10 December 2025

Economic Regulation Authority
Level 4, Albert Facey House
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**Via email: publicsubmissions@erawa.com.au**

**2026 Gas Rate of Return Instrument Review**

Thank you for the opportunity to comment on the method for calculating the allowed rate of return on capacity for gas network service providers. We appreciate the inherent tension between consumers' interest in affordable energy and service providers' need for a fair and sustainable rate of return that supports ongoing investment.

We have reviewed the Economic Regulation Authority's (ERA) 2026 gas rate of return instrument review discussion paper and make the following recommendations on the overall approach to setting the rate of return and the methodological aspects of estimating its individual parameters.

**Alinta Energy's recommendations:**

1. **The benchmark efficient entity should be specified as a network service provider operating in Western Australia.**
2. **Five-year estimates should continue to be used as the primary estimates for estimating equity beta.**
3. **Principal weight should be placed on the beta estimates derived from the domestic comparator set, as these will better reflect the risk profile and market conditions relevant to gas network service providers operating in Western Australia**
4. **The equity beta estimate for the 2026 Rate of Return instrument should be below the equity beta for the domestic equity comparables as energy network service providers in Western Australia are exposed to a lower degree of operational risk than network service providers in the Eastern States of Australia.**
5. **Domestic energy networks should continue to be used to estimate gearing.**
6. **If an international set of beta comparators is to be applied, New Zealand, the United Kingdom, Canada and the US should be used as these markets have sufficient trading liquidity and similar regulatory regimes.**
7. **The assumed efficient debt strategy underlying the estimation of the cost of debt should be revised so that it more closely aligns with network service providers' actual debt financing strategies.**
8. **The full trailing average approach to estimating the cost of debt should be adopted.**
9. **If the full trailing average approach is adopted, no transitional arrangements are necessary.**
10. **The benchmark credit rating, established based on any comparable set, should be adjusted upward to reflect the relatively lower risks borne by network service providers operating in Western Australia.**
11. **Domestic energy networks should be used to determine the benchmark credit rating.**
12. **We support the adoption of a real GDP growth rate of 2.2 per cent.**

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**Benchmark Efficient Entity**

1. **The benchmark efficient entity should be specified as a network service provider operating in Western Australia.**

   We note that:

   Paragraph 42 of the Discussion Paper states - *"The ERA will estimate a benchmark expected rate of return that is applied to a benchmark gas network service provider."*

   Paragraph 43 of the Discussion Paper states - *"The ERA defines the benchmark efficient entity as a pure-play network service provider operating within Australia without parental ownership, with a similar degree of risk as that which applies to the service provider in respect of the provision of gas pipeline services."*

   Paragraph 44 of the Discussion Paper states - *"The rate of return must renumerate the efficient financing costs of the service provider."*

   We acknowledge the regulatory precedent for the approach to the gas rate of return, and its connection to incentive-based regulation. However, for the purpose of the Gas Rate of Return Instrument for use in Western Australia (WA), we are strongly of the view that:

   - the benchmark efficient entity should be specified as a service provider operating in WA; and
   - to prevent over estimation of the rate of return, any rate of return determination must have regard to the debt strategies used by network service providers operating in WA (efficient debt strategies).

   We consider that a unique set of economic and policy circumstances in WA have given rise to a context for gas network service providers which is distinct from other Australian States and Territories. As a consequence, the aggregate risks inherent in the operations of gas networks based in WA are lower than for network service providers in other States and Territories. We consider that this unique set of circumstances warrants consideration of the material differences in the efficient rate of return WA based gas networks such that the benchmark efficient entity should be specified as a service provider operating in WA and that this should be taken into account in determining the equity beta and credit rating for the Rate of Return Instrument.

   The unique circumstances we refer to are:

   - *Government policy*

     The WA State Government policy towards natural gas has remained favourable for network service providers. Unlike other States and Territory Governments, the WA Government has not introduced a ban on new residential gas connections. The current State Government has stated that it will not introduce such a ban, meaning that there is a higher level of certainty for gas network service providers in WA than in others states and territories.

