

AER 2026 Draft Rate of Return Instrument

Network Sector Concerns

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Network sector concerns with the Draft RoRI



An unbalanced decision

- Networks have expressed surprise and concern at the contents of the Draft RoRI and the regulatory process that has produced it.
- Networks consider the draft outcomes on all of the 3 key issues to be **unsupported by the evidence and inconsistent with the “largely settled” features of the AER’s regulatory approach.**

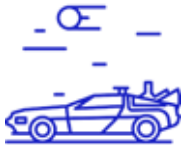


The process itself has fallen well short

- Stakeholders’ expectations were **clearly misaligned about the nature of a “targeted” review:**
 - **Equity:** Items that were included among the “settled” issues were opened up without warning. Static domestic evidence on beta has been reinterpreted and the approach to estimating MRP has changed.
 - **Debt:** There was no indication at all that the longstanding principle of setting the allowed return to match benchmark efficient financing costs would be abandoned in this review.
- An April Draft RoRI was touted as a significant improvement in the process allowing testing of the draft. Decision has been delayed to end of May. We are concerned about the reduced time for proper scrutinization and consultation on the Draft Instrument – **particularly given the very material changes that were not identified as being ‘in play.’**



Network sector concerns with the Draft RoRI



The reasoning behind prior RoRIs has been revised

- Of most concern is the AER's **re-imagining of its past decisions** as being somehow consistent with its new approaches:
 - The domestic equity beta of 0.6 in the 2018 and 2022 RoRIs already factored in the “majority regulated” argument. But that **same issue** is now used to support the possibility of 0.4 forming a reasonable domestic estimate.
 - The 2018 and 2022 RoRIs clearly identified the special role of the post-1988 data as being “most relevant,” “preferred,” and “more representative” than any other period. In both cases, the MRP was set equal to the average excess return from 1988 without any adjustment. But the draft RoRI claims that the post-1988 period **never actually had** any special significance at all.



We're astonished and concerned

- We expected the development of a **structured approach that would provide guidance** about how the allowed return might change in the future as the evidence evolves.
- Regulatory judgement is important, but shouldn't supplant the observable evidence.
- It is one thing for the AER to materially change its approach, in an unpredictable way, from one RoRI to the next – but it creates a whole new level of uncertainty for one RoRI to go back and **revise the reasoning** that was applied in past RoRIs.



Focus of this presentation

BETA

- The AER identified the problem with its domestic comparator set and indicated that it was considering two approaches:
 - Continue to give primary weight to the set of **nine** domestic comparators; or
 - Have regard to the current domestic comparator set and a set of international comparators.
- Instead, the AER has revised its previous assessment of the domestic evidence in a way that outweighs its introduction of the international evidence.

MRP

- The AER included MRP among the list of “largely settled” issues but has now proposed a different approach to that adopted in its 2018 and 2022 RoRIs.
- Worse still, the AER has re-imagined its previous decisions and now claims they are consistent with the proposed new approach.

RETURN ON DEBT

- The AER’s previous approach has always been to set the allowed return on debt to “match benchmark efficient financing costs.”
- The Draft RoRI abandons that approach, accepting that “incorrect compensation” will be provided.
- No indication was provided that the AER was contemplating a departure from its longstanding framework.

Equity beta





Equity beta

2018 RoRI

- Domestic comparators support equity beta of 0.6 (p. 174).
- Lower estimates for “majority regulated” domestic comparators cited as a reason for reducing beta from 0.7 to 0.6, even though the estimates for all firms had increased since 2013 (pp. 168, 189-190).
- 0.6 cited as being **best estimate** of equity beta on the evidence – no conservatism (p. 168).

2022 RoRI

- Again considered CRG submission that majority regulated firms should receive relatively more weight (p. 323).
- Equity beta maintained at 0.6.
- 0.6 again confirmed as being **best unbiased estimate** (p. 19).

2026 Draft RoRI

- Delisted domestic comparators generate no new data.
- AER now uses subset of 5 “majority regulated” domestic comparators to obtain a figure of 0.4.
- Paired with estimate of 0.7 from international comparators.
- Estimate of 0.55 selected.

If the (static) domestic evidence still supports 0.6, and we now give explicit weight to estimates from international comparators (“which tend to be around 0.7” (p. 21.) how is it **logically possible** to end up at 0.55??

OR

Has the AER re-visited the same de-listed domestic evidence and concluded that its previous unbiased estimate of 0.6 was, in fact, 50% too high?



