2 September 2022

Mr Warwick Anderson
General Manager, Network Finance and Reporting
Australian Energy Regulator

By email: RateofReturn@aer.gov.au

Dear Mr Anderson,

Re: Response to AER RORI 2022 Draft Decision

The Network Shareholders Group (**NSG**) welcomes the opportunity to respond to the Australian Energy Regulator's (**AER**'s) Draft Decision on the 2022 Rate of Return Instrument (**2022 RORI**).

As you are aware, the NSG comprises a mix of Australian and foreign investors with significant and ongoing capital invested in Australian electricity network assets that are subject to economic regulation by the AER. We are AMP Capital, Brookfield, CDPQ, HRL Morrison & Co, IFM Investors, Macquarie Asset Management, OMERS and Spark Infrastructure. Collectively, we have invested more than $600 billion[1] in equity across infrastructure assets globally, including significant interests in all privately-owned network businesses in the National Electricity Market (**NEM**). Our electricity network assets serve consumers in New South Wales (**NSW**), South Australia (**SA**) and Victoria (**VIC**).

We play a critical role in ensuring energy policy and regulatory processes in Australia are well-informed and carefully consider conditions in financial markets. In turn, this supports necessary and efficient capital investment to ensure that government infrastructure and policy commitments can deliver improvements to the lives of all Australians.

The 2022 RORI Review comes at a critical juncture in the NEM's history characterised by acceleration of the Commonwealth Government's commitment to achieve net zero emissions and an unprecedented network investment program required to facilitate that transition while continuing to efficiently deliver safe and reliable supply. The Australian Energy Market Operator (**AEMO**) has identified $12.7 billion in necessary transmission network investments alone[2], with NSG members looking to commit capital to renewable generation and storage in addition to network investments. In the medium to long-term, this investment in the nation's electricity system will transition Australia's energy market to an environment of lower wholesale prices for the benefit of consumers.

Indeed, the evidence presented by consumer groups as part of this process show strong consumer support for the transition to renewables and ensuring long-term reliability of supply.[3] This also reinforces the direct alignment between the long-term interests of consumers with the objectives of investors, which is to enable prudent and efficient investment in assets that are necessary to support the energy transition and ultimately deliver lower cost electricity supply to consumers.

The regulatory framework – and the AER's increased responsibility in operationalising it – is critical and should create an environment that is conducive to efficient investment, and the RORI is one of the key elements of the regulatory construct as it directly impacts the returns that investors will be able to realise on regulated assets. Also important is the way in which the AER applies its discretion in making decisions under the RORI and how its approach impacts on regulatory risk.

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[1] Infrastructure equity investments for Spark Infrastructure reflects that of its shareholders, KKR, Ontario Teachers Pension Plan and PSP Investments.
[2] Australian Energy Market Operator (2022). 2022 Integrated System Plan, June
[3] Energy Consumers Australia (2022). Consumer Challenges in the Energy Transition, AER Public Forum on Rate of Return, 27 July.

In our view, the underlying principles of good regulatory practice should reflect the following:

1. The AER's process and approach must be unbiased;
2. Regulatory stability and predictability are essential for encouraging investment;
3. The long-term nature of investment decision making needs to be considered;
4. Market evidence, experience and expertise are relevant to the task;
5. Impacts and outcomes need to be measured; and
6. Transparency of the regulator's decision and process are paramount.

Investors' position

Our position since 2018 RORI has been that the risk-adjusted return on regulated networks in the NEM has been below efficient level and hence unsustainable. We are of the view that the 2022 Draft RORI Decision does not remedy this outcome.

Based on confidential data supplied by our members, since the commencement of the 2018 RORI the average equity risk premium (**ERP**) we require to invest in an Australian electricity network has been around 6.7%. This is approximately 304 basis points higher than the ERP under the 2018 RORI and 262 basis points higher than the ERP under the draft 2022 RORI[4]. Adding the ERP to a risk free rate that is based on a five year term to maturity will further reduce the allowed return on equity compared to investors' required IRRs, which are based on a ten year term to maturity (in Australia).

Our experience is consistent with the findings of independent valuation experts in recent transactions for Spark Infrastructure and AusNet Services, which concluded that the current market cost of equity capital is 200 basis points higher than the AER's allowance under the 2018 RORI.[5]

As another data point, some of the investors we represent must also target MSCI unlisted infrastructure benchmarks (as required by the Federal Government for Australian superannuation fund investors' infrastructure portfolios), which was 10.86% as at 30 June 2022.[6]

Overall, our fundamental concern with the Draft Decision is that the paradigm within which the AER assesses rates of return – or the assumptions it makes about how investors form (or should form) their return expectations – is markedly different from what investors actually do in practice. We submit that as the providers of capital to the networks that are subject to the AER's RORI, understanding and aligning RORI with market practice as applied by investors is critical to the AER's regulatory task and the achievement of its NPV=0 principle, as recently acknowledged by the Economic Regulation Authority (**ERA**), which operates under the same Law and Rules.[7]

In particular, the AER's departure from market practice in its proposal to shorten the term of the risk free rate in the return on equity to match the length of the regulatory period, comes as a surprise to us given the level of engagement on this issue during the course of this review and the level of support amongst stakeholders for the retention of a ten year term.[8] Applying a ten year term to maturity has been a longstanding practice by the AER and consistent with the approach now applied by all other Australian regulators. Basing the term of the risk free

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[4] Applying the AER's estimated MRP for a five year regulatory control period.
[5] Energy Networks Association (2022). Rate of Return Instrument Review, Response to AER's Final Omnibus and Information Papers, 11 March.
[6] MSCI Australia Quarterly Private Infrastructure Fund Index (Unfrozen) as at 30 June 2022
[7] Economic Regulation Authority (2022). Explanatory Statement for the 2022 Draft Gas Rate of Return Instrument, June, p.98.
[8] Australian Energy Regulator (2021). Rate of Return: Term of the Rate of Return and Rate of Return and Cashflows in a Low Interest Rate Environment, Final Working Paper, September, p.26.

rate on the longest liquid sovereign government bond is also common practice globally in evaluating long-term infrastructure investments.

There are two important points we wish to raise in this context.

Firstly, we question how the rate of return 'required' by investors can be determined without having regard to what investors actually require. If the RORI is to satisfy the revenue and pricing principles and deliver an outcome that will encourage efficient investment that is in the long run interests of consumers in support of the NEO/NGO, then consideration needs to be given to the process that an investor will follow in practice rather than a process that is nothing but a theoretical exercise.

What is especially disconcerting for investors is that the AER has made this decision despite acknowledging that:

> *"Investors typically use a 10year discount rate when making their investment decisions on infrastructure investments. If we change to a shorter term our revenue allowance would not meet investor expectations."*[9]

Secondly, the Draft Decision highlights that the way in which the AER is potentially interpreting its task, as well as what it considers is required to meet the NEO/NGO (having regard to the pricing principles), can be subject to change through time. We are becoming increasingly concerned with these changes and the implications for regulatory risk.

