Rate of Return Instrument; Review discussion paper

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About the Justice and Equity Centre

The Justice and Equity Centre is a leading, independent law and policy centre. Established in 1982 as the Public Interest Advocacy Centre (PIAC), we work with people and communities who are marginalised and facing disadvantage.

The Centre tackles injustice and inequality through:

- legal advice and representation, specialising in test cases and strategic casework;
- research, analysis and policy development; and
- advocacy for systems change to deliver social justice.

Energy and Water Justice

Our Energy and Water Justice work improves regulation and policy so all people can access the sustainable, dependable and affordable energy and water they need. We ensure consumer protections improve equity and limit disadvantage and support communities to play a meaningful role in decision-making. We help to accelerate a transition away from fossil fuels that also improves outcomes for people. We work collaboratively with community and consumer groups across the country, and our work receives input from a community-based reference group whose members include:

- Affiliated Residential Park Residents Association NSW;
- Anglicare;
- Combined Pensioners and Superannuants Association of NSW;
- Energy and Water Ombudsman NSW;
- Ethnic Communities Council NSW;
- Financial Counsellors Association of NSW;
- NSW Council of Social Service;
- Physical Disability Council of NSW;
- St Vincent de Paul Society of NSW;
- Salvation Army;
- Tenants Union NSW; and
- The Sydney Alliance.

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The Justice and Equity Centre office is located on the land of the Gadigal of the Eora Nation.

Contents

1. Introduction

The Justice and Equity Centre (JEC) welcomes the opportunity to respond to the Australian Energy Regulator's (AER) discussion paper on the Rate of Return Instrument review (the discussion paper).

We support a robust review of the Rate of Return Instrument (RORI) as a critical opportunity to ensure consumers are paying no more than necessary for the energy they need, particularly in the context of rising energy bills.

The RORI is ultimately a setting where consumer and network service providers (NSP) interests are in opposition to one another. Any excess returns earned by NSPs are paid for by consumers. The capacity of NSPs to gain returns over and above the rates commensurate with the risk these businesses actually face is facilitated directly by consumers paying more for their energy than is necessary. This makes setting the RORI a process which is critically important for promoting the consumer interest.

Two points of context are particularly significant for the 2026 review of the RORI:

- the sharp and ongoing rise in energy bills experienced by consumers in the years since the last review, and the ongoing role of energy in the cost-of-living crisis and inflationary pressure, and
- the consistent overperformance of returns to NSPs in the National Energy Market (NEM) over those years.

This context and experience should inform the setting of RORI.

Accordingly, we support setting the equity beta closer to 0.5 than 0.6.

We also support further consideration of a more effective 'true up' mechanism to nullify the risk of windfall value transfers between consumers and network businesses arising from inaccurate estimates of the cost of debt.

2. Experience of the 2022 RORI

The JEC fundamentally disagrees with the position that:

> *Overall, the 2022 RORI remains broadly fit for purpose and provides a balanced and stable foundation for estimating the rate of return. We have seen no evidence that it has deterred investment since its making, with network businesses continuing to propose capital expenditure and innovation allowance projects.*[1]

[1] AER, 2025, '2026 RORI review discussion paper,' p.7.

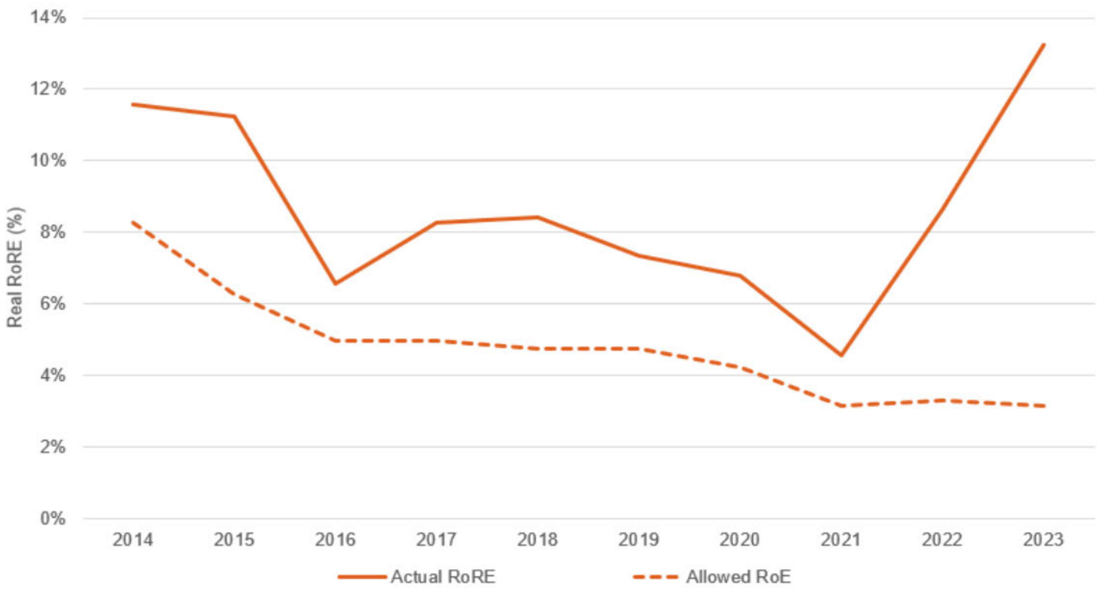
Specifically, we disagree with the claim the current RORI has produced a 'balanced outcome' in the sense of "avoid[ing] outcomes that favour either service providers or consumers".[2]