Equity beta: Everywhere else

Equity betas allowed by comparable regulators (60% gearing, debt beta of 0.1)

Regulator	Equity beta
FERC	0.84
NZCC – electricity networks	0.85
NZCC – gas pipelines	0.97
ERA	0.78
Ofgem (low)	0.64
Ofgem (mid)	0.77
Ofgem (high)	0.89
AER	0.55

As our resulting approach is not identical to that of any other regulator, it follows that our resulting equity beta estimate may also be different to that of other regulators.
[Draft RoRI Explanatory Statement, p. 50]

“I just think the rest of the world has gone a bit peculiar.”

Wonko the Sane

So Long, and Thanks for all the Fish

Book 4, Hitchhiker’s Guide to the Galaxy

Douglas Adams

Market risk premium





Market risk premium: Re-imagining of past decisions

2018 RoRI

- MRP set to HER estimate using data starting in 1988.
- Post-1988 period identified as being “most relevant,” “preferred,” and “more representative” than any other period.
- DGM receives “no significant weight” (p. 263) due to “diminished confidence” (p. 92).

2022 RoRI

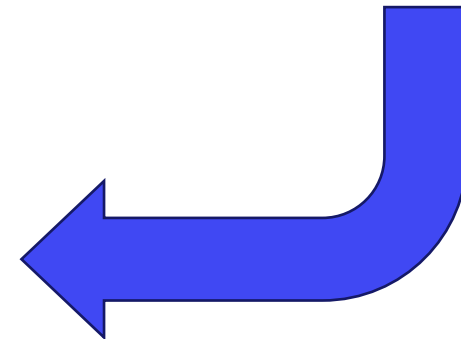
- MRP set to HER estimate using data starting in 1988.
- Post-1988 period identified as being “most relevant,” “preferred,” and “more representative” than any other period.
- DGM has “lesser persuasive value” and no impact on adopted estimate (p. 18).

2026 Draft RoRI

- **No special role for post-1988 data.**
- Period starting in 1988 is **no longer** “most relevant,” “preferred,” or “more representative” than any other period.
- **DGM is back!** Cited as a primary reason for departure from use of post-1988 HER estimate (p. 92).

Re-imagined interpretation of 2018 and 2022 RoRIs

- Post-1988 period actually **never had** any special role.
- Period starting in 1988 actually **never was** “most relevant,” “preferred,” or “more representative” than any other period.
- Always had regard to DGM evidence.





An unconditional estimate?



AER clearly states that it estimates the **unconditional** (long-run average) MRP (p. 92).



The Historical Excess Returns (**HER**) method is the only method that produces an estimate of the unconditional (long-run average) MRP.



The AER's HER estimates have **increased** since 2022.

