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2 September 2022

Mr Warwick Anderson
General Manager Network Regulation
Australian Energy Regulator
Level 17, 2 Lonsdale Street
Melbourne VIC 3000

By email: RateOfReturn@aer.gov.au
Cc: Warwick.Anderson@aer.gov.au

Dear Mr Anderson

Re: Response to AER draft Rate of Return Instrument

We are writing to respond to the AER's draft *Rate of Return Instrument*, and the associated *Explanatory Statement*, which were published in June 2022 as part of the 2022 *Rate of Return Instrument* (RoRI) review.

Nation-building transmission investment is becoming more critical

Our previous submission in March 2022 noted that the current *Rate of Return Review* is taking place at a time when very significant network investment is required to support the decarbonisation of the Australian economy. Transgrid is a key player in the required build-out of Australia's transmission network and is expected to undertake Actionable and Future ISP projects, totalling $7.0 billion (Real 2022-23)[1] over our next 2023-28 regulatory period alone:

- HumeLink
- Victoria to New South Wales Interconnector (VNI) West
- Sydney Ring (reinforcing Sydney, Newcastle and Wollongong supply) – Southern Network Option[2], and
- Queensland to New South Wales Interconnector (QNI) connect.

This is in addition to capex of $2.6 billion (Real 2022-23) approved by the AER in the current 2018-23 regulatory period for Powering Sydney's Future, Project Energy Connect (PEC), VNI Minor and QNI Minor and attests to the scale of the investment required across the entire NEM over the next few decades.[3]

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

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1 This comprises $3,672.2 million for HumeLink (Stage 1 and 2), $657.7 million for VNI West, $2,497.6 million for Sydney Ring project (Southern Network Option) and $167.7 million for QNI Connect.
2 The 2022 ISP states that the Southern network option may 'proceed through the New South Wales, ISP or RIT-T framework'
3 This comprises $254.6 million for PSF, $2,008.0 million for PEC, $240.4 million for QNI and $49.7 million for VNI.

Since our March 2022 submission, there have been two important developments:

- AEMO has finalised its *Integrated System Plan*, which reinforces the critical need for extensive transmission investment in the very near future. AEMO notes that this investment is required to support the decarbonisation of the Australian economy, improve system reliability, and lower wholesale electricity prices. AEMO estimates that every dollar of network expenditure will generate $2.20 of benefits for consumers.
- The new Commonwealth government has committed to a materially higher 2030 emissions reduction target, with the relevant legislation before the Parliament. Meeting this target will be impossible without very significant transmission investment over our next regulatory period, which ends on 30 June 2028.

There would seem to be little prospect of meeting higher emissions reductions targets, or of the timely unlocking of consumer benefits, if key transmission projects are delayed while regulators and other government agencies devise bespoke arrangements to support the commercial viability of such investments – as was our experience with PEC.

Moreover, Commonwealth and state energy ministers have recently announced their intention to include an emissions objective into the national energy objectives.[4] This highlights the importance of providing the necessary incentives for the investment that is required to support the energy transition and the achievement of the new emissions objective. We consider this to be an important consideration, given that the 2022 RoRI will determine allowed returns for up to 9 years – beyond the 2030 legislated net zero commitments.

The allowed return is central to network investment

We note that the current RoRI review is being undertaken in parallel with the AEMC's *Transmission Planning and Investment Review*. Our submission to the AEMC's review proposes that formal financeability tests and accelerated depreciation are important tools in ensuring that major new projects are commercially viable.

However, these tools do not correct or substitute for an inadequate allowed return.

It is essential that the AER's allowed return properly reflects the market cost of capital – the return that real-world investors actually require to commit capital to major new projects.

Like all networks and network investors, we are concerned with some elements of the draft RoRI – particularly the proposed change to a 5-year risk-free rate.

Just when networks and investors are being asked to provide record amounts of capital investment, the AER is proposing a change that would *reduce* the allowed return, even after:

- The Brattle report commissioned by the AER demonstrated that the AER's allowed return on equity was, by every metric, lower than that of all comparable regulators that were examined. Brattle concluded that the AER's approach was "not as effective" as that of other regulators, and
- The independent expert valuation reports prepared as part of the recent Spark Infrastructure and AusNet Services transactions concluded that the current market cost of equity capital (with gearing at 60 per cent) is 7.5 – 8 per cent while the AER's current allowance is 5.5 per cent.

Within this context, we are particularly concerned that the AER has maintained its consideration of some potential changes to its approach that would *reduce* allowed returns – further below the levels provided by comparable regulators and used by independent experts.

[4] https://www.energy.gov.au/government-priorities/energy-ministers/priorities/national-energy-transformation-partnership.

The term of the risk-free rate must remain at 10 years

The AER is proposing to reduce the allowed return on equity by reducing the term of the risk-free rate from 10 years to 5. The proposed change is inconsistent with:

- Every previous decision made by the AER
- The AER's approach to the allowed return on debt
- The approach adopted by every other Australian regulator
- The approach adopted in every independent expert report, including those for networks regulated by the AER
- The clear evidence of market practice, including the practice of infrastructure investors, and
- The approach recommended by leading textbooks.