     Additionally, the WA domestic gas ('Domgas') policy, which reserves a portion of gas produced within the state for local consumption, is another policy favourable to the use of gas within WA as compared to other Australian jurisdictions. Domgas is widely recognised as driving significantly lower wholesale gas prices in WA when compared to the East Coast. The average wholesale gas price in WA in 2024-25 was $7.45/GJ[1], this is significantly lower than the average wholesale gas price in east coast markets in the same year, which was $12.88/GJ[2].

   - *Growth trends supporting the use of gas, including population growth and industrial activity growth.*

     Population growth is a fundamental driver of demand for natural gas. WA had the highest growth rate of all Australian states and territories in the year to March 2025, at 2.3% compared to a national average of 1.6%[3].

[1] WA Department of Mines, Petroleum and Exploration, 2024-25 Major Commodities Resource Data File, online.
[2] AER, *Gas Market Prices,* online.
[3] Australian Bureau of Statistics, *National, state and territory population,* March 2025, online.

WA's population growth is forecast to remain positive through to at least 2036[4]. WA's Gross State Product is expected to grow by 2.5% in 2025-26, and remain between 2% and 3% between 2026-27 to 2028-29[5].

Financial theory suggests that a risk averse investor will require higher returns for higher risks. It follows that higher risk operations should have relatively higher costs of financing, and relatively lower risk operations should have relatively lower costs of financing. We therefore consider that the lower risk faced by WA network service providers should be reflected in a lower overall rate of return for these service providers.

We hold strong views that the unique operating context of WA gas network service providers should be reflected in a lower beta value (and hence lower cost of equity) and higher credit rating (and hence lower cost of debt). We elaborate on these views in our comments on these parameters below.

**Beta Value – Cost of Equity**

**2. Five-year estimates should continue to be used as the primary estimates for estimating equity beta.**

In the 2022 Rate of Return Instrument Explanatory Statement, the ERA has stated that:

*"the five-year estimates are still the primary estimates which are used for the determination of equity beta. 10-year estimates are used as additional information for the exercise of the ERA's regulatory discretion….. The balance between relevance and statistical robustness still lies in favour of five-year estimation windows as the primary estimate"*[6].

We support this position.

International regulatory precedent also supports the use of shorter estimation windows. For equity beta, longer estimation windows can include data that is irrelevant due to changes in market conditions, and we consider that their use would be inconsistent with the ERA's principle of seeking forward-looking estimates. We therefore recommend that the ERA continue to use Five-year estimates as the primary estimates for estimating equity beta for the 2026 Instrument.

**3. Principal weight should be placed on the beta estimates derived from the domestic comparator set, as these will better reflect the risk profile and market conditions relevant to gas service providers operating in Western Australia**

The Discussion Paper sets out updated equity beta estimates consistent with the ERA's suggested refinements to the equity beta estimation process. This set shows that the equity beta estimates for the domestic set (5-year estimate 0.43, 10-year estimate 0.55) are significantly below those for the international comparators. Inclusion of the equity beta estimates for the international comparators increases the estimated beta for the combined set to 0.63 (5-year estimate, mean all methods) and 0.73 (10-year estimate, mean all methods)[7].

The Australian Energy Regulator (AER) has observed in its recent Rate of Return Instrument Discussion Paper that "empirically that using our current methodology, international energy firms' long-term equity beta estimates tend to be higher than that of Australian energy networks. Over the short-term, the equity beta estimates of international energy firms can also diverge significantly from that of Australian energy network"[8].

As the inclusion of the equity beta estimates for the international comparators inflates the rate of return above that expected of a network service provider operating in WA, we recommend that principal emphasis be placed on the domestic comparator set when determining the point estimate for equity beta. Applying this approach would suggest an equity beta significantly lower than 0.7 is appropriate.

[4] Department of Planning, Lands and Heritage, April 2025, *Western Australia Tomorrow Population Forecasts*, accessed online.
[5] Government of Western Australia, May 2024, *State Budget 2024-25 Budget Paper No. 3 Economic and Fiscal Outlook*, pp. 12 – 13.
[6] ERA, December 2022, *Explanatory statement for the 2022 final gas rate of return instrument*, paragraphs 979 and 982.
[7] ERA, October 2025, *2026 gas rate of return instrument review discussion paper,* page 43.
[8] AER, August 2025, *Rate of Return Instrument Revise discussion paper*, pages 16 – 17.