As with other stakeholders, the NSG has lodged multiple submissions over the course of this review, including in response to specific technical matters set out in various working papers published by the AER. We would expect the AER to have due regard to our arguments laid down in those submissions.

Having regard to our role as providers of capital to fund current and future network investments, the focus of this submission is to revisit how investors assess investments in regulated energy network infrastructure in practice. Recognising that each organisation has its own internal assessment, governance and decision-making processes, we will summarise the overall approach that is taken and the key principles that are applied. Our response is set out in more detail in the Attachment.

Investment Mandate - In assessing where to best invest our scarce capital, we consider high quality opportunities in regulated and unregulated industries globally and make decisions based on a relative risk/ return profile of various investment opportunities.

Investment Horizon - Investments are evaluated on a whole of life basis, which for energy network infrastructure, is often fifty years or longer. This also (typically) reflects our commitment to hold these investments long-term.

Valuation Approach - Investments are evaluated using a detailed bottom-up approach and based on a target hurdle rate (or internal rate of return (**IRR**)). Investors make these multi-million (and in some cases, billion) dollar investment decisions at a point in time, using capital raised at that point in time. As with any investment decision, it is made based on forecasts made at that time based on the best possible information available.

Hurdle Rates - The target IRR is determined when the initial investment is made. As the basis of the investment decision, the target IRR that is applied to a particular project is not adjusted over time, nor is it 'reset' in line with a regulatory determination and in accordance with any changes to the AER's RORI. The risk free rate in our target IRR is based on the longest liquid sovereign debt instrument in the relevant market – in Australia, this is ten years.

Pricing of Risk - The performance of our investments is actively monitored over time. Any differential between regulatory return and our required return on these assets will be 'looked through', provided that there is an expectation that over time, the regulated rates of return will revert to, or align with, the target IRR. Stability, transparency and predictability of regulatory framework is critical to this investment concept.

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[9] Australian Energy Regulator (2022). Draft Rate of Return Instrument: Explanatory Statement, June, p.10.

Any change to the way the AER assesses allowed returns presents a risk to investors. This will impact our decisions to commit future capital in this jurisdiction depending on the relative risk/return profile offered by opportunities in other jurisdictions.

Differences between the AER's allowed rate of return and an investor's required rate of return will impact capital availability for new investments, including major capital expenditure that is necessary to renew or expand the network. As noted above, investment decisions are made on the expectation that the target IRR will be met over time. This can only occur if regulated rates of return are set in an unbiased manner, taking into account the returns required by investors. The AER's proposal to shorten the term of the risk free rate below ten years – in the knowledge that this is contrary to what investors do in practice – will further entrench systematic under-compensation over the longer term.

As investors operating in international financial markets, if there is no longer confidence in the expectation that required returns will be achieved over the life of an investment, this is likely to further reduce investors' willingness to deploy capital to the Australian energy market in a timely and sustained manner, and to shift the focus and attention of investors to opportunities in other sectors and offshore.

We would welcome the opportunity to engage with the AER further on these matters.

Gerard Dover
Acting CEO
Spark Infrastructure

Christopher Curtain
Senior Managing Director, Asia-Pacific
OMERS Infrastructure

Jean-Etienne Leroux
Managing Director – Australia & New Zealand, CDPQ

Ray Neill
Managing Director, Infrastructure
Brookfield Infrastructure Group (Australia)

Michael Hanna
Head of Infrastructure – Australia
IFM Investors

Michael Cummings
Global Co-Head of Asset Management
AMP Capital

Kieran Zubrinich
Senior Managing Director
Macquarie Asset Management

Steven Fitzgerald
Global Head of Asset Management
HRL Morrison & Co

ATTACHMENT

This attachment sets out further comments on key aspects of the AER's Draft Decision that are of most importance to NSG members.

Significant investment in electricity networks is required to transition the economy to net zero emissions

The review of the 2022 RORI coincides with an industry and economic environment that presents the most significant opportunities and challenges faced since the inception of economic regulation. This includes a major capital investment program that will be necessary to support the market's transition to a renewable energy future.

In June 2022, the Commonwealth Government lodged an updated Nationally Determined Contribution (**NDC**) to the United Nations Framework Convention on Climate Change secretariat as part of Australia's obligations under the Paris Agreement. This updated NDC commits Australia to a more ambitious target to reduce emissions by 43% below 2005 levels by 2030 (15 percentage points above the previous target) and reaffirms a commitment to net zero emissions by 2050.

The new Labor Government's Powering Australia policy sets out its plan to enable this accelerated transition, requiring an estimated $76 billion of investment and creating 604,000 jobs.[10] Within that context, the Rewiring the Nation policy commits $20 billion to the transmission network alone.[11] On 30 June 2022, AEMO released its 2022 Integrated System Plan (**ISP**), which identifies $12.7 billion in necessary transmission projects that are forecast to deliver net market benefits of $28 billion.[12] This is not discretionary investment – this is investment required to maintain a resilient and reliable electricity grid.

This transition is also important to consumers as the ultimate beneficiaries of the investment. As well as wanting cleaner, greener energy sources, these investments will also enable consumers to realise the benefits from their own behind-the-meter investment in solar PV and battery storage (for those consumers who are able to do so). AEMO identifies that around 30% of detached homes in Australia have rooftop PV, which is projected to increase to over 50% by 2032 and 65% in 2050.[13] Concurrent with this, coal-fired generation has been withdrawing faster than anticipated, presenting challenges for system reliability, as recently experienced over the winter months in a number of States.

The results of a survey by the Energy Consumer's Association that it summarised at the AER's Stakeholder Forum on the 27th of July 2022 revealed consumer support for a faster transition to 100% renewables, with 14% of consumers surveyed supporting this by 2025, 29% by 2030 and 14% by 2040.[14]

At the same time, consumers are facing major cost of living pressures. Significant increases in wholesale energy prices have been driving up the cost of energy, concurrent with increases in the prices of a range of essential goods and services, along with mortgage interest rates. These cost of living pressures and affordability concerns were also highlighted by consumer representatives at the AER's Stakeholder Forum.

We are highly cognisant of these pressures, which remain key policy matters for Government. Importantly, in the medium to longer term, the investments made in the network will transition Australia's energy market to an environment of lower wholesale prices for the benefit of all consumers.

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[10] https://www.alp.org.au/policies/powering-australia
[11] https://alp.org.au/policies/rewiring_the_nation
[12] Australian Energy Market Operator (2022). 2022 Integrated System Plan, June.
[13] Australian Energy Market Operator (2022). p.9.
[14] Energy Consumers Association (2022). Sentiment Survey, June 2022, https://ecss.energyconsumersaustralia.com.au/sentiment-survey-june-2022/featured-content-household-sentiment-june-2022/.

