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10 December 2025

Mr Steve Edwell
Chair
Economic Regulation Authority
Level 4, Albert Facey House 469 Wellington Street
Perth WA 6000

Dear Mr. Edwell

Re: Rate of Return Instrument Discussion Paper

Thank you for the opportunity to respond to the Rate of Return Instrument Discussion Paper published in October 2025.

The ERA's Discussion Paper outlines an incremental approach in this review of the Rate of Return Instrument. Whilst ATCO supports the regulatory stability that comes from an incremental review, we recognise that some areas of the Rate of Return Instrument need change to reflect the new circumstances that were not as prevalent when the Instrument was made in 2022.

The Rate of Return process is unfolding against a backdrop of change and heightened uncertainty for regulated gas networks. Australia's energy transition is accelerating, and gas networks face an unprecedented level of policy uncertainty.

In the context of increased market volatility and regulatory uncertainty, the ERA should continue to exercise regulatory judgement to ensure a fair and competitive rate of return remains commensurate with the risks faced by service providers and is sufficient to attract ongoing investment.

The ERA should be mindful of the international competition for capital and regulatory returns received by gas network providers in countries like US, Canada, New Zealand and UK. ATCO is concerned that there continues to be a material difference in the regulated rate of return between other jurisdictions, including North America, and the ERA's position in the Discussion Paper.

As an example, Alberta Utilities Commission (AUC) released their Generic Cost of Capital Decision in October 2023 to determine the rate of return. Using a formulaic approach, the Commission approved a return on equity for 2024 of 9.28%. The AUC updates this return on equity annually, with the 2025 update being 8.29%. It should be noted that the ERA set ATCO's return on equity at 5.02% in 2024 and 8.23% in 2025.

We note that, due to the original four-week timeframe for submissions, some of our responses are necessarily brief and reflect preliminary views. We appreciate the subsequent two-week extension granted close to the initial deadline, however, given the inherent complexity in the rate of return a six-week period should have been available from the outset. For example, the AER's 2026 RORI discussion paper was published on 4 August 2025 with submissions closing on 28 November 2025.

I look forward to continuing to work with the ERA throughout this review process. If you have any questions or would like to discuss any of these matters further, please contact me or Warrick Ambrosa, Senior Manager Regulation Strategy.

Yours faithfully

Hugh Smith
Executive General Manager Strategy, Technology and Corporate Affairs

Attachment 1: ATCO submission

ATTACHMENT 1: ATCO SUBMISSION

2026 RATE OF RETURN INSTRUMENT DISCUSSION PAPER

GAS DIVISION

10/12/2025

CONTENTS

1. INTRODUCTION

ATCO welcomes the opportunity to respond to the Economic Regulation Authority's (ERA) Discussion Paper titled "2026 Gas Rate of Return Instrument Review" dated October 2026.

1.1 Overview

ATCO's response to 2026 Gas Rate of Return Discussion Paper is summarised in the following table:

Table 1.1: Summary of ATCO's response to ERA's 2026 Gas Rate of Return Instrument Discussion Paper

Parameter	Summary of ATCO's response
2022 gas instrument performance	• Performance of the 2022 instrument will only become evident after ATCO's sixth access arrangement concludes. • International firms in ERA's comparator set earn higher equity returns, increasing investment risk for WA gas networks due to global competition for capital.
Shrinking sample size	• ATCO supports retaining only APA Group in the domestic sample. • Delisted firms (DUET Group, Spark Infrastructure Group, Ausnet Services) should be removed as their information is irrelevant to future returns. • ATCO supports ERA's continued inclusion of international firms. • ATCO recommends broadening the criteria for selecting international comparators to increase sample size.
Gearing	ATCO supports a gearing ratio of 55%.
Benchmark credit rating	ATCO supports the use of a benchmark credit rating of BBB+ for the 2026 gas instrument. The ERA should continue to use domestic energy networks to determine the benchmark credit rating.
Debt approach	ATCO does not support a change to a full trailing average for the return on debt. We advocate to retain the current 10-year hybrid trailing average methodology. This will: • Provide regulatory certainty • Be reflective of current market conditions, and • Closely mimic efficient debt management strategy of the benchmarked entity ATCO utilises 5-year swaps as a debt management strategy over the course of the access arrangement to achieve a fixed five-year rate. A multi-year transition to a trailing average will be complex. It will be slow to react to changing market conditions.
MRP methods	ATCO supports the principle that the Dividend Growth Model (DGM) should use robust macroeconomic inputs, including long run GDP parameters. A single source estimate of the GDP growth rate risks embedding the limitations of that model into the regulatory framework.
Equity beta	At a high level, ATCO accepts ERA's three proposed simplifications.

1.2 Structure of the document

Section 2 provides ATCO's responses to the questions in ERA's Discussion Paper and is structured as follows:

- Section 2.1 answers questions related to the 2022 gas instrument related to ease of calculation and performance.
- Section 2.2 answers questions related to the 2026 gas instrument.