4. **The equity beta estimate for the 2026 Rate of Return instrument should be below the equity beta for the domestic equity comparables as energy network service providers in Western Australia are exposed to a lower degree of operational risk than network service providers in the Eastern States of Australia.**

   It is well known that Beta reflects a firm's exposure to systematic risk, which is influenced by its business (operational) and financial risk. The AER states that "the greater the uncertainty around the returns of a firm, the greater its level of risk"[9].

   As outlined above in our comments on the benchmark efficient entity, we consider that due to differences in the economic and policy circumstances of WA, energy network service providers in WA are exposed to a lower degree of operational risk than network service providers in the eastern states. Consistent with risk-return trade-off theory we consider that it is reasonable to expect the beta for a gas network service provider in WA to be lower than that of a gas network service provider elsewhere in Australia. Based on this point, and combined with the other observations we have outlined in this submission, we recommend that:

   a. The equity beta estimate for the ERA's 2026 Rate of Return instrument should be lower than the equity beta for the domestic equity comparables; and
   b. The equity beta estimate for the 2026 Instrument should be well below its current value of 0.7.

   We acknowledge that a key complication in applying this approach is a lack of WA-based comparators. We therefore consider that it would be a proper application of the ERA's regulatory judgement to estimate the appropriate adjustment to the beta value to account for the locational factors we have outlined. As stated in the 2022 Rate of Return Instrument:

   *"The market cost of capital for gas network service providers cannot be directly observed and must instead be estimated. This creates a degree of uncertainty… and therefore the ERA, as a regulator, must exercise judgement when considering evidence."*[10]

5. **Domestic energy networks should continue to be used to estimate gearing.**

   As we recommend that the ERA should place principal weight on beta estimates for the domestic comparator set rather than the international comparator set, we support the retention of a domestic sample.

6. **If an international set of beta comparators is to be applied, New Zealand, the United Kingdom, Canada and the US should be used as these markets have sufficient trading liquidity and similar regulatory regimes.**

   While a domestic comparator set is preferred and recommended, if an international set of beta comparators is to be applied, we support the ERA's proposal to use New Zealand, the United Kingdom, Canada and the US as the markets from which international comparables are drawn. We consider this approach to be consistent with established regulatory practice where comparables are selected from markets with sufficient trading liquidity and similar regulatory regimes.

**<u>Credit Rating - Cost of Debt</u>**

7. **The assumed efficient debt strategy underlying the estimation of the cost of debt should be revised so that it more closely aligns with network service providers' actual debt financing strategies.**

   Currently, the hybrid trailing average approach to the estimation of the cost of debt assumes that the benchmark entity enters into an assumed benchmark efficient debt strategy. This benchmark efficient debt strategy entails a portfolio of 10-year fixed rate debt with 10 per cent of the debt refinanced each year in a staggered fashion. The benchmark efficient entity is then assumed to use derivative arrangements to adjust rates from the efficient debt portfolio to lock in five-year interest rate swaps rates[11].

   We recommend that the ERA reconsider the assumed efficient debt strategy underlying estimation of the cost of debt and adopt an approach that more closely aligns with network service providers' actual debt financing strategies. We consider it artificial to assume that the benchmark efficient entity would refinance an even 10 per

[9] AER, March 2018, Equity Beta (Discussion paper), page 7.
[10] ERA, December 2022, *Explanatory statement for the 2022 final gas rate of return instrument*, paragraphs 71 – 72.
[11] ERA, *Explanatory statement for the 2022 final gas rate of return instrument*, paragraphs 71 – 72, paragraph 296.

cent of its debt liability portfolio each year, and this assumption results in a regulatory cost of debt estimate which is upwardly biased.