A stable, transparent and predictable regulatory construct is required to stimulate this investment

In setting the rate of return to apply to a network business at each regulatory determination, the AER's primary goal is to support the achievement of the National Electricity Objective (**NEO**) and the National Gas Objective (**NGO**). In each case, the objective is to promote efficient investment in, and the efficient operation and use of, the relevant electricity and gas services, for the long-term interests of consumers with respect to the price, quality, safety, reliability and security of supply.

The feedback from consumer groups reinforces the direct alignment between the long-term interests of consumers with the objectives of investors, which is to enable prudent and efficient investment in assets that are necessary to support the energy transition and ultimately deliver lower cost electricity services to consumers. The rate of return is of direct relevance to enabling this investment.[15]

The scale and nature of the investment required presents a different risk profile compared to what network businesses and investors have faced historically. This increased risk profile is not compensated in the rate of return. Indeed, on reviewing the AER's Draft Decision, while it acknowledges the scale of the future investment program, there is no recognition of this change in risk profile and how it might impact incentives to invest.

As will be outlined in this submission, investors make their investment decisions based on their required rate of return. Further, this investment horizon is long-term, reflecting the long economic lives (and capital recovery profile) of these assets. Investors need to consider a range of risks in committing capital over such a long timeframe – this includes regulatory risk. Changes to the regulatory approach increases risk and the benefits and costs of any such changes therefore need to be carefully balanced against a more stable and predictable regime. As investors, we value this stability and predictability, noting that this assumes that our starting point is a regime where the rate of return is established in a manner that aligns with how investors determine their required returns.

The Draft 2022 RORI is not supportive of efficient network investment since it promotes systematic under-compensation of equity capital

Overall, our fundamental concern with the Draft Decision is that the paradigm within which the AER assesses rates of return – or the assumptions it makes about how investors form their return expectations – is markedly different from what investors actually do in practice. As discussed further below, one of the main divergences is the horizon for estimating the term for the risk free rate in the return on equity.

The AER maintains the view that it has a "different task" to market practitioners (which includes investors).[16] As we have previously submitted, we disagree that the AER has a different task in this context.[17] As the AER notes, if it is to satisfy the revenue and pricing principle in the National Electricity Law (**NEL**) and National Gas Law (**NGL**) (collectively referred to herein as **the Law**), which is to provide the service provider with a reasonable opportunity to "at least" recover its efficient costs, there needs to be "just enough cashflow left over to cover investors' required return on the capital invested."[18]

This has two implications. The first is that it is the required return, not some other theoretical or assumed return, that is part of the efficient costs of delivering the relevant services. The AER has also stated that:

> *"For equity, our task is to estimate the returns investors expect in the future to incentivise efficient investment for the long-term interests of consumers."*[19]

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[15] In terms of ensuring the efficient operation and use of the infrastructure, the rate of return has less of a direct role to play. This is the key role of operating expenditure allowances, incentive regimes and tariff structures, including pricing that can signal the costs of utilising energy during peak and off-peak demand periods and encourage the most effective utilisation of resources such as solar PV.

[16] Australian Energy Regulator (2022). p.14.

[17] For example, refer: Network Shareholders Group (2022). Response to the AER Rate of Return Information Paper and Omnibus Final Working Paper, 11 March.

[18] Australian Energy Regulator (2022). p.51.

[19] Australian Energy Regulator (2022). p.8.

Second, the principle recognises that service providers need to be able to generate sufficient cashflow over the life of the investment to compensate investors for this required return (which the AER has termed the 'NPV=0' principle[20]). Investors recognise that of course, this is not guaranteed. However, this principle will never be able to be achieved if that required return has been mis-specified. In this case, assuming a normally upward sloping yield curve, the AER's approach will permanently lock in a rate of return that will under-compensate investors.

If the way in which the AER estimates the expected rate of return differs in material respects from how investors actually set their return expectations, the risk of regulatory error is heightened, with potential flow-on consequences for investments as already acknowledged by the AER.[21] Over the longer term, investors have more flexibility in relation to where to deploy their capital. The AER has previously acknowledged that it is consumers that will ultimately bear the cost of the regulator getting the rate of return estimate wrong.[22]

The way in which the AER is potentially interpreting its task, as well as what it considers is required to meet the NEO/NGO (having regard to the pricing principles), has also been subject to change through time. We are becoming increasingly concerned with these changes and the implications for regulatory risk. As we have previously submitted, as network investors we are seeking stability, transparency, consistency and predictability over time, assuming that our starting point is a regime where the rate of return is established in a manner that aligns with how investors determine their required returns.

We make significant investments in long life infrastructure that span more than one regulatory period or RORI term. We are not getting our capital back and/or making a new investment decision at the end of each regulatory period. Putting aside the issues associated with the AER's proposal to shorten the term of the risk free rate, particularly from an investors' viewpoint, the way in which it has rationalised this proposal has heightened concerns regarding further potential shifts in interpretation in the future. This increases investors' exposure to regulatory risk and will impact how this will be assessed in making future investment decisions.

The AER's application of 'NPV=0'

One of the most contentious issues over the course of this review has been the AER's application of the 'NPV=0' principle and how it has interpreted this within the context of the Law and Rules, noting that the legislative framework itself does not explicitly prescribe this as a principle or condition.

The AER is now of the view that to set the term of the risk free rate to be anything other than the length of the regulatory period would violate the NPV=0 principle. This view is underpinned by the theoretical framework put forward by Dr Lally.

In its review of the 2018 RORI, the AER also considered the issue of shortening the term of the risk free rate to match the length of the regulatory period. In this review, it also referred to advice from Dr Lally that this would satisfy the present value principle "better than a ten year term"[23], which was also considered in its review of the 2013 Rate of Return Guideline. In its final Explanatory Statement for the 2018 RORI, the AER concluded that:

> *"…the issue with using a term equal to the length of the regulatory control period, is it requires the assumption that the full recovery of the residual value of the RAB (in cash) at the end of the term is guaranteed. The ability of regulated businesses to over or under perform their allowed rate of return and other allowances, and the volatility of the stock market make it difficult to say whether (and to what extent) Lally's assumptions would hold in reality."*[24]

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[20] It is noted that the AER refers to the need to "at least" provide compensation for these efficient costs, not "to only" provide that compensation.
[21] Australian Energy Regulator (2022). p.52.
[22] Australian Energy Regulator (2021). Assessing the Long Term Interests of Consumers: Position Paper, May, pp.8-9.
[23] Australian Energy Regulator (2018). Rate of Return Instrument, Explanatory Statement, p.130.
[24] Australian Energy Regulator (2018). p.130.

Further:

> *"…we consider our approach is consistent with the long lived nature of the assets to which we are applying the CAPM, market practitioners and academic evidence."*[25]

Concurrent with the release of the AER's Draft Decision for the 2022 RORI, the Economic Regulation Authority (**ERA**) released its Draft Gas Rate of Return Instrument.[26] This is governed under the same Law and Rules. The ERA also refers to satisfaction of the NPV=0 condition in determining the approach that will best meet the NGL. The ERA was similarly advised by Dr Lally, who continued to advocate matching the term of the risk free rate to the length of the regulatory period.

