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## **SUBMISSION TO THE AER ON THE DRAFT RATE OF RETURN INSTRUMENT 2022**

Infrastructure Partnerships Australia is pleased to respond with this submission to the Australian Energy Regulator (AER) on the draft decision regarding the review of the Rate of Return Instrument, released in June 2022.

Infrastructure Partnerships Australia is an independent think tank and an executive member network, providing research focused on excellence in social and economic infrastructure. We exist to shape public debate and drive reform for the national interest. As the national voice for infrastructure in Australia, our membership reflects a diverse range of public and private sector entities, including infrastructure owners, operators, financiers, advisers, technology providers and policy makers.

Infrastructure Partnerships Australia has long been an advocate for energy market reforms, as well as measures to improve efficiency, transparency and value-for-money of investments in Australian infrastructure. However, the proposal to reduce the long-established term of equity from ten years to five years in the draft Rate of Return Instrument sits outside the mainstream regulatory approach and will generate substantive, avoidable risk towards future investment decisions. This is crucial in a moment where sustaining effective long-term signals to drive capital investment in a successful energy transition is paramount – both for the benefit of energy consumers and achieving Australia's commitment to net zero emissions by 2050.

### **Australian energy consumers have been well served by reforms in the past**

Australia's energy system is inarguably undergoing the most dramatic transformation in its history. Previous reforms of the settings underpinning the market, and guiding the energy transition, have been hard won in the past, but sustained innovation in this space will be needed to prepare for the scale of change required in the coming decades. The energy system, participants in the National Electricity Market (NEM), and – most importantly – energy consumers will benefit from such reforms.

### **But now is not the time to overturn key investment settings in regulatory frameworks**

Since the formation of the AER in 2005, the ten-year term of equity has represented a stable foundational basis for third party access pricing decisions for gas and electricity transmission and distribution infrastructure. It has formed a consistent foundation for infrastructure investment, financing and pricing decisions that apply to long-lived energy infrastructure across the NEM, serving millions of energy consumers daily.



To effectively shorten the allowed term of equity from ten years to five years will only add to existing uncertainty and concern in the market among proponents and investors. This is counter-productive at a time when Australian energy users are relying on these players to get on with the job of delivering the infrastructure they need.

### **Reducing investor uncertainty is paramount to ensuring an orderly and rapid energy transition**

Infrastructure markets are already stretched, and more policy and regulatory uncertainty could drive investors away. Infrastructure Partnerships Australia conducts annual research on investor sentiment towards policy and regulatory issues, with the most recent edition – the *2021 Australian Infrastructure Investment Report* – released last year and the 2022 edition due to be published shortly.

Last year's report found 73 per cent of investors agree that policy and regulatory uncertainty limits their willingness to invest. While perceptions of the relative attractiveness of the Australian energy market have improved over recent years among investors, this can be easily undone. Competition for capital – particularly among projects with strong ESG credentials – has never been stronger, driven by rapidly expanding pipelines in the European Union and United States of America. The message from investors was clear – capital is a coward and will go where it is treated well.

As highlighted in Infrastructure Partnerships Australia's major report, *Decarbonising Infrastructure*, a low-carbon energy system is vital for a low-carbon Australia. While the path to decarbonising Australia's energy system with a renewables-dominated electricity system has been clear for many years, this must happen in an orderly fashion.

The scale of the investment needed to achieve this transition is substantial. In its latest Integrated Systems Plan, the Australian Energy Market Operator identified an urgent requirement for \$12.7 billion of additional investment deliver the necessary transmission infrastructure needed to realise this.

Ensuring the energy transition is adequately supported as easily as practicable must be the overarching focus of current regulatory reform. Yet changing the allowed term of equity thereby lowering investment incentives would create another stumbling block in the road to an orderly transition.

### **The proposed reform will cause significant but avoidable uncertainty and risk**

A reduced term of equity is a departure from not only the AER's own practice of a stable two-decade precedent, but also the established practice of other global and Australian regulators. It is concerning that the AER would progress a reform agenda at odds with the accepted practice of other Australian regulators – most notably the WA Economic Regulation Authority, who the day after the Draft Instrument was released, announced its intention to abandon its five-year term of equity approach in favour of a 10-year one.

The impacts of this change will serve to make network investment less attractive, generate higher customer prices during severe recessions or global financial crises compared to the current approach, and worsen existing financing challenges facing major interconnector projects.

For investors, this proposal also risks undercompensating investors' actual required equity return by the historical difference between shorter tenor Commonwealth securities and longer-term benchmarks used by Australian and overseas regulators (generally 10 to 30 years in length).

Lastly, the AER's dismissal of the relevance of investor practice and perspectives arising from its proposed new interpretation of the implications of the 'NPV=0 principle' is deeply concerning. The importance of critically assessing and weighing investor and market perspectives in formulating a Rate of Return Instrument cannot be overstated. The AER should be setting the required return on equity based on the expected and required returns of investors providing the capital.

It is Infrastructure Partnerships Australia's view that a finalised 2022 Rate of Return Instrument should be aligned to market and regulatory practice and consistent with its previous decisions on term of equity.

#### Further information

We would be happy to provide further evidence in support of our submission. Should you require further information, please contact Director of Policy and Research, Mollie Matich on 02 9152 6000 or [mollie.matich@infrastructure.org.au](mailto:mollie.matich@infrastructure.org.au).



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