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Mr Warwick Anderson
General Manager, Networks Finance and Reporting
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

By email: RateOfReturn@aer.gov.au
Cc: [redacted]

Dear Mr Anderson

Re: Response to AER Rate of Return Omnibus papers

Thank you for the opportunity to respond to the AER's Rate of Return Omnibus papers, which were published on 15 July 2021 as part of the 2022 Rate of Return Instrument (RoRI) review.

We commend the AER's early and ongoing engagement on this important review, which is occurring at a critical time in the evolution of Australia's energy system.

The role of the rate of the return allowance in supporting efficient investment

Efficient investment has the potential to improve reliability, safety and security of energy supply to millions of consumers—households and businesses—across the NEM. Transmission network service providers, such as TransGrid, have a particularly important role in supporting the transformation of the NEM that is currently underway.

Efficient investment can only occur if investors are fairly remunerated for the risks and opportunity costs they incur when they commit capital to those network investments. The best way to support efficient investment is to set the allowed return in line with the best possible estimate of the market cost of capital at the time of each regulatory decision.

The 2018 RoRI has produced allowed returns that are simply too low to attract the financial capital required to facilitate the major investments that network service providers are being asked to make.

A good example is TransGrid's recent experience with Project Energy Connect (PEC). With a total cost of $2.28 billion (of which $1.8 billion is to be financed by TransGrid), PEC is one of Australia's largest energy infrastructure projects (the largest ever financed under the Rules), and is the largest single investment project undertaken by TransGrid to date.

PEC will deliver vital infrastructure required to connect the power grids of NSW, SA and Victoria and expand the wholesale energy market across these three states—increasing reliability and security of electricity supply, while lowering power bills for consumers. It will make a significant contribution to the decarbonisation of Australia's economy.

The project has been supported widely by stakeholders, has passed the AER's transmission Regulatory Investment Test, and has received cost approval by the AER. There is no doubt that PEC would promote the long-term interests of consumers of electricity—if it were to proceed.

However, the returns that would have been generated by this project were insufficient to support a commercially viable business case under the regulatory regime that would have applied to it. The binding nature of the 2018 RoRI meant that TransGrid had no other recourse but to seek a Rule Change that would have changed the timing of the cash flows in a way that would have enabled the business case to move forward. Whereas much of the Rule Change process focused on different interpretations of the meaning of ‘financeability,’ the core issue was whether or not the project was commercially viable. Under the prevailing regulatory arrangements, it was not.

TransGrid worked very hard to find a way to ensure the success of PEC – given its crucial role in Australia’s network infrastructure. We were able to secure nearly $300 million in Federal Government support provided by the Clean Energy Finance Corporation (CEFC) - the largest investment the CEFC has made to date.

TransGrid considers it unlikely that such government-backed financing would be available for any of its future ISP projects and that it is highly unlikely that such support would be generally available in the market for the broader set of projects identified in the ISP.

TransGrid submits that a regulatory framework that compels network service providers to rely on lines of funding provided by government entities in order to deliver investments that are clearly in the long-term interest of consumers is not fit for purpose nor sustainable.

The relationship between the RoRI, financeability, and efficient transmission investment

TransGrid notes that the issues referred to above in relation to PEC can only be partially addressed in the 2022 RoRI.

TransGrid strongly agrees with the AER’s conclusion that a necessary condition for efficient investment (in the long-term interests of consumers) is that the allowed return must reflect the best unbiased estimate of the market cost of capital. Thus, it is crucial that the allowed return in the 2022 RoRI corrects the deficiencies in the 2018 approach – which is not producing sensible estimates in the current market conditions.

But it is also important to recognise that, even with an appropriate rate of return allowance, the current regulatory arrangements delay the recovery of expenditure on significant new projects in a way that places pressure on the credit ratings of proponent networks. This is an issue that cannot be addressed as part of the RoRI review.