The ERA is now proposing to move to a ten year term to maturity. It has determined that the weight of evidence supports a change in approach that was more consistent with common market practice. It cited the following list of advantages in applying a ten year term:

- *"It recognises that efficient and prudent infrastructure companies require a long-term rate to reflect the long-term cashflows of their networks.*
- *It is consistent with standard practice adopted by market investors, valuation professionals, academics and practitioner textbooks.*
- *Recognises the reality of regulatory cashflows and returns being realised by equity investors over the life of the asset.*
- *Does not disadvantage regulated assets which have to compete for funding with unregulated infrastructure with similar risk. Regulated infrastructure investments must compete for equity capital with similar unregulated investments, for which the required return is typically based on a 10-year term for equity.*
- *Meets the NPV=0 principle. If the goal is to match the regulatory allowance to the market cost of capital (i.e. the return that investors require) the term should be set to match the practices of investors. A 10-year term for equity supports efficient financing costs over multiple regulatory periods.*
- *The use of a 10-year term for equity is widely applied by Australian and international regulators. Regulators have generally accepted the argument that the term of equity should be a proxy for the life of the regulated asset. Given the long-term nature of infrastructure asset investment, regulators generally consider that a long-term rate better reflects the expectations of investors rather than a shorter term."*[27]

We note that these considerations give prominence to aligning with market practice. Of particular note is that the ERA considers that matching the practices of investors (i.e. setting a return that aligns with what investors require) will achieve NPV=0.

Putting aside the theoretical and technical issues and evidence regarding the choice of term to maturity and the incongruence of a shorter term with what investors do in practice, as outlined above, one of the more concerning aspects of this decision is that it signals heightened regulatory risk for investors. All stakeholders, including the AER, are advocating a stable and predictable regulatory framework and a high bar for change. This should

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[25] Australian Energy Regulator (2018). p.131.
[26] Economic Regulation Authority (2022). Explanatory Statement for the 2022 Draft Gas Rate of Return Instrument, June, p.98.
[27] Economic Regulation Authority (2022). p.98.

similarly apply in relation to interpretation of requirements under the governing Law and Rules, including what is required to satisfy the 'NPV=0' condition.

The AER should take into account a return that is required by capital providers

In this section we put aside the approaches applied under the regulatory framework and summarise how investors actually evaluate these investments in practice (i.e. how do we assess and apply required rates of return). We emphasise that the actual approaches will vary between each investor depending on (amongst other things) their objectives, investment philosophy, asset management strategy, risk profile and governance framework.

Investment Mandate

While the scope considered by each investor will differ, investments in Australian regulated network infrastructure will typically be compared against other asset classes. This can include other regulated and unregulated infrastructure in Australia, as well as overseas.

All major investors tend to have a global focus and hence are identifying and examining opportunities in multiple jurisdictions.

Investment Horizon

Investments are evaluated on a whole of life basis (i.e. based on the economic life of the assets). For energy network infrastructure, this is often fifty years or longer. This typically reflects a commitment to hold these investments for the long-term.

Valuation Approach

The expected cashflows for the investment are modelled based on the economic life (typically based on a very long-term cashflow profile with a terminal value). The models we use tend to be very detailed bottom-up models. We note that the 'NPV=0' principle is a regulatory construct – it is not a principle that is applied by investors as part of their decision-making.

The timing of regulatory periods and determinations does not directly impact that cashflow profile, other than having regard to the timing of the inclusion of capital expenditure in the RAB under the PTRM. This also becomes relevant in monitoring actual performance of the investment over time.

Sensitivity and scenario analyses are also conducted. As noted previously, the transformation of the energy market is changing the risk profile of network investments and the way in which this risk is analysed and assessed. Examples include:

- increased operational risks, including:
    - the impact of climate risks on physical assets, along with an increased major storm and bushfire risk;
    - increased complexity in managing the network given the potential increase in the number of generators/loads, volatility in net demand and decreasing baseload generation – all of which present challenges in managing network stability;
- increased development risks, with long lead times involved in developing and assessing the feasibility of investments – in the meantime, the businesses will be incurring costs with some residual uncertainty as to when and how they will be recovered (particularly in advance of the approval of a Contingent Project Application);
- increased construction risk, with conditions in the construction industry (including markets for key inputs such as steel) expected to remain challenging for some time (noting the benefit/risk sharing framework under the Capital Expenditure Sharing Scheme (**CESS**));
- increased political and regulatory risks, including from concerns as to the consequent price impacts in recovering the costs of investment from consumers – this is particularly evident at the current time; and
- increased stranding risk for existing assets that may become redundant.

Required rate of return

The hurdle rate (target Internal Rate of Return (**IRR**)) for a project or investment is determined when the initial investment is made. As the basis of the investment decision, this target return is not adjusted over time, nor is it 'reset' in line with a regulatory determination.

The target equity IRR is a long-term forward-looking estimate. The risk free rate benchmark is based on the longest liquid sovereign government bond in the relevant jurisdiction. In Australia, this is ten years. In the US (for example), this can be thirty years.

Investors can look at target equity IRRs on both relative terms (i.e. compared to risk free rates and comparable market benchmarks), as well as absolute terms. In relation to the latter, this involves assessing the reasonableness of the estimate overall, rather than on a parameter-specific basis (which is the AER's approach). It should be noted that many equity providers are private funds that raise capital from investors on the basis of this targeted return. Infrastructure investment funds therefore need to invest in opportunities that will deliver those targeted returns.

Each investor's target IRR is highly commercially sensitive information. However, based on confidential data from our members regarding their target equity IRRs, since the commencement of the 2018 RORI the average equity risk premium (**ERP**) has been around 6.7%[28]. This compares to:

- the ERP under the 2018 RORI of 3.66%
- the ERP under the draft 2022 RORI of 4.08%[29].

This is consistent with the findings of independent expert valuation reports prepared as part of recent transactions for Spark Infrastructure and AusNet Services, which concluded that the current market cost of equity capital is 200 basis points higher than the AER's current allowance (under the 2018 RORI).[30]

If this is then added to a risk free rate that is based on a five year term to maturity, this will only further reduce the allowed return on equity compared to investors' target IRRs, which are based on a ten year term to maturity (in Australia).

In addition, the Federal Government requires that Australian superannuation fund investors' infrastructure portfolios (including Australian energy network businesses) must also target MSCI unlisted infrastructure benchmarks, which was 10.86% as at 30 June 2022[31].