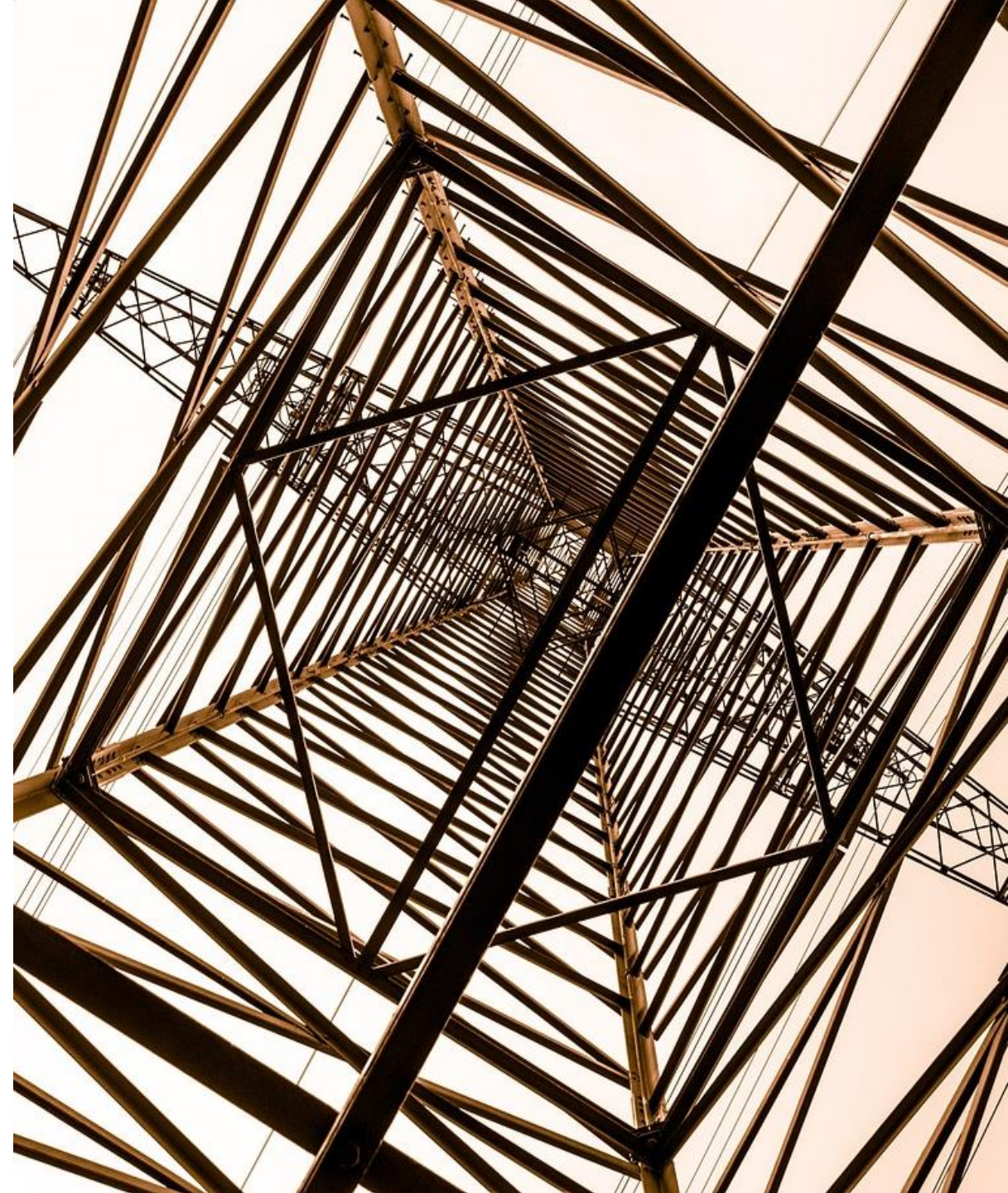


But the allowed MRP has been **reduced** on the basis of estimates of the **conditional** (point in time) MRP.



- The AER appears to base its estimate of the long-run, unconditional mean on a judgement call around the deviation of point-in-time conditional estimates from their long-run averages.
- When it already has evidence on changes in the long run, unconditional mean, why not use that evidence directly?

Weighted trailing average





Weighted trailing average return on debt

2018 RoRI (p. 35)

- AER set allowed return on debt to **match benchmark efficient financing costs.**
- Consistent with NPV=0.
- Best achieves the NEO and NGO.

2022 RoRI (p. 58)

- AER set allowed return on debt to **match benchmark efficient financing costs.**
- Consistent with NPV=0.
- Best achieves the NEO and NGO.

2026 Draft RoRI

- AER recognises that weighted trailing average best reflects benchmark efficient financing costs and NPV neutrality.
- But allowed return on debt **no longer set to match benchmark efficient financing costs.**
- AER accepts that there will be **“incorrect compensation.”**
- Previous objective of matching efficient costs appears to not apply if that would result in higher consumer bills.
- Inconsistent with Revenue and Pricing Principles: *‘reasonable opportunity to recover efficient costs’*



The role of “incorrect compensation”

We acknowledge there is currently broad stakeholder support for a weighted trailing average, in principle. In some circumstances, a weighted trailing average may better reflect the timing and scale of actual debt issuances than a simple trailing average, and we agree it has theoretical merit in those circumstances. However, any incorrect compensation under the simple trailing average is likely to be transitory as, on average, outcomes under the simple trailing average and the QTC weighted trailing average approaches will converge over time. (AER Draft RoRI p.60)

For each tranche of debt, the incorrect compensation is permanent

- Excess debt (i.e., beyond the standard 10% refinancing) raised in Year 1 will be under-compensated **every year for 10 years**. And that under-compensation will **never be reversed**.
- Although the allowed return on debt converges to the same figure after 10 years, the incorrect compensation aggregates every year for 10 years.

Will the incorrect compensation cancel out over time?

- The AER estimates that there will be \$200 million of under-compensation under the 2026 RoRI.
- Perhaps there will be \$200 million of over-compensation next time?
- Can the current AER bind future AERs to over-charge future consumers?
- Or would it be better to set the allowed return equal to the benchmark efficient cost in every RoRI? (The “guiding principle” of the 2022 RoRI)

Steps required





Steps required from here

BETA

- There is **no new evidence** to support a change to the AER's domestic beta estimate of 0.6.
- Applying direct weight to the international evidence can only, logically, **increase the estimate above 0.6**.
- **Further target consultation required** on the integration of international and domestic beta evidence, using a structured, durable, predictable methodology.