The criteria overweight ensuring network businesses obtain the conditions necessary for investment at the expense of ensuring consumers do not pay more for energy than is necessary. That is, NSPs are being overcompensated at the expense of consumers.

Research from the Institute for Energy Economics and Financial Analysis (IEEFA) shows a clear and consistent trend of network businesses receiving 'super-normal' profits during this period.[3][4] They point to $4.35 billion in excess profit obtained by these businesses in regulatory year 2023 alone, a figure far in excess of the 'normal' profits implied by the regulated allowance.

The AER has confirmed the accuracy of these claims. Its own figures confirm that actual return on equity for NSPs has exceeded the forecast return on equity for many years. They have also confirmed that in the period of falling interest rates since 2022, the actual returns have jumped to levels far above those forecast (see fig 1.).

Figure 5-7 Real RoRE[111] versus allowed RoE - electricity NSP



Source: Electricity financial performance model
Note: Financial performance numbers are nominal. The weighted average RoRE is calculated by multiplying an electricity NSP's real RoRE against the proportional size of the electricity NSP's regulated equity.

Figure 1: AER, September 2024, '2024 Electricity and gas networks performance report', p.82.

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[2] *Op. cit.*
[3] Orme, S. (November 2023) 'Power prices can be fairer and more affordable'. Available at https://ieefa.org/sites/default/files/2023-11/Power%20prices%20can%20be%20fairer%20and%20more%20affordable_Nov23_1.pdf
[4] Gordon, J. (November 5, 2024) 'Taming electricity price inflation starts with addressing network supernormal profits'. Available at https://ieefa.org/resources/taming-electricity-price-inflation-starts-addressing-network-supernormal-profits

These factors warrant reconsideration of fundamental aspects of the current RORI calculation.

The causes of the current divergence of return/profit allowed by the regulator from that actually realised do not impact the point that network businesses have routinely earned returns over and above the levels implied by the level of risk they hold. This is the result that is both agreed to by all parties and the one that is most relevant to the setting of the RORI.

The second broad aspect of context is well established. Energy costs have increased sharply in recent years, in terms of the bills faced by end consumers and in terms of the costs incurred by taxpayers – including government underwriting of generation, transmission and storage and substantial bill relief. High energy bills have contributed to the cost-of-living crisis both directly and indirectly via their ongoing impacts on generalised inflation.

Ensuring that energy costs to consumers are no higher than necessary is a central task of the AER and should be a first order ambition of the RORI review. In this context, ensuring NSPs are compensated only to the level necessary and 'efficient' – in large part through the RORI - is a priority.

While the AER is right to note there is no evidence that the 2022 RORI deterred investment by NSPs, this is not evidence that the levels set are 'fit for purpose'. To reach this conclusion, it is also necessary to establish that NSP returns in the period were not excessive and were proportionate to the risk held by these businesses relative to others in the Australian economy.

We contend this has not been established; to the contrary, there is compelling evidence that NSPs have been overcompensated.

3. A balanced ambition for the RORI

The optimal rate of return should not be defined as the level adequate to induce NSP investment. It should instead be described as the *minimum tolerable* level return required to induce efficient investment.

The excessive profits of recent years result from conditions in the regulatory system which are likely to continue.

It is theoretically possible, for example, to redesign the interaction of the network performance incentive mechanisms with the regulated rate of return to allow NSPs meeting performance incentives to have their returns aligned with businesses holding equivalent risk. This would be in contrast to the current state where meeting performance incentives takes returns earned by an NSP beyond the risk-appropriate level of returns.

