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To: Australian Energy Regulator
RE: Draft 2026 Rate of Return Instrument

Thank you for the opportunity for the Institute for Energy Economics and Financial Analysis (IEEFA) to provide input to the Australian Energy Regulator (AER)'s Draft 2026 Rate of Return Instrument (RORI). We acknowledge the substantial work involved in preparing the draft decision and outline our feedback below.

IEEFA is an independent energy finance think tank that examines issues related to energy markets, trends and policies. The Institute's mission is to accelerate the transition to a diverse, sustainable and profitable energy economy.

Equity beta has been reduced and should be reduced further

The AER has reduced equity beta from 0.6 to 0.55, which is a step in the right direction; however, this should be reduced further to 0.5 or less. This is in line with our recommendation in the IEEFA submission to the discussion paper. This is informed by the following evidence.

The Consumer Reference Group's 2022 submission to the draft 2022 RORI decision supported an equity beta of 0.5 or less, stating:

> *"We find the evidence and the AER's analysis overwhelmingly supports a point estimate of beta of 0.5 or less."*

In the draft 2026 RORI explanatory statement, the AER explored a range of comparators to estimate equity beta:

> *"For our domestic comparator set, the average equity beta estimate is 0.56 over the longest period. The estimates of the 5 majority-regulated firms (AusNet Services Limited, DUET Group, Envestra Limited, GasNet Australia Group and Spark Infrastructure Group) tend to be around 0.4.*
>
> *"For our international sample, the average equity beta estimate is 0.68 over the longest period. This is broadly consistent with our estimates of other international samples (as proposed by stakeholders or used by some regulators) which tend to be around 0.7."*

IEEFA believes the AER should give greater weight to data from regulated or majority-regulated firms in setting the equity beta, rather than non-regulated firms. Australian NSPs, as regulated monopolies, are lower-risk businesses than non-regulated firms: they are not exposed to competition in the supply of regulated services, and their regulated revenue or price-setting frameworks substantially limit their exposure to demand risk.

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IEEFA is also concerned that the AER's international sample does not appear to be a relevant comparator set. Analysis by Electricity Market Advisory Services (EMAS), commissioned by Energy Consumers Australia (ECA), found that most of the comparator set was not representative of NSP risk profiles:

> *"Of the 48 entities in the AER's 2026 international sample, we have found only three firms that are comparable to NSPs in terms of systematic risk: Hydro One of Canada, Vector of New Zealand and National Grid of Great Britain. In our view, inclusion of the other 45 entities provides irrelevant information in a statutory decision-making process."*

Therefore, IEEFA's view is that an equity beta of ~0.4 (based on domestic majority-regulated firms) would appear to be most relevant, rather than an equity beta of ~0.56 (based on domestic firms) or 0.68 (based on international firms, of which EMAS found only three comparable to NSPs in terms of risk). The AER's draft equity beta setting of 0.55 is closest to the domestic average equity beta, rather than closer to the domestic majority-regulated estimate (0.4) which appears more representative of actual NSP risk exposure. IEEFA recommends the AER reconsider the evidence, which appears to support an equity beta of 0.5 or below.

Inclusion of a debt beta tightens the AER's methodology and is a positive step

IEEFA notes the AER's draft decision to include a debt beta of 0.1 for the first time, correcting a longstanding omission in its methodology that applied no debt beta. This is a positive step.

The risk-free rate term should be reviewed in more detail

The AER's draft decision is to continue to use the yield to maturity on Commonwealth Government Securities (CGS) with a 10-year term for the risk-free rate, rather than adopting the five-year term as proposed by ECA's consultant EMAS.

The AER stated in the draft 2026 RORI that aligning the term with the regulatory control period (typically 5 years) may satisfy the NPV=0 condition (net present value of zero).