Future capital expenditure

A projection will be made of expected capital expenditure requirements as part of the initial assessment. However, all future investments will still be subject to an internal review and approval process based on each organisation's governance process prior to that investment being made. This will follow similar principles to the above, including having regard to:

- the risk profile of the investment, including development and construction risks;
- a comparison of the expected equity IRR, which is benchmarked against similar projects (on a risk-adjusted basis) that are being assessed at the same time (recognising that there is only finite capital available to fund competing investment opportunities); and

[28] This is calculated with reference to contemporaneous ten year Commonwealth Government bond yields.
[29] Applying the AER's estimated MRP for a five year regulatory control period.
[30] Energy Networks Association (2022). Rate of Return Instrument Review, Response to AER's Final Omnibus and Information Papers, 11 March.
[31] MSCI Australia Quarterly Private Infrastructure Fund Index (Unfrozen) as at 30 June 2022.

- the strategic rationale for the investment, including whether it is discretionary or non-discretionary (e.g. to maintain reliability standards), as well as other policy and/or commercial drivers.

Ongoing monitoring and review

The performance of each investment is evaluated on at least an annual basis with reference to the original target equity IRR. As relevant, this will consider the interactions with the AER's incentive schemes. Additional targets to reduce expenditure may also be set within the business at a project or asset level.

The AER's characterisation of the investors' perspective

In the table below we summarise how the AER has characterised the investor's perspective (or what it assumes is the investor's perspective) in its Draft Decision against what actually happens in practice.

The AER's characterisation/assumptions	What happens in practice
"Our practice of resetting the allowed rate of return on equity at each regulatory determination affects the profile and riskiness of regulatory cash flows. In turn this impacts the expected return investors require." (p.14, p.94) "Matching the term of the allowed return on equity to the length of the regulatory period better aligns our regulatory allowance with the efficient costs of providing regulated services and risks borne by the investors." (p.14, p.94))	Regulated network investments span multiple decades. Investments are evaluated based on a forecast of expected cashflows over the life of the assets. Further, this lifespan is not modelled as a consecutive series of regulatory resets, in other words, the practice of periodic regulatory resets does not directly impact the profile of the cashflows on an ex ante basis. Each determination will impact the riskiness of the cashflows. However, from an investors' perspective, this is primarily about regulatory risk and how it could impact the realisation of those cashflows over time – this includes downside risk if the regulator reduces revenue below the amount that is considered necessary to fully compensate the business for its efficient costs. Indeed, if this occurs, this will only heighten investors' concerns about regulatory risk over the longer term – any reassessment will impact required returns over the remaining life of the investment, not the next five years of the regulatory period. This does not support term-matching the risk free rate to the length of the regulatory period, as the AER assumes.
"Investors typically use a 10year discount rate when making their investment decisions on infrastructure investments. If we change to a shorter term our revenue allowance would not meet investor expectations." (p.10, p.94)	The use of a ten year rate generally applies in Australia. The principle is to use the longest liquid benchmark available in the relevant market. While more recently, the yield curve has been inverted (meaning that a five year term to maturity would produce a higher return on equity than a ten year term), given the yield curve is typically upward sloping, the adoption of a five year term will entrench systematic under-compensation over the long-term. We agree that in changing to a shorter term, the revenue allowance would not meet investor expectations.
"Investor expectations of future returns are informed by past realised returns." (p.16, p.128)	Investors adopt forward-looking estimates, based on an assessment of future cash flows and risks over the long-term. Indeed, to assume that historical performance will continue into the future, particularly in what has been a highly dynamic and uncertain (industry and financial) market environment, would prove misleading.
"Discount rates used by market analysts and valuation reports may be an indication of the rate of return expected by investors." (p.30)	Yes, this is highly relevant information that evidences how investors determine required returns. Unlisted equity investors regularly update their investment valuations – typically, this is undertaken by an independent valuation firm, which will determine a discount rate reflective of the required market equity returns from the investment.

The AER's characterisation/assumptions	What happens in practice
"Depending on the purpose of the discount rates used by statutory bodies, they may provide an indication of the rate of return expected by investors." (p.30)	Yes, we agree that this can also be a relevant information source, depending on the purpose.
"Stability and predictability of the regulatory framework and its application is important for both investors and consumers. Stability and predictability promote efficient investment because investors and consumers can make commitments with confidence. They can reasonably foresee how they will be treated under the regulatory framework." (p.31, p.297)	We strongly agree with this statement. This is particularly important to investors given the long economic life (and capital recovery profile) of regulated infrastructure investments. The assessment of regulatory risk is a very important consideration for investors, including the comparative risk of different regimes.
"Since investors can eliminate non-systematic risk, it is unlikely that investors require compensation for these risks and it would be inefficient to compensate for non-systematic risk in the allowed rate of return." (p.63)	In practice, many investors do include a premium for these risks in the discount rate. Otherwise, an allowance for non-systematic risk may be built into the cashflows, even though this would not be reflected in the building blocks revenue allowance determined by the AER. Putting aside the issue as to how treated, under the current regulatory framework there are some commercial and regulatory risks that will remain uncompensated.
"The critical allowance for an equity investor in an efficient firm in the supply of Australian regulated energy network services is the allowed equity risk premium over and above the estimated risk-free rate at a given time. Under the standard application of the SL CAPM, this equals the MRP multiplied by the equity beta." (p.84)	Investors typically apply a CAPM-derived rate of return as a primary method, and it is recognised that this is the approach used to determine "allowed" returns for regulated energy networks.
"The risk-free rate is the expected return on a riskless investment. It characterises investors' time value (opportunity cost) of money. That is, it reflects how investors value a unit of money at the end of a given period relative to the beginning of the same period." (p.95)	We agree with this statement.
The AER summarises the different assumptions applied by theories of the term structure of interest rates (i.e. why yield curves are typically upward sloping). (p.96)	In practice, there are a range of factors influencing the term structure of interest rates (which is not always reflected in an upward sloping yield curve), including inflation expectations, liquidity and other factors that affect demand and supply dynamics.
"The reset frequency of the return on equity affects the profile of the regulatory cashflows. It may also affect the associated level of risk equity holders are exposed to and the expected return on equity investors require for investing in similar regulated assets." (p.100)	Refer comments above, including that investment opportunities are modelled based on a whole of life cashflow profile. The allowed rate of return under the AER's framework (based on the prevailing RORI) would certainly be a key consideration for an investor in making a decision to undertake new investment. Depending on the circumstances and the size of that investment, this is likely to be include a comparison against other alternatives (for regulated and unregulated assets). The reset frequency has no impact on the horizon of the rate of return required by investors when evaluating those investment opportunities – this will always be (at least) a ten year term (in Australia). The AER's rationale does not support term-matching the risk free rate to the length of the regulatory period.