TransGrid notes that the RoRI review has considered the use of ‘financeability tests’ applied to a generic benchmark efficient firm to ensure that the allowed return supports the credit rating that was assumed in deriving that allowed return. That is, it is a test of the internal consistency of the AER’s allowed return for the generic benchmark firm.

TransGrid considers this to be appropriate, but notes that it does not address the issue of large new transmission investments. The *delay* in the allowed return on large new investments is an issue in addition to the *level* of those returns. Whereas the level of returns is an important issue that must be addressed in the 2022 RoRI, the delay in those allowed returns must be addressed in other processes.

TransGrid submits that it will be important for the 2022 RoRI to make a clear statement about this – that the role of the RoRI is to determine the appropriate level of the allowed return, that any ‘financeability tests’ conducted as part of that process are only directed at ensuring that the level of the required return is internally consistent, and that the RoRI does not (and cannot) address the issue of the timing of cash flows for large new transmission projects.

TransGrid's proposed nation-building transmission investments

TransGrid has identified transmission network investment needs totalling nearly $7 billion that could be made over our next regulatory period alone. This attests to the scale of the investment required across the entire NEM over the next few decades to support the transition. These projects include:

- PEC: requiring $1.8 billion of financing from TransGrid;
- HumeLink, a new 500kV transmission line that would carry electricity to customers from new generation sources, including the expanded Snowy Hydro scheme, and which has been identified by AEMO as a priority investment: requiring approximately $3 billion of financing from TransGrid; and
- Other projects including the QLD-NSW interconnector (QNI) upgrade, the VIC-NSW interconnector (VNI) upgrade, the VIC-NSW interconnector West (VNI West), a new transmission cable from Potts Hill to Alexandria (Powering Sydney's Future): requiring approximately $2 billion of financing from TransGrid.

The feedback we have received through our extensive stakeholder engagement processes is that these projects are wanted and needed by our customers, deliver savings, and are in the long-run interests of consumers.

However, no matter how beneficial these projects would be to consumers, they cannot proceed unless they are commercially viable. TransGrid is not seeking any additional allowances or 'aiming up' in the 2022 RoRI process – just allowed returns that are capable of attracting the financial capital required to facilitate those investments. The key is simply that the regulatory allowance should reflect the market cost of capital.

TransGrid's view is that the 2022 RoRI will, for the next decade or more, determine whether the critical investment that is needed throughout the NEM will be made.

TransGrid's views on specific elements of the allowed return

We endorse the Energy Network Australia (ENA) submissions, which set out detailed responses to the matters raised in the Rate of Return Omnibus papers.[1]

TransGrid wishes to highlight five key issues that are raised in the ENA submissions and which are of great importance to transmission network businesses at the current stage of the once-in-a-generation transition to new energy sources:

1. *The need for the AER to give meaningful and explicit weight to all of the available evidence that contributes useful information in order to produce the most reliable estimate of the required rate of return, rather than rely only on a narrow subset of the evidence.*

   It is always important for the regulatory allowance to create the appropriate incentives for efficient investment, and it is a crucial underpinning of the very significant investment in transmission assets that will be required within the next decade. By its very definition, consumers benefit from efficient investment, and efficient investment is supported by a regulatory allowance that reflects the market cost of capital at the time of that investment.

   The required return on equity allowances produced by the AER's 2018 RoRI methodology have declined materially since 2018. There is compelling evidence—including advice from the AER's own advisers—that the allowances currently being produced by the 2018 RoRI are among the

[1] ENA, September 2021, *Overall rate of return*; ENA, September 2021, *ENA response to equity omnibus paper.*

lowest available across a wide range of jurisdictions.[2] In particular, the Brattle Group (2020)[3] has reported that:

- The AER's allowed return on equity is lower than that allowed by any of the comparable regulators considered (on both a real and nominal basis);[4] and
- The AER's allowed equity risk premium (defined as the allowed return minus the adopted risk-free rate) is lower than that allowed by any of the comparable regulators considered (on both a real and nominal basis).[5]

Brattle concluded that the approach adopted in the 2018 Rate of Return Instrument is "not as effective as the approach of other regulators" and recommended the AER consider several changes to its approach throughout the 2022 RoRI review.[6]

In TransGrid's view, the 2018 RoRI methodology for estimating the required return on equity is no longer fit for purpose – it does not produce allowances that reflect the market cost of equity capital in the current market conditions and it is these current conditions in which record amounts of transmission investment are required. As such, it does not advance the long-term interests of consumers.