MRP

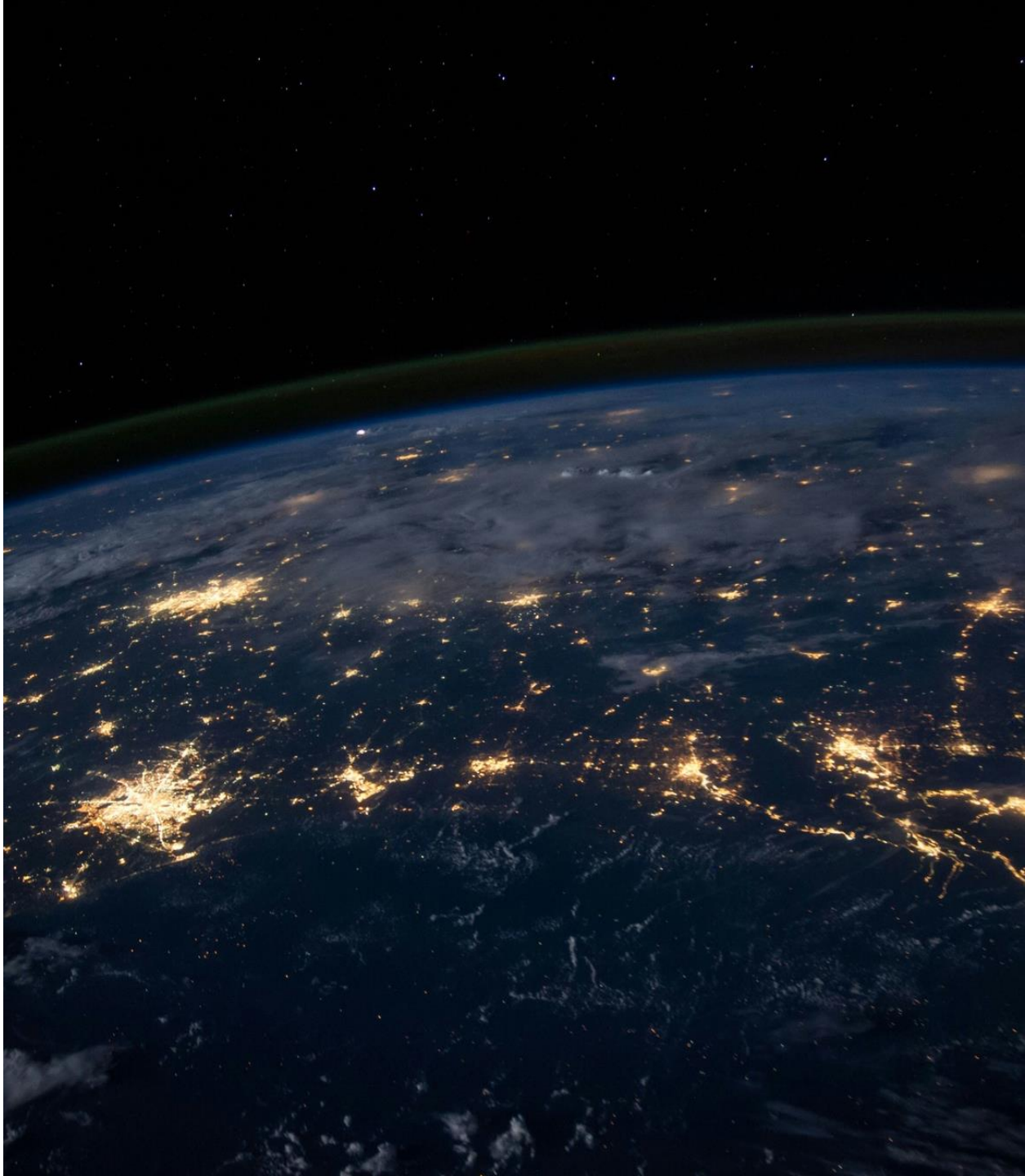
- Application of the **approach applied in 2018 and 2022** now produces an estimate of 6.3%.

RETURN ON DEBT

- ENA proposes that the allowed return on debt should be set **to match the benchmark efficient financing costs**.
- No network should ever be awarded "incorrect compensation" under the RoRI.
- The AER should explicitly recognise that any such "incorrect compensation" would be permanent and never recovered.