The AER's characterisation/assumptions	What happens in practice
"With 5-year resets, investors in regulated assets do not bear the risks associated with locking in the rate of return beyond a 5-year regulatory control period. Therefore, compensation for these risks is not part of the opportunity cost of equity capital and would not be necessary to attract investors." (p.100)	The AER is suggesting that investors don't need to apply ten year rate because they don't need to be compensated for the risks of locking in rates for an extra five years. Regardless of what the AER decides to do in setting the term of the risk free rate, investors will continue to set required returns based on a ten year term (in Australia), consistent with the long investment horizon. This is not because this contains a term premium that is seen as necessary compensation for risks. Investors do not receive the capital back at the end of each regulatory period for reinvestment at the start of the next period. Investors evaluate risk over the life of the investment, not the term of the regulatory period.
"[Lally] made several simplifying assumptions and established that to satisfy the NPV=0 principle, the allowed rate of return on equity should be set equal to the relevant discount rate – that is, to the required return on equity investors expect to receive over the regulatory period." (p.103)	Putting aside Lally's simplifying assumptions, investors set a required return on equity they expect to receive over the life of the asset. There is no concept of an expected return that is only specified for the length of the regulatory period.
"Actual investor valuation practices appear to be consistent with using long-term government bonds. In the case of Australia these are 10-year CGS." (p.107)	Yes, this is consistent with actual practice.
"Market practitioners and valuation professionals may use the same discount rate to discount all cashflows, regardless of the timing of the cashflows. This appears to suggest that infrastructure investors expect to receive the same (10-year) rate of return, independently of the holding period of the investment. However, the 10-year rate is used as a proxy, rather than because investors are indifferent between investing for a shorter or a longer period. A more theoretically correct approach would be to match the discount rates to the period in which cashflows arise" (p.107) "Further, evidence does not appear to show that investors would in practice require the same (per year) return over a one-year or 5-year period as they do over 10 years or 50 years." (p.107) "To summarise, based on both corporate finance theory and commercial evidence, it appears unlikely that the investors' required return would be invariant to the length of the period over which this return is expected to be recovered." (p.109)	Infrastructure investors are concerned with assets with long economic lives. The ten year bond rate is applied because in Australia, this is the longest liquid 'proxy' for the risk free rate in this market. In evaluating infrastructure investments, the period "in which the cashflows arise" – and the period "over which this return is expected to be recovered" - is over the life of the assets, not the current (or next) regulatory period. The only circumstances under which a rate with a shorter term may be applied is if the relevant investment had a short economic life (i.e. less than ten years).
"We also consider it appropriate to maintain our assumption that non-resident investors derive zero value from imputation credits." (p.244)	We agree that this is an appropriate assumption.

The AER's characterisation/assumptions	What happens in practice
"For an 'eligible' investor, each dollar of imputation credit received is assumed to be fully returned to the investor in the form of a reduction in tax payable or a refund. Therefore, we have considered that eligible investors have a utilisation rate of 1." (p.251)	In practice, investors do not typically fully value franking credits. It depends on the value of those credits in the market. This could be zero.
"…for all investors, including non-residents, we assume undistributed imputation credit are worthless." (p.258)	We agree with this assumption.
"We think there is value to be drawn from RAB multiples because they are a direct indicator of the value that investors place on the businesses we regulate." (p.263)	We disagree with this statement. In the first instance, as the AER has recognised, those RAB multiples need to be disaggregated between regulated and unregulated services. Even if 100% of the business's assets (and the services provided by those assets) are regulated, this is still only a starting point, as the value that a purchaser may place on the business can still reflect other factors, such as, perceived opportunities for efficiency gains, portfolio diversification benefits and future opportunities to provide unregulated services.
"RAB multiples materially above 1.0 demonstrate investor confidence that the overall calibration of the regulatory settlement is favourable (historically and prospectively). Although we use 1.0 as a benchmark here to demonstrate investor confidence, we note that different benchmark levels can be used to trigger further investigation." (p.264) "We could have expected RAB multiples to trend downwards, not upwards, during periods of falling interest rates, because falling interest rates will lead to lower rates of allowed return for both debt and equity investors. An upward trend suggests that investors remain confident." (p.265) "…we have seen vigorous competition among investors for these assets. In this context, it is difficult to conclude there is a material under-remuneration of investors. We consider RAB multiples indicate that investors are confident in the current and future regulatory returns as being sufficiently high to remunerate their costs. Further, it could be argued that our current and expected rates of return are sufficient (as part of the overall regulatory compensation to investors) and potentially higher than that needed to attract investment." (p.266)	In practice, an investor is unlikely to invest in a project with a RAB multiple of 1, particularly given the risks that could impact the realisation of that outcome over time and the existence of alternative opportunities in the market. We disagree that RAB multiples can be used to provide any reliable indicator of investor confidence in the regulatory framework – let alone infer that returns are potentially higher than what is needed to attract investment. Reference is made to the information provided below.
"Discount rates used by market analysts and valuation reports may be an indication of the rate of return expected by investors." (p.279)	Along with other information, discount rates used by market analysts and valuation practitioners are used by investors in establishing target IRRs. It is noted that the AER is proposing to place limited or no weight on this information.

The AER's characterisation/assumptions	What happens in practice
"We find that the 2022 Instrument would navigate the low interest rate scenario well, considering it shares many aspects with the 2018 Instrument. The previous Instrument was applied during a period of low interest rates and low inflation. Demand from investors, as measured in our RAB multiples, actually increased."	As we have previously submitted, we consider that the rates of return determined under the 2018 RORI under-stated actual required rates of return. RAB multiples cannot be used to assess the performance of the AER's RORI. Reference is made to the information provided below.
"If the rate of return is upwardly biased… investors will be overcompensated for the risk involved in supplying capital to networks, so will show increased willingness to invest in regulatory assets in comparison with other investments in the economy." (p.296)	While this might be seen as an appropriate theoretical starting point, this does not flow through to practical reality or how investors perceive investment incentives. First, regulated network investments are assessed on a whole of life basis. Over this period, investors are exposed to regulatory risk that could impact the cashflows generated by these investments. Regulatory risk is not compensated in the rate of return. There would have to be material and persistent over-compensation for this to potentially incentivise 'over-investment'. Even then, given the long capital recovery profile for these assets, it would still be risky for an investor to rely on this being sustained over that period. Second and more importantly, each network's proposed capital expenditure program is subject to detailed review and assessment by the AER. Only prudent and efficient capex is rolled into the RAB. The CESS also provides for the businesses to share any capex savings with consumers. It is more difficult to conceive how a business could deliberately over-invest in network assets in this environment - the regulatory framework provides a very strong disincentive for 'gold plating'.
"If the rate of return is downwardly biased… investors will be undercompensated for the risk involved in supplying capital to networks, so will show reduced willingness to invest in regulatory assets in comparison with other investments in the economy." (p.296)	We agree with this statement. However, while this might reduce the incentive, the business may have no choice to undertake non-discretionary investments e.g. to maintain mandated reliability standards.

The above table highlights a number of points of difference between the AER's draft 2022 RORI and the returns required by investors. The most significant ones are summarised below.

Investment Horizon

The AER rationalises setting the term of the risk free rate in the return on equity to match the length of the regulatory period because each determination has the potential to alter the cashflows and the associated risk profile.