The regulatory allowances under the 2018 AER's return on equity approach are informed by a very narrow subset of the relevant evidence. TransGrid considers that better, and more robust, estimates of the required return would be supported by giving real consideration and weight to *all* relevant evidence.

In this regard, TransGrid supports the ENA submission that:

- For the purposes of estimating the Market Risk Premium (MRP), material weight should be given in the 2022 RoRI to forward-looking Dividend Growth Model (DGM) evidence, and that consideration of historical evidence should place equal weight on the fixed MRP and fixed Total Market Return (TMR) approaches; and
- For the purposes of estimating beta, no weight should be given to 'dead' comparator firms that no longer contribute any useful information. Instead, material weight should be given by the 2022 RoRI to 10 years of historical data on domestic comparators, the estimates determined by other comparable energy regulators overseas, and estimates derived using data on international comparators.

2. *The need for meaningful cross-checks to ensure the reasonableness of the allowed rate of return.*

TransGrid supports the use of cross-checks to test the reasonableness of the allowed rate of return. However, any cross-checks must be meaningful—in the sense that they should be capable of informing the AER's regulatory allowances.

TransGrid considers that one key cross check is the returns being allowed in other similar regulatory jurisdictions. The evidence presented in the Brattle report, and in the ENA submissions, indicates that allowances under the 2018 RoRI are among the lowest in the world. TransGrid's investors all have opportunities to invest in many international markets, and the relativity of allowed returns in different markets is a consideration they make when determining where to allocate capital.

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[2] ENA, *Allowed returns in a low interest rate environment: ENA submission on the AER's draft working paper*, 2 July 2021, section 3.

[3] Brattle Group, June 2020, A review of international approaches to regulated rates of return.

[4] Brattle, 2020, Table 4, Rows 3 and 9, p. 49.

[5] Brattle, 2020, Table 5, Rows 4 and 9, p. 50.

[6] Brattle, 2020, p. 58.

TransGrid also endorses ENA's proposal that financeability tests and forward-looking scenario testing of rate of return outcomes (using a set of possible future scenarios for market rates that reflect a broad range of plausible outcomes) would be useful and meaningful cross-checks that should be incorporated into the 2022 RoRI. Ensuring that the RoRI produces sensible outcomes across a range of future scenarios is particularly important for a Binding Instrument.

3. *Problems with using the industry debt data (EICSI) in a determinative way.*

   TransGrid considers that the allowed return on debt should be determined by the AER defining what it considers to be the appropriate benchmark efficient debt financing approach (e.g., 10-year, BBB+, staggered maturity) and by using independent third-party data sources to determine the efficient cost of implementing that financing strategy. The EICSI data then has a role to play as a cross check – to determine whether a network adopting the benchmark efficient strategy would be able to achieve a lower cost. That is the approach that the AER has adopted to date.

   TransGrid is concerned about the potential for the EICSI data to now be used in a determinative way. This would be an important step away from the AER's longstanding approach of setting the return on debt allowance to reflect the cost of implementing an efficient debt financing approach, to compensating the actual debt costs incurred by networks. It is not clear that the incentive effects of such a change have been fully thought through.