Moreover, the change is being proposed in circumstances where:

- The change has been driven by the AER and not stakeholders
- There is no new evidence or argument that has not been previously considered by the AER on many prior occasions, and
- Record network investment is required over the coming decade to meet Australia's decarbonisation commitments and unlock cost savings for consumers.

The AER has provided two main rationales for the proposed change – both of which involve the opposite position to that previously held by the AER:

- In its past decisions the AER has been clear about setting the allowed return to reflect the market cost of capital – the return that real-world investors actually require. The AER has concluded that a 10-year risk-free rate reflects the practice of investors, is consistent with NPV=0, and best promotes the NEO and NGO. The AER now proposes to take the opposite position.
- In its 2020 *Regulatory Inflation Review*, and in every subsequent publication including the December 2021 *Omnibus Paper*, the AER stated that regulatory inflation and the return on equity have different roles to play so one has no implications on the term for the other. The AER now proposes to take the opposite position.

Transgrid is concerned not just about the proposed change to a 5-year term itself, but also about the implications for the stability and predictability of the regulatory regime which is essential to attract the capital needed to fund the transition.

We note that the ENA submission contains a point-by-point response on the technical elements of the AER's decision. We endorse that position and do not repeat those points here. However, we do note that the AER has had particular regard to a mathematical analysis performed by Dr Lally, even though it has previously rejected that same analysis many times before. Dr Lally's analysis begins with the assertion that Schmalensee (1989) shows that the allowed return must match the term of the regulatory period. Professor Schmalensee from MIT has now provided a report explaining why Dr Lally is wrong and why the appropriate regulatory task is to set the allowed return in accordance with the return that real-world investors actually require. In our view, this is quite telling.

In summary, Transgrid has concerns about the AER losing credibility in the eyes of networks and investors if the 5-year term is maintained.

An appropriate return should be allowed for major new projects

Our March 2022 submission noted that no matter how beneficial our augmentation projects will be to consumers, they cannot proceed unless they are commercially viable. We raised two issues here:

- The allowed return must be reasonable – it must match the market (risk reflective) cost of capital, and
- The regulatory allowance must be provided in a way that enables network businesses to maintain the benchmark BBB+ investment grade credit rating (that is assumed when setting the regulatory allowance under the AER's Rate of Return Instrument) while funding network augmentation projects.

We noted that these issues would not be addressed by the weighted trailing average approach that the AER raised for consideration. Rather, we proposed that:

- A reasonable allowed return would recognise that major new projects have the character of construction projects and involve construction type risks until they are commissioned into use. We proposed that the allowed return should properly reflect the nature of the risk involved – that they are construction projects and not regulated network assets until they are commissioned, and
- The financeability issues, insofar as they pertain to major new projects, will be addressed via the AEMC's *Transmission Planning and Investment Review*.

In relation to the allowed return during the construction period, we noted that a number of regulators have recognised that major construction projects differ from the operation of regulated infrastructure assets and have put in place regulatory arrangements that reflect those differences. For example, Heathrow Airport was allowed a special 'construction margin' on capital invested during the construction phase of its new Terminal 5 (or T5) and the European Commission recommended that national regulators should also allow higher rates of return during the roll-out phase of fibre networks. These precedents reflect the widely-accepted view that construction activities support relatively less debt finance and have a higher level of systematic risk than energy network operations.

We also noted that very large ISP-type projects involve significant construction-type risks including environmental, bio-diversity, geotechnical, land access and indigenous heritage risks, tight delivery timeframes, and shortages in available labour and construction resources. For major company-changing projects, like the examples above, the scale of these construction-related risks is well beyond that which pertains to replacement or more incremental augmentation capex.

The AER's June 2022 *Explanatory Statement* contains a brief response to our submission.[5] Essentially, the AER's view is that the National Electricity Law (NEL) does not permit our proposed approach. The *Explanatory Statement* sets out the AER's understanding that the NEL prevents a business from having different rates of return for different components of the RAB and leaves the matter there.

Very significant transmission investment is required during the course of our next regulatory period. Providing investors with a business-as-usual network return, while asking them to bear (significantly higher) construction risk is an impediment to the commercial viability of major new construction projects. Setting an allowed return that does not properly reflect the risk does not satisfy the NPV=0 principle. This is precisely why a construction return is allowed on construction projects in other regulatory jurisdictions.

The AER's view appears to be that its hands are tied by the NEL, requiring it to provide a single business-as-usual network return even while projects face (significantly higher) construction risk. Even if the NEL does prevent the AER from allowing a return commensurate with the risk involved during the construction phase

[5] AER, June 2022, *Draft rate of return instrument: Explanatory statement*, p. 239.

of major new projects (which Transgrid does not concede) this would not prevent the AER from engaging with the substance of our submission.

In our view, good regulatory practice would involve the AER making a clear statement about whether or not it agrees that the market cost of capital during the construction phase of major new projects differs from that of business-as-usual network assets.

If the AER does not agree, it should explain why.