We understand that such a change is likely to be outside of the scope of this review. It does, however, demonstrates that the AER can – and should – set a RORI that is more appropriate than the current level, meaning one that is lower. This is necessary given the absence of opportunity to enact more fundamental changes to the existing regulatory structures.

The apparent ease with which network businesses have retained and secured new investors in the current period – for instance, Transgrid – in conjunction with the excessive profits of recent years, indicate an investment strike is unlikely to impact NSPs in the NEM. We have seen no credible evidence to indicate a material threat to NSP's ability to attract capital under the current settings. Read in conjunction with data on actual returns to NSPs, there is a strong case that further value can be returned to consumers without materially increased risk of disinvestment.

4. The Equity Beta

The JEC supports reducing the equity beta to 0.5.

We have detailed our contention that the returns on equity currently received by NSPs are in excess of that matching the risk they face.

However, we also contend the risks faced by NSPs in the NEM are systematically reduced by the National Electricity Rules (NER). We highlight table 1 in Greg Watkinson and Simon Orme's paper[5] demonstrating how this occurs. We agree this shows how NSPs are insulated from the following risks normally faced by businesses operating in the Australian economy:

- Market competition
- Revenue volatility
- Customer/counterparty risk
- Cost of goods sold
- Operating expenditure
- Capital expenditure risk
- Asset stranding risk
- Inflation; and
- Regulation.

This leaves only volume risk as a major category faced by NSPs. This may be material for gas network businesses. However, electricity NSPs have revenue certainty and relative certainty from all parties that demand will rise strongly and continuously not only for the period relevant to this review but also for the decades ahead as the economy electrifies.

The purpose of regulatory risk and return settings can broadly be seen to serve as a proxy for the actual risk a comparable business would face in the market. On this context the reduced risk actually faced by regulated NSPs should be reflected in the equity beta.

The current equity beta – and those used in previous periods – input to the RORI did not account for these factors and was not appropriate. Accordingly, we contend a lower estimate should be set for this period.

Selection of comparators

Comparator business selection is an important consideration for the setting of the equity beta.

[5] Watkinson, G. and Orme, S. (November 2025) 'Preliminary Report for Energy Consumer Australia's Submission to the AER's 2026 Rate of Return Instrument Review, p.15.

In this context the JEC supports the use of listed energy networks in other economies with comparable investment and societal circumstances, subject to passing liquidity and data sufficiency requirements. We agree with Dinesh Kumareswaran that the largest and broadest sample possible should be used to improve the statistical reliability and dampen the impact of outliers.

Comparators must also be selected from businesses with similar risk profiles to Australian NSPs, which are established statutory monopolies. Therefore, vertically integrated energy firms should be excluded.[6]

We note the necessity to identify and adjust for differences between the settings of the comparator business and the NEM. This should be done on an individual comparator basis. We recommend this as a remedy for the artificial inflation of the beta that may occur simply as a result of introducing international comparators into the methodology.

5. Weighted trailing average return on debt

We have two major concerns regarding the proposal to introduce a weighted trailing average return on debt.

First, we are concerned that the financeability issues a weighted trailing average return is intended to respond to[7] have already been managed elsewhere. Indeed, we are concerned that financeability has been supported with multiple tools, at material cost to consumers and taxpayers. It would not be in consumers interests for further measures – such as a weighted trailing average return on debt – to be implemented.

Second, we agree with assessments that simple trailing averages have not been a success in that:

- there is little evidence it has contributed to price stability;
- it has not produced a tight control on debt costs (to the detriment of consumers); and
- it has not produced efficient investment signaling.

However, we do see how, under the right conditions, a weighted trailing average could result in an increase in prices.[8]

Accordingly, we support further consideration of the options tabled by the independent experts, namely:

- the introduction of a net present value-neutral true-up mechanism, as recommended by Dinesh Kumareswaran, and
- the use of the asset beta in the CAPM proposed by Ass. Prof. Partington, which eliminates the need to estimate debt costs altogether.

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[6] *Ibid*. p.20.
[7] *Ibid*. p.2
[8] *Ibid*. p.10

We strongly recommend the AER further consider these issues and alternatives in the process of setting the RORI for the coming period.

6. Continued engagement

We welcome the opportunity to meet with the AER and other stakeholders to discuss these issues in more depth. Please contact Michael Lynch at [redacted] regarding any further follow up.