   Moreover, TransGrid submits that it would be inappropriate to use the EICSI data in a determinative way while fundamental concerns about the reliability of that data remain unresolved. For example, it is clearly the case that the inclusion of senior debt, and the exclusion of subordinated debt in the same firm, will lead to a bias in the EICSI estimates. Another bias arises if temporary short-term debt facilities issued by recently-privatised networks is included. This debt is not reflective of a business-as-usual efficient debt financing approach, so is not an appropriate basis for the regulatory allowance.

   Even when these issues have been resolved, and stakeholders can have confidence in the reliability of the EICSI data, it should only be used as a cross check and not as the basis for a new approach of compensating the actual debt costs incurred by networks, rather than the AER's assessment of the benchmark efficient financing approach.

4. *The need for the return on debt allowance to be replicable by an efficient benchmark business.*

   The AER's preliminary assessment of the industry debt data (EICSI) is that the benchmark term of debt might be lower than 10 years. However, TransGrid notes that ENA has demonstrated that the average term is 10 years if short-term debt issued by recently privatised firms is removed and if subordinated debt (which has all of the economic characteristics of debt) is included. TransGrid can confirm that privatised networks, indeed most privatised infrastructure businesses, begin with shorter-term debt and take some time to build up to a steady-state portfolio of staggered-maturity long-term debt.

   TransGrid is particularly concerned about the AER's suggestion that it may change the benchmark credit rating to reflect its interpretation of a shorter benchmark term. TransGrid has a strong view that changing one parameter to reflect a perceived change in a different parameter fails every test of good regulatory practice.

   ENA, and the AER's own consultants, have explained why it is important for the allowed return on debt to be based on a strategy that could feasibly or viably be implemented in practice. TransGrid considers it to be inappropriate to adopt, as the efficient benchmark, a debt management strategy that could not be implemented by any regulated network. The benchmark network cannot simply decide to increase its credit rating to match a new regulatory assumption, and it is not good regulatory practice to adopt a parameter value (higher credit rating) that is inconsistent with the regulator's own assessment of the observed evidence (BBB+).

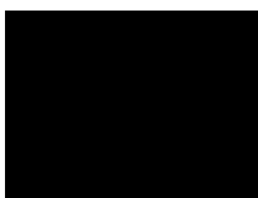
5. *The weighting of tranches in the return on debt allowance.*

The AER is seeking stakeholder views about whether the tranches in the trailing average return on debt allowance should receive equal weight (which is the AER's current approach) or differential weight based on forecast CAPEX requirements.

TransGrid's view is that the equal weighting approach should be maintained for three reasons:

- An approach based on firm-specific CAPEX forecasts would be a step away from the AER's longstanding approach of setting a generic benchmark efficient allowance. If firm-specific characteristics are introduced in relation to CAPEX forecasts, it is not clear where the line should be drawn. For example, should firm-specific credit ratings be used? Should firm-specific terms be used? TransGrid submits that the generic benchmark efficient allowance has the benefits of simplicity, objectivity, transparency and longstanding regulatory precedent. It should not be changed without very careful consideration of the implications of moving towards a more firm-specific form of regulation.
- Network firms do not raise debt in the way that is contemplated by a CAPEX-weighting approach. For example, TransGrid raises debt on its aggregated balance sheet – it does not issue discrete tranches to finance particular components of capital expenditure. The fixed costs associated with the issuance of significant debt tranches means that it is not viable for firms to issue a new tranche of debt to match the annual capital expenditure for a particular year.
- Most networks have predominantly incremental (BAU) CAPEX requirements, so a difference in weighting schemes may not be material for them. For the networks that do have substantial new CAPEX requirements, such as TransGrid, there is significant uncertainty about the timing of that expenditure – due to uncertainty about regulatory approvals, internal business case approvals, and acquisition of financing. Consequently, it is very difficult to accurately forecast the timing of CAPEX requirements over a 5-year period.

Thank you again for the opportunity to provide this submission. TransGrid remains committed to actively contributing to the consultation process throughout the 2022 RoRI preview. We note the particular importance of this RoRI review in light of the substantial network investment required over coming years.



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