparator firms, rather than aspiring to the impossible task of seeking exact replicas of Australian networks.

We also consider it unnecessary and impractical to adjust for international differences in market composition, via an international CAPM or otherwise. Again, we make no such adjustment for changes in market composition over the sample period for domestic comparators as the standard of comparability does not require identical market composition. Instead, we recommend the AER continue with its current approach not to account for these differences as it is consistent with the approach taken by many international regulators and independent expert valuation professionals.

We refer to the ENA's submission for more detailed recommendations with respect to adopting long term estimates, re-levering with the Brealey-Myers formula and use of OLS regression to produce longer-term estimates re-levered to a common 60% level of gearing.

The ENA submission also summarises a significant weight of evidence on the appropriate beta estimate, based on which we consider there is compelling evidence that an equity beta estimate in the order of 0.8 would best promote the objectives of the RORI.

Capex weighted trailing average cost of debt

The AER is considering moving from a simple to capex weighted trailing average cost of debt in recognition of the material capex requirements that networks, particularly transmission networks, face as part of the energy transition. A capex weighted trailing average will better promote the NPV=0 criterion that the AER highlights is key to producing an unbiased estimated of WACC.

The key consideration for this proposed change is whether the incremental gain in accuracy of the benchmark estimate cost of debt is worth the additional complexity associated with making this change. In our view, the AER's transition model would not pass this test. This model assumes that networks will issue 10 new tranches of debt every year which is virtually impossible for networks to replicate in practice. Under this method, we would not support a change from the current approach, or in the alternative, would suggest its use be subject to a materiality threshold and coupled with an increase to the debt raising costs associated with this approach.

Instead, we are supportive of the simplified QTC model which adopts the AER's transition method used previously for transitioning from the rate-on-the-day approach to a 10-year trailing average. Consistent with the ENA position, we recommend:

- the trailing average continues to apply to existing debt;
- additional debt is assumed to be raised at the then prevailing benchmark rate;
- the transition approach is per the QTC model;
- this is applied to all networks via total debt in the PTRM; and
- this should relate to actual debt rather than forecast debt.

The latter is consistent with what occurs currently via the roll-forward of the asset base and the operation of the Capital Efficiency Sharing Scheme (CESS). It also recognises the difficulties in forecasting capex

accurately, both quantum and profile, several years prior to it occurring. In reality, networks must respond to changing circumstances and investment drivers, in which case relying on forecast capex may not resolve the issue the AER are attempting to address.

Separately, we also support the ENA's proposal to apply a simple approach of extrapolating the RBA's yield estimates.

Estimating MRP

As noted above we remain of the view that the overall return, particularly the equity return, benchmarks below comparable regulatory frameworks. In addition to the equity beta, improvements could also be made to the approach taken for estimating the MRP.

For instance, considering a broader set of evidence like Dividend Growth Models and the Wright method, adopting a long-term averaging period in implementing the Historical Excess Returns method and accounting for the relationship between the total allowed return on equity and the risk-free rate.

However, we accept that these matters were considered as part of the 2022 RORI and that the AER do not propose to revisit them as part of the 2026 RORI. We encourage the AER to consider this matter again following the 2026 RORI process to ensure the MRP remains robust in a range of market conditions and reflects an unbiased estimate of investor expectations. For the 2026 RORI we expect the AER will continue to apply the method adopted for the 2018 and 2022 RORIs. In doing so, we would be grateful for clarity from the AER regarding whether it intends to update the MRP with observations up until 2025 or 2026. Due to the delay in the release of the 2022 RORI the AER was able to incorporate the 2022 year in its estimate of the MRP, and we therefore wish to understand whether the AER intends to revert to the previous practice on a standard review timeline.

If you have any enquiries about our submission, please contact Patrick Duffy, Manager Regulatory Transformation and Policy at Endeavour Energy via email at [redacted]

Yours sincerely

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