Investors model the cashflows on a whole of life basis and not as a series of consecutive regulatory resets. Once an investment is made, each determination can impact the riskiness of the cashflows. However, from an investors' perspective, this impacts our continual assessment of regulatory risk and how it could impact the realisation of those cashflows over the longer term. If a regulatory determination reduces revenue below the amount that is considered necessary to fully compensate the business for its efficient costs, this will only heighten investors' concerns about regulatory risk over the longer term, extending well beyond the period of that determination. Any reassessment of the risk profile of those cashflows will be based on the remaining life of the investment, not the next five years of the regulatory period.

If the AER shortens the term of the risk free rate to match the length of the regulatory period, the return on equity will not reflect investors' required return. If the yield curve is upward sloping (which is typically the case), that will mean that the AER's return on equity is too low. This will not allow the service provider to be compensated for the efficient costs of delivering the relevant services and will not achieve NPV=0.

We are also concerned that the AER has misrepresented our position on this matter by taking comments made as part of its review of its inflation approach out of context.

We consider that the estimation of expected inflation and the required returns are two fundamentally different and independent tasks. In the AER's December 2021 rate of return omnibus paper it reaffirmed its view that "the terms of equity, debt and inflation do not have to be of the same value."[32]

In our submission to the AER's inflation review we argued that for the purpose of estimating expected inflation, it is better to align the term for forecasting those efficient costs with the revenue allowance that compensates the business for those costs. In particular, this ensures consistency within the Post Tax Revenue Model (**PTRM**) between the inflationary gain adjustment made to the Regulated Asset Base (**RAB**) and the deduction of that inflation adjustment from depreciation to avoid double-counting. In other words, it ensures consistency between what you 'take out' (via regulatory depreciation) and what you 'put in' (via the inflationary gain in the RAB).

The AER's position on expected inflation addressed the mismatch that would otherwise result in modelling the impact of inflation on the RAB. In terms of the required rate of return, shortening the length of the term of the risk free rate will introduce a mismatch between the regulated return on equity and the actual returns required by investors.

Information sources in assessing required rates of return

The AER is proposing to place limited or no weight on a number of information sources, such as reports from market analysts and valuation practitioners and the approaches and outcomes applied by other regulators.

Investors consider a range of information sources in setting required rates of return, including opinions and reports of market analysts and valuation practitioners. Investors also refer to the approaches and outcomes applied by other regulators. This in turn reflects the fact that in evaluating investments in regulated energy network infrastructure in Australia, investors are comparing these against regulated alternatives, both in Australia (in other industries) and overseas.

It is not just the outcomes that are relevant here – it is how the regulator's approach, including in applying its discretion – impacts the assessment of regulatory risk. In placing limited or no weight on these other information sources (that are referred to by investors), the AER risks setting a rate of return that does not reflect required returns.

As we have previously submitted, appropriate cross-checks of the reasonableness of the overall rate of return estimate are critical.[33] It also aligns with what investors do in practice. These cross-checks should include:

- market analyst and valuation expert estimates;
- publicly stated gross target returns for core infrastructure funds;
- financeability assessments;
- actual investment levels and trends;
- information on the returns allowed by other regulators (in Australia and overseas);
- discount rates applied in the Integrated System Plan; and

[32] Australian Energy Regulator (2021). Rate of Return, Overall Rate of Return, Equity and Debt Omnibus, Final Working Paper, December, p.24.
[33] Network Shareholders Group (2021). Response to AER RORI Omnibus Papers.

- the MSCI infrastructure index.

The issue of RAB multiples is discussed below.

Reliance on RAB multiples as an indicator of investor confidence in the AER's RORI

The AER proposes to refer to RAB multiples as a cross-check and sees them as an indicator of investor confidence in the AER's RORI and whether the rate of return is adequate (or excessive).

The AER has acknowledged that there are a number of factors that can influence RAB multiples beyond the regulated rate of return and return on equity.[34] To be able to reliably assess RAB multiples for this purpose requires the AER to:

- first, decompose the multiple into regulated and unregulated services;
- second, identify and remove the impact of other factors on the RAB multiple for regulated services.

The AER has published a report by CEPA that has attempted to decompose the RAB multiples. Submissions have been made in response to this, including a report by Frontier Economics.[35] Frontier scrutinised the CEPA methodology and analysis in detail and found a number of fundamental flaws. It found that by making a small number of changes to the assumptions used in the AusNet analysis that are more consistent with the Grant Samuel report, the estimated disaggregated RAB multiple falls from 1.68 to 1.06[36]. It does not consider that the Spark Infrastructure analysis can be utilised at all.

In making adjustments to the disaggregated regulated RAB multiples for other factors, the factors applied in the CEPA analysis (and critique by Frontier) all relate to features of the regulatory framework. However, there can be factors outside of the regulatory framework that have still impacted that RAB multiple, such as portfolio benefits of investing in the relevant assets (for diversification or other reasons), as well as future opportunities to provide unregulated services. This will vary on an asset-by-asset basis.

Frontier concluded that "a reliable disaggregation of the RAB multiple is an impossible task."[37] We concur with this view. The reliance on RAB multiples as a cross-check could result in regulatory error, particularly if it prompts the AER to adjust one or more parameters. They also cannot be used as an indicator of investor confidence in the RORI.

Other parameters

Beta

Its proposal to continue to estimate beta from its existing sample, which now only comprises a single 'active' firm. The AER's beta assessment needs to reflect contemporary risk. Especially given the significant changes occurring as part of the transformation of the energy market, an expansion of the sample is needed, including international energy network businesses. Some of the fundamental systematic risk drivers of energy network businesses operating in major developed economies are highly similar. Further, most of the major developed economies are also transitioning to renewables. The beta estimates from these firms can therefore provide some information on the impact of this transition on systematic risk.

Relying on long-term historical estimates of a sample comprising firms who are now mostly delisted, increases the risk of error in this context. It is noted that consideration of the use of international firms was recommended by the Independent Panel.[38]

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[34] Australian Energy Regulator (2022). p.25.
[35] Frontier Economics (2022). Response to the May 2022 CEPA report.
[36] Energy Networks Association (2022). Draft AER Rate of Return Instrument, Initial Network Sector Views, AER Stakeholder Forum, 27 July.
[37] Frontier Economics (2022). p.1.
[38] Independent Panel (2022). Independent Panel Report, AER Draft Rate of Return Instrument.

Market risk premium

We note that the AER continues to evaluate an alternative approach that incorporates estimates from Dividend Growth Models (**DGMs**). We are concerned that the AER's DGM would result in estimates that are systematically below average historical observations. To ensure that any such estimate is unbiased, we would endorse the approach put forward by the Energy Networks Association.

What are the consequences of the misalignment between the AER's proposed approach and investors' required rates of return?

The impact on investment decisions

As previously discussed (and should not be contentious), the rate of return allowed by the AER will have a direct impact on the investment decisions made by investors. This can impact those decisions in two main ways.