If the AER does agree, it should join Transgrid in seeking to expedite whatever changes are required to ensure that it is able to set an allowed return that properly reflects the risk involved. This is particularly important in light of the very significant capital investment that will be required in our next regulatory period.

Equity beta

Like many observers, Transgrid is surprised at the AER's reliance on a comparator set that now consists of a single live firm. As the set of domestic comparators reduces in size, and as the evidence from de-listed firms becomes ever more stale and redundant, it must surely receive relatively less weight.

The ENA submission notes that all other comparable regulators allow an equity beta (re-geared to 60%) in the order of 0.8 and above. This is a full one third higher than the AER's allowed beta of 0.6. It is not credible that networks regulated by the AER are so materially less risky than all other electricity networks.

In contrast to the AER's approach, other regulators have regard to international evidence. Most notably, the Economic Regulation Authority (ERA) in Western Australia, who is undertaking a parallel RoRI review to the AER's developed, and consulted on, a sample of proposed international comparator firms in December 2021.[6] By contrast, the AER has (despite repeated urging by network businesses) undertaken no original work during this RoRI review to compile and consult on a feasible comparator set. The *Explanatory Statement* simply says that "there are complex issues" associated with using international comparators, and that "more work is needed in this area."[7] We encourage the AER to undertake this necessary work, and have proper regard to this international evidence prior to making its final decision in December.

RAB multiples and transaction evidence

We endorse the ENA submission in relation to RAB multiples and recent transaction evidence.

The ENA notes that the independent expert reports for the Spark Infrastructure and AusNet Services both indicate that the market cost of equity capital is materially higher than the AER's regulatory allowance. In our view, this is important and relevant evidence. We can find no indication in the *Explanatory Statement* of this issue even having been considered by the AER.

The AER's analysis of RAB multiples is even more problematic.

The AER has recognised that it is meaningless to compare an enterprise value that includes regulated and unregulated assets (and other things) with the regulated RAB. This led to CEPA being commissioned to compute a disaggregated RAB multiple for each of the two recent transactions. ENA has demonstrated that CEPA has very significantly under-valued AusNet's regulated assets, and correcting that one problem produces a RAB multiple of 1.06. Correcting three other smaller errors reduces the RAB multiple to 0.87 –

[6] ERA, December 2021, *2022 gas rate of return instrument review: Discussion paper*, p.111.
[7] AER, June 2022, *Draft rate of return instrument: Explanatory statement*, p. 182.

consistent with the independent expert report conclusions that the allowed return is less than the market cost of capital.

The *Explanatory Statement* notes that the AER has not yet been able to consider this evidence.

Nevertheless, the *Explanatory Statement* does conclude that this transaction evidence "would suggest our current and expected rate of return are at least sufficient…and potentially higher than that needed to attract investment."[8] This conclusion appears to be based on the aggregated RAB multiple from the Grant Samuel independent expert report for AusNet – which includes the value of unregulated assets.[9] This is in spite of the fact that:

- The same Grant Samuel report provides estimates of the market cost of equity capital materially above the AER's regulatory allowance
- The same Grant Samuel report provides an estimate of the RAB multiple after deducting the value of unregulated assets. This figure is clearly more relevant (and in line with why the AER commissioned the CEPA report) but is not mentioned in the AER's reasoning, and
- Having decided that it was impossible to reach a conclusion about RAB multiples without a proper disaggregation (hence commissioning the CEPA report), in our view, the AER has done precisely that.

Summary of key concerns

We are particularly concerned about:

- The AER's proposed change to a 5-year risk-free rate – a change based on a flawed theoretical analysis, and contrary to observed commercial and regulatory practice, including that of the AER itself
- The dismissal of our submission about the allowed return during the construction phase of major new projects
- An equity beta allowance that suggests that AER networks are materially less risky than all other electricity networks, including those nearby in Western Australia and New Zealand
- The fact that the AER has undertaken no meaningful work to compile and consult on a feasible set of international comparator firms—even though the ERA has managed to do just that within the same RoRI timeframes as the AER
- An apparent mischaracterisation of what recent independent expert reports from the Spark and AusNet transactions imply about the adequacy of the AER's allowed return on equity, and
- Continued reliance on flawed RAB multiple evidence to justify the adequacy of the AER's allowed return on equity, despite compelling analysis submitted by the ENA that, if interpreted properly, the evidence indicates RAB multiples for recent transactions that are less than 1.

These concerns go to the credibility of the regulatory framework and the regulator – at precisely the time when greater confidence in the regulatory framework and the regulator is needed in order to promote investor confidence.

[8] AER, June 2022, *Draft rate of return instrument: Explanatory statement*, p. 265.
[9] AER, June 2022, *Draft rate of return instrument: Explanatory statement*, p. 265.

Next steps

Thank you again for the opportunity to provide this submission. We remain committed to actively contributing to the RoRI consultation process throughout 2022 and note the particular importance of the outcome of it in the delivery of the substantial network investment needed to ensure Australia's energy transition. If you have any questions on this letter, please contact our General Manager Regulation, Stephanie McDougall, on [redacted] or [redacted]

Yours sincerely

[redacted]

Brett Redman

Chief Executive Officer