We consider it more realistic to apply a debt strategy assumption that reflects that efficient service providers would refinance larger tranches of debt during periods when debt is relatively cheap, and refinance relatively smaller tranches of debt during periods when debt is relatively expensive. It has been observed from the AER's Energy Infrastructure Credit Spread Index (EICSI)[12] that network service providers' costs of debt for the entirety of the 2013-2017 period were persistently below regulatory returns on debt. One inference that could be drawn from this is that networks' actual financing practices are different from the assumed efficient strategy[13].

Network service providers are not bound to follow the assumed efficient debt financing strategy. The AER has itself observed, the EICSI may be "*reflective of an active debt management strategy*"[14] which differs from the assumed efficient debt strategy. Under the current assumed debt strategy, the cost savings from the actual efficient debt strategies applied by networks are never passed onto consumers.

We do not consider that assuming an efficient debt strategy closer to the WA network service providers' actual debt strategies would be contrary to the objectives of incentive-based regulation. Supporting this point, the AER has expressed for example that:

*"A regulated return on debt set using the EICSI (in whole or in part) would still be a benchmark approach, because the EICSI reflects costs across all networks rather than any network individually" and that "the desirable properties of the incentive regime are preserved. That is, networks have an incentive to pursue efficiency gains across time, and consumers benefit in the long term when these efficient costs are revealed."*[15]

*"As you use more business-specific information and rely less on benchmarked inputs into the cost allowance, you may move further along the spectrum from incentive-based regulation towards cost-of-service regulation. Even some of the most high-powered incentive-based regulatory frameworks have some element of a cost-of-service regime. For example, the provision of cost pass-throughs, which allows for some ex-post recovery of those costs considered beyond the control of a network business".*[16]

Adopting an assumed efficient debt strategy that is closer to the WA network service providers' actual debt strategies would also accord with the ERA's own principle that an *"effective gas instrument should be… sufficiently flexible as to allow for changing market conditions"*[17]. This is because an assumed debt strategy which more closely accords with the debt strategies actually applied by networks is more closely reflective of dynamic responses adopted by networks to market conditions.

We note that in its current review of its Rate of Return Instrument, the AER is contemplating one approach to estimating the cost of debt which may in theory accord more closely with networks' actual financing costs than the current assumed efficient debt strategy. This is a weighted trailing average approach which the AER outlines as follows:

*"The return on debt continues to be calculated using a 10-year trailing average, but the weights applied to each year's debt are adjusted to reflect the yearly timing and amount of new debt raised, rather than assuming a fixed 10% refinancing profile. This is particularly important in scenarios where large volumes of debt are raised over a short time period, such as can be the case with large ISP-related investments."*[18]

*"New debt is assumed to be raised at prevailing market rates, consistent with the existing benchmark approach. These rates are then gradually phased into the trailing average over time. The model could also use a true-up to adjust for differences between forecast and actual capital expenditure. If applied, this would reduce the risk that businesses are either over- or under-compensated due to capital expenditure forecasting inaccuracies."* [19]

[12] The EICSI is an index of actual network debt costs based on data collected from regulated networks on their debt instruments.
[13] The assumed efficient debt strategy applied in the AER's current Rate of Return Instrument is the same as that applied in the ERA's current Instrument.
[14] AER, November 2020, *Rate of Return Energy Network Debt Data Final Working Paper*, p. 32.
[15] AER, November 2020, *Rate of Return Energy Network Debt Data Final Working Paper*, p. 32.
[16] AER, August 2025, *Rate of Return Instrument Review discussion paper,* p. 23.
[17] ERA, October 2025, *2026 gas rate of return instrument review discussion paper,* paragraph 60.
[18] AER, August 2025, *Rate of Return Instrument Review discussion paper,* p. 24.
[19] AER, August 2025, *Rate of Return Instrument Review discussion paper,* p. 24.

As a result we request that the ERA consider the alternative weighted trailing average approach outlined by the AER as a possible alternative to the current assumed efficient debt strategy. This recommendation is discussed separately below.