First, differences between the AER's allowed rate of return and an investor's required rate of return will impact capital availability for new investment, including major capital expenditure that is necessary to renew or expand the network. As investors operating in international financial markets, we caution that any further reduction in the rate of return is likely to further reduce investors' willingness to deploy capital to the Australian energy market in a timely and sustained manner, and to shift the focus and attention of investors to opportunities in other sectors and offshore.

As we have previously submitted, there is already considerable evidence to suggest that the rate of return set in the 2018 RORI, which reduced the equity risk premium by 95 basis points, was too low to attract the necessary investment:

- Australia was recently ranked in the third quartile for relative attractiveness of investing in regulated networks;[39]
- Australia was ranked second lowest at 1.6% on the allowed pre-tax WACC (adjusted for inflation and government bond yields to account for sovereign risk);[40]
- the AER's own advisors, the Brattle Group, have highlighted that the AER's 'outlier' approach led to an equity return lower than seven other regulators in UK, US, NZ, Italy, and the Netherlands.[41]

Reference is also made to the additional information we provided in our September 2021 submission.[42]

Second, the AER's RORI, the way it is applied by the AER (including how and where it exercises discretion), and the outcomes resulting from that RORI affect investors' assessment of regulatory risk. The AER has acknowledged that regulatory decisions impact the risk profile of the investments – although it truncates this at the end of the regulatory period rather than the life of the asset.

Regulatory risk is one of a number of key risk factors evaluated by investors and is considered over a long horizon. That is, it is not limited to the rate of return allowed in the current period, but also investors' ongoing exposure to further changes in the framework and/or the way it is applied in the future. There is no effective recourse available once these decisions have been made.

As outlined above and in previous submissions made by the NSG and other stakeholders, this review comes at a critical time in the history of Australia's energy market, given the magnitude of the investment program required to enable the market's transition to renewables. This transition is also important to consumers.

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[39] Morgan Stanley (2021). Utilities Global Lens: Where to invest in regulated utilities amidst global macro environment, April, p.3.
[40] Morgan Stanley (2021). p.11.
[41] The Brattle Group (2020). International Approaches to Regulated Rates of Return, September, p.11.
[42] Network Shareholders Group (2021). Response to AER RORI Omnibus Papers, 3 September.

As a pertinent and live example that is directly relevant to the current climate faced by investors, we previously summarised the issues associated with Project EnergyConnect, which is a critical piece of national energy transmission infrastructure and part of the NSW Government's Infrastructure Roadmap that will assist Australia to meet its climate change targets, drive competition in the whole electricity market and enhance grid stability and reliability.[43]

As we outlined, this project ultimately required funding support from the Clean Energy Finance Corporation (**CEFC**). There are limits to the extent to which hybrid funding with green banks such as CEFC can support Australia's transitional energy needs going forward as this form of funding can quickly become limited and can cause concentration issues. CEFC's Grid Reliability Fund is limited to $1 billion and is not restricted to large grid/interconnector augmentations – it is also expected to be used to support storage projects, grid stabilising technologies and other innovative solutions.

The AER makes passing mention of this situation in its Draft Decision, referring to the CEPA report commissioned by the AEMC, which "found that financing of large new projects, like Project EnergyConnect, at the benchmark efficient entity's capital structure would result in pressure on Transgrid's and ElectraNet's credit rating."[44] However, this reference is only seen as relevant in supporting its decision to maintain a simple (rather than weighted) trailing average for the return on debt. This missed the fundamental point made in our previous submission, which was not referred to by the AER, being that the regulatory framework should deliver outcomes that do not require ongoing government support. The cost of this is ultimately borne by taxpayers, either directly or at the expense of other priorities and programs.

It is also important to note the investments made by Australian superannuation funds in energy network infrastructure, which is also important to members of those funds. The industry depends on the continued capital commitments made by these funds, along with other investors, in funding the future investment program. However, superannuation funds have an obligation to members to deliver returns that will enable them to build their retirement savings, having regard to alternative opportunities available in the market and the risks associated with those investments (including political and regulatory risks). As noted previously, these funds are also benchmarked against the MSCI unlisted infrastructure index by Government, which is currently 10.86%.

Conclusions and implications

In conclusion, we do not consider that the AER's Draft Decision proposes a 2022 RORI will result in an allowed return that reflects the actual returns required by investors. This will not create an environment to support future network investment, at a time when the industry is expected to embark on the largest investment program in its history. This will make it increasingly difficult for projects to attract the necessary capital. As evidenced by the Project EnergyConnect example, this will otherwise necessitate reliance on government funding so that they can continue to proceed.

Consistent with our previous submissions, we reiterate the following conclusions.

1. **The AER's process and approach must be unbiased** – we remain concerned about the continued downward pressure on rates of return that are not reflective of actual changes in the efficient cost of capital. We remain of the view that it is important to consider the relationships between parameters and the overall outcomes, which is also consistent with the approach taken by investors.
2. **Market evidence, experience and expertise are relevant to the task** – it is critical that the AER gives weight to actual practice of equity analysts, valuation experts and views of equity investors in fulfilling its task of estimating the efficient cost of equity. Relying on a theoretical approach that does not attract actual capital is not in the long-term interests of consumers. The AER should not dismiss or discount market

[43] Network Shareholders Group (2021). Response to AER RORI 2022 Working Papers, 2 July, p.8.
[44] Australian Energy Regulator (2022). p.229.

information and practice in assessing whether its estimate is indeed the best impartial estimate of an efficient market return on equity.

3. **The long-term nature of investment decision making needs to be considered** – investors assess infrastructure investments over the life of those assets, which span multiple decades (and regulatory periods). There is merit in addressing the uncertainty and volatility between and across regulatory periods that is apparent in the AER's current approach to determining the cost of equity. The RORI settings applied now will underpin energy infrastructure investments that will last the next 40-50 years (or longer). The long-term interests of consumers will only be achieved if today's investment decisions relating to long-term infrastructure assets are appropriate.

4. **Regulatory stability and predictability are essential for encouraging investment** – we have outlined our concerns with the changes in the AER's interpretation of what is considered to meet the requirements of the NEO/NGR, including the application of its NVP=0 principle. These changes signal an increase in regulatory risk for investors. With an established track record of more than 20 years' of setting the rate of return, the need for ongoing change should be minimal and reflect evolving changes in the efficient return required by investors.

5. **Impacts and outcomes need to be measured** – in demonstrating that it has satisfied the requirements of the Law and the NEO/NGO the AER has largely relied on a qualitative description of the process it has followed and the matters it has considered. It has not established how it will assess and demonstrate that its estimate of the efficient cost of capital is consistent with the Law and the NEO/NGO. This includes how returns estimated under the RORI impact on incentives for investment and the long-term interests of consumers. This can be done by the AER demonstrating that its estimate is the best unbiased estimate and does not introduce unnecessary risk or create unintended consequences such as deteriorating financeability of investments.

6. **Transparency of the regulator's decision and process are paramount** – as an effective review process is not in place, and there are a number of aspects of the framework where the AER can (and needs) to apply discretion, adequate transparency and accountability is of fundamental importance.