> *"As we noted when we made our 2022 RORI, it has been acknowledged that aligning the term with the regulatory control period may satisfy the NPV=0 condition from a regulatory perspective, as the allowed return is reset at the start of each regulatory control period. At the same time, retaining a longer-term benchmark may satisfy the NPV=0 from an investor perspective, given it reflects the fact that investors in long-lived regulated infrastructure assets require returns consistent with long asset lives."*

The AER had recommended a five-year term for the return on equity in the draft 2022 RORI, saying:

> *"We think the better view is that we should estimate the return on equity over a period that matches the regulatory period (typically 5 years) rather than 10 years."*

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The AER then stated in the 2022 RORI that various stakeholders reached different conclusions and ultimately settled the question as a matter of regulatory judgment rather than clear-cut evidence.

> *"After extensive consultation and consideration, our view is that the question of the term of return on equity must be settled through the exercise of regulatory judgement. We have seen cogent cases made for employing a term that matches the length of the regulatory period and a term of 10 years, consistent with our current practices. Intelligent and reasonable people have reached different conclusions on this issue. Stakeholders, experts, regulators and review panels have reached different conclusions supported by detailed and thorough reasons."*

> *"We maintain our view from the draft Instrument that there is a sound rationale for employing a term that matches the length of the regulatory period as was recognised and supported by our Independent Panel. However, there is also a case for continuing to use a 10-year term."*

EMAS recently recommended the AER reconsider the use of a 5-year term for the risk-free rate in the 2026 RORI, drawing on regulatory experience in Western Australia and New Zealand.

> *"In our view, the move to a 5-year term for the return on equity would not compromise an NSP investor's incentive to invest as that has not been the experience in regulatory settings where the 5-year term has been applied, such as in Western Australia and in New Zealand."*

From the evidence and the history of shifting positions on this question, it does not appear to be a settled case that the 10-year term is appropriate. IEEFA recommends the AER review this topic to come to a strongly justified conclusion on the risk-free rate that preserves incentives for efficient investment while protecting consumers.

Inflation and its impact on equity returns should be addressed in the 2026 RORI

Actual returns on equity have consistently exceeded the allowed returns on equity historically, as seen in the AER Network Performance Report. The network performance report explains how in recent years inflation has been a key driver of higher than expected actual return on regulated equity, saying, "The high inflation rate environment from 2022 to 2024 has led to RoRE returns being significantly higher than allowed returns, which was most noticeable in 2023." Analysis by EMAS found that over a 10-year period where the inflation rate variation was material, the impact delivered a net gain to NSPs of about $2 billion between 2015 and 2024.

The AER said it will consider whether further work on the treatment of inflation is warranted, which IEEFA encourages. However, the AER states it does not consider it to be a rate of return issue, and considers it outside the scope of the 2026 RORI review. By contrast, analysis by EMAS states that "the IRV [inflation rate variation] effectively reprices an NSP's TAPRD [trailing average portfolio return on debt], which is a core RoRI issue." The analysis also finds that the impact of the inflation rate variation is biased towards NSPs. IEEFA's view is that given the EMAS evidence,

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the interdependence between inflation and interest rates, and the persistent equity returns outperformance, inflation should be reviewed in the 2026 RORI, rather than in a separate process. IEEFA recommends the AER review the proposal from EMAS that the AER "demonstrate how the outcomes from the Inflation Rate Variation (where return on debt is adjusted by actual inflation) are consistent with the trailing average portfolio return on debt (TAPRD) framework and clause 9 of the RoRI."

Retaining the existing trailing average approach for estimating the return on debt is a reasonable approach

The AER's draft decision has retained the existing trailing average approach for estimating the return on debt, rather than moving to a weighted trailing average. IEEFA believes the AER's assessment and conclusion on this appears reasonable. We noted in our previous submission to the 2026 RORI discussion paper that recent rule changes and the establishment of the Rewiring the Nation Corporation had already sought to address financeability issues arising from "lumpy" transmission capex. We also noted the views of eligible experts on the weighted trailing average were mixed, and that Transgrid viewed it as a "second-order consideration".

Please do not hesitate to get in touch with any questions on any part of this submission at aus_staff@ieefa.org.

Kind regards,

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