8. **The full trailing average approach to estimating the cost of debt should be adopted.**

   We recommend a change in the return on debt approach to a full trailing average as this is more closely aligned with the actual financing practices of network service providers. As outlined in the paragraphs above, we consider this an appropriate and important principle in the estimation methodology for the return on debt. Our position on this point aligns with the ERA's view that *"As the full trailing average approach assumes stable, long-term debt management, it is more consistent with the nature of regulated assets and better aligned with real-world financing strategies of large infrastructure firms*."[20]

   Additionally, we consider a full trailing average approach is more appropriate than a hybrid trailing average approach because the hedging practice assumptions implicit in the hybrid trailing average assumptions are likely misaligned with the actual financing strategies adopted by efficient networks. Our position on this point aligns with the ERA's view that "*Comparatively, the hybrid trailing average approach assumes that firms hedge using swaps to achieve a five-year fixed rate, which may not reflect actual practice*".[21]

9. **If the full trailing average approach is adopted, no transitional arrangements are necessary.**

   In the event that a full trailing average debt approach is adopted for the 2026 Instrument, we consider that no transitional arrangements are needed because the current assumed efficient debt strategy has resulted in the WA network service providers being historically overcompensated for their debt financing costs. As further overcompensation should be avoided, we do not consider that there is justification for a gradual 'phasing out' of this arrangement and that it would be in the interests of consumers if the full trailing average debt approach is implemented fully and without delay.

10. **The benchmark credit rating, established based on any comparable set, should be adjusted upward to reflect the relatively lower risks borne by network service providers operating in Western Australia.**

    Relatively lower (higher) credit ratings signify higher (lower) risk to debt (and equity) capital providers and convey information about an entity's ability to repay its obligations[22]. In applying risk-return trade-off theory, a relatively lower (higher) credit rating would lead debt capital providers to demand higher (lower) returns on invested debt capital.

    As outlined in the paragraphs above regarding the benchmark efficient entity, we consider that due to differences in the economic and policy circumstances of WA, compared to the eastern states, energy network service providers in WA are exposed to a lower degree of operational risk than network service providers in the eastern states. This lower degree of operational risk would lead to less uncertainty regarding WA network service providers' cash flows and therefore, their ability to repay debt. As a result we would expect that, all other things equal, the credit rating of an efficient network service provider operating in WA should be higher than the credit rating of efficient network service providers elsewhere in Australia.

    We therefore recommend that any benchmark credit rating established based on a comparable set should be adjusted ("notched") upwards to reflect the relatively lower risks borne by WA network service providers. We acknowledge that a key complication in applying this approach is determining the appropriate upwards adjustment to apply to the credit ratings of WA network service providers compared to an unadjusted benchmark credit rating. We consider that it would be a proper application of the ERA's regulatory judgement to estimate the appropriate degree of this upwards notching.

    We note that the degree of difference between the yields on debt issues of different credit ratings widens during economic recessions. We therefore consider that the implications of not applying appropriate notching to account for the lower operational risks of WA network service providers can result in material over-compensation, particularly during periods of economic slowdown and market volatility.

[20] ERA, October 2025, *2026 gas rate of return instrument review discussion paper,* paragraph 151.
[21] ERA, October 2025, *2026 gas rate of return instrument review discussion paper,* paragraph 151.
[22] CFA Program Curriculum, *2020 Level II Volume 3 Corporate Finance*, page 109.

**11. Domestic energy networks should be used to determine the benchmark credit rating.**

We support the use of domestic energy networks to determine the benchmark credit rating. However, as outlined in the paragraphs above, we consider that the credit rating established by reference to a comparable set should be adjusted upwards to reflect the lower degree of risk for energy network service providers operating in WA as compared to other parts of Australia.

**12. We support the adoption of a real GDP growth rate of 2.2 per cent.**

The parameters applied to estimate the market rate of return through the Dividend Growth Model per the current instrument are outdated, having remained the same since 2013. The source the ERA proposes to use for the real GDP growth assumption, the Commonwealth Treasury's Intergenerational Report is credible and more contemporaneous than the GDP estimate currently applied. The factors that the Intergenerational Report cites as driving slower Australian economic growth in the future – lower projected population growth, reduced labour force participation driven by an ageing population and slower productivity growth – are credible and broadly cited as factors creating a drag on Australia's GDP growth.

Thank you for your consideration of Alinta Energy's submission. If you would like to discuss this further, please contact me at [redacted]

Yours sincerely

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