Appendix

Process and treatment of evidence issues in draft RoRI





Further critical issues: Process and treatment of evidence in Draft RORI

Issue	Questions raised
Invalid comparisons	The Draft RoRI (p. 36) makes the point that some other regulators use comparator samples of 9 firms when estimating equity beta. But the AER does not acknowledge that those other regulators use <i>live</i> firms whereas all but one of the AER's sample firms have been delisted, some for decades. Is this a balanced characterisation of the evidence?
Conditional vs unconditional estimations	Suppose we already have an estimate of the long-run average water height in a particular port. We then measure the water height at a single point in time and see that the height is lower than the observed average (e.g., because it happens to be low tide at the time of measurement). Should we reduce our estimate of the long-run average?
Lack of new evidence to support methodology change	<p>The MRP was not identified as a key area of focus for this review. However, in response to (I) submissions, we have considered whether a change to the point estimate is warranted,</p> <p>No stakeholder submission proposed re-consideration of the approach to estimating the MRP, and no information was provided to the AER that had not been previously considered.</p>



Further critical issues: Process and treatment of evidence in Draft RORI

Issue	Questions raised
<p>Estimates moving in opposite direction to evidence</p>	<p>Are bubbles and corrections relevant in one direction, but not the other?</p> <p>In 2018, when equity beta estimates had increased since 2013:</p> <p><i>The main factors suggesting the increase in the point estimate are an increase in short term estimates and a marginal increase in estimates from the longest estimation period. However, we caution over-reliance on short-term results as bubbles and corrections are normal part of market operation. During these periods, the firms we regulate (sometimes referred to as 'defensive stocks and due to their steady regulated revenue), attract greater investor attention (sometimes called the 'flight to quality') and experience rising beta estimates. (2018 Explanatory Statement, p. 168).</i></p> <p><i>...it uncertainty (sic) that movements since 2013 support an increase in the systematic risk of supplying Australian regulated energy services. (2018 Explanatory Statement, p. 170).</i></p> <p>But now, one of the three reasons cited for the change in beta is:</p> <p><i>Our latest update shows the 5-year estimates of both domestic (APA Group) and international firms have declined and are now below their longest-period estimates (Draft Decision, p. 22)</i></p> <p>What's changed?</p>



Further critical issues: Process and treatment of evidence in Draft RORI

Issue	Questions raised
Inconsistent and asymmetric treatment of evidence	<p>How can it be the case that:</p> <ul style="list-style-type: none">• A complete lack of data for the last 5 years is so inconsequential that it doesn't matter – because it wouldn't change anything anyway [<i>“a lack of data for the most recent 5 years (for domestic firms) is unlikely to significantly affect the overall estimation results”</i>]; but• The last 5 years of data is so important that it is advanced as a primary reason for reducing equity beta even further below that adopted by all comparable regulators?
Inconsistent and asymmetric treatment of evidence	<p>How can it be the case that:</p> <ul style="list-style-type: none">• APA is “not an optimal comparator” and “not a valid” comparator to the extent that it has been cut entirely from the reduced domestic sample; but• The last 5 years of data for APA (for just those years) is advanced as a primary reason for reducing equity beta even further below that adopted by all comparable regulators?
Process issue: Independent Panel	<p>It appears the Independent Panel will be assessing the draft Instrument without being informed in any way of stakeholders concerns on (i) the scope of changes in the draft Instrument being beyond those set out in the Discussion Paper and stakeholder discussions, and (ii) the apparent reinterpretation of approaches and methodologies in previous decisions.</p> <p>How can an Independent Panel process provide genuine assurance of the quality and rigour of the draft Instrument when it is not able to be informed about, or address, what have turned out to be key review issues?</p>



Further critical issues: Process and treatment of evidence in Draft RORI

Issue	Questions raised
Inconsistent and asymmetric treatment of evidence	<ul style="list-style-type: none">• The AER is clear about the fact that it estimates the unconditional (long-run average) MRP.• The Historical Excess Returns (HER) approach is the AER's evidence of the unconditional (long-run average) MRP.• All of the HER estimates have increased since the 2022 RoRI, yet the adopted MRP is lower.• Logically, the only explanations appear to be that either:<ul style="list-style-type: none">• The AER does <i>not</i>, in fact, estimate the unconditional (long-run average) MRP after all; or• The 2022 AER erred in estimating the unconditional MRP to be 6.2% p.a.; or• The current AER has misconstrued the evidence since 2022.
Quality of evidence and accounting for errors highlighted	<ul style="list-style-type: none">• How can any consideration at all be given to a beta estimate obtained as follows: <i>....where did my 0.4 for the asset beta come from? It came from introspection on my priors – I simply asked myself, what do you think is the most likely value for the asset beta of an NSP? And the answer came back, 0.4.</i>• How has it occurred that the estimate is cited in a way that perpetuates the clear mathematical error in the proponent's re-levering calculation (Draft RoRI, p. 40), rather than the corrected version of that calculation set out in the ENA submission last December (pp. 58-59)?