2. LIST OF QUESTIONS FROM THE DISCUSSION PAPER

2.1 2022 gas instrument performance

2.1.1 Mechanical calculation of market parameters

Question 1

Has the 2022 gas instrument supported the effective mechanical calculations of the rate of return required for access arrangement and tariff variation processes?

Yes. The 2022 Gas Rate of Return Instrument has provided a clear and consistent mechanical framework for calculating the allowed rate of return. The formulas, data sources, and averaging-period requirements prescribed in the instrument have enabled access arrangement determinations and annual tariff variation processes to be undertaken with a degree of predictability and mechanical accuracy.

2.1.2 Reflection of changing market conditions

Question 2

How has the 2022 gas instrument performed in reflecting changing financial market conditions? Are there any areas of concern that the recent volatility of financial markets has presented?

The actual performance of the 2022 RORI in "reflecting changing financial market conditions" will only be observable after the AA6 period concludes. Neither the ERA nor ATCO can make any major adjustments to ATCO's weighted average cost of capital (WACC) for the sixth access arrangement and it is effectively locked for the 2025-29 period based on market data observed around the 2022 determination.

ATCO also notes, that instead of comparing WACC estimates of gas network service providers in WA with ERA's 2022 gas rate of return sensitivity analysis (Table 3 in the Discussion Paper), a clearer benchmark would be to compare between WA's network service providers and other benchmarked entities. In a global investment environment where capital flows freely and projects compete on risk-adjusted returns, WA gas networks face heightened investment risk when allowed returns fall materially below those earned by peer networks internationally.

Table 2 in Appendix A lists the return on equity for international comparators that the ERA uses to estimate equity beta. For the entire international comparator set the return on equity was approximately 9.5% on an average. The highest return on equity was observed for firms operating in the UK which was in the range of 9.6% to 10.1% in 2023/24. The Alberta Utilities Commission (AUC) has set the 2024 formulaic return on equity at 9.28% under its Generic Cost Of Capital framework, which will be updated every year. By contrast, the ERA has set ATCO's return on equity for AA6 at 8.23%. While the Discussion Paper identifies a theoretical range of 6.2% to 9.9% for this parameter, ATCO considers that the ERA's adopted value does not compare favourably with its own international comparator set, potentially weakening Western Australia's competitiveness for new capital.

Finally, ATCO acknowledges that the ERA's hybrid approach to estimating the return on debt helped the RORI better reflect prevailing financial market conditions. By setting the base rate using a five-year interest rate swap averaged over the 20-day window before AA6, ATCO was able to execute market swaps during that averaging period, aligning with the behaviour of an efficient benchmark entity. This approach was beneficial in managing interest-rate volatility during a period of rapidly shifting financial conditions.

2.2 Key topics for 2026 gas instrument review

2.2.1 Listed companies in the sample

Question 3

Do you support the ERA's proposed approach for the domestic sample (retain the use of APA, Spark Infrastructure Group and Ausnet Services, remove the DUET Group)?

ATCO supports retaining only APA Group in the domestic sample even though regulated revenues make up a low percentage of APA Group's total revenue. Domestic gas network service providers provide sound benchmarks as an efficient entity, as defined in the Discussion Paper (Paragraph 89).

ATCO does not support using data for delisted comparators because of its limited relevance to future returns. In 2022 ATCO submitted in response to ERA's 2022 Draft Rate of Return Instrument:[1]

> *"Delisted firm comparator data (as employed by the ERA for 3 of the 4 firms identified in its Domestic Energy Sample) contributes no information on the prevailing conditions in the market for equity funds and should not be used."*

Delisted firm data does not contribute any information relevant to the future financial returns and should not be used. Therefore, DUET Group, Spark Infrastructure Group and Ausnet Services should be removed from the domestic sample.

The ERA should also consider the timing of ATCO's next Access Arrangement decision in deciding on retaining delisted domestic firms. For ATCO's seventh access arrangement the ERA will estimate parameters like debt risk premium and risk-free rate based on financial information in 2029. As stated in the Discussion Paper:[2]

> *"Related to this is that the ERA has considered that recently delisted firms can still be informative, but this relevance weakens over time and as historic estimates become less useful."*

Lastly, ATCO reiterates its position, consistent with its response to ERA's 2022 Rate of Return Instrument, that while international energy networks provide superior comparators due to similar services and regulatory regimes, other domestic infrastructure firms offer a viable alternative for expanding the comparator set and represent the next best option. The ERA should provide further information and analysis on why other domestic infrastructure companies in rail, transportation, ports, airports and telecommunications are or are not suitable comparators. As stated in ATCO's submission on ERA's Rate of Return Discussion Paper:[3]

> *"ATCO supports the ERA further examining adding domestic infrastructure providers to the domestic comparator set but recognises it as a second-best option to using international energy infrastructure comparators. ATCO notes that the Discussion Paper does not support an expanded domestic sample incorporating companies in rail, transportation, ports, airports and telecommunications. However, there was limited evidence of the analysis undertaken by the ERA to support this conclusion. For example, beta estimates for the firms were not incorporated into the Discussion Paper.*

1 ATCO's 2022 response to ERA's Draft Instrument.
2 ERA 2026 Rate of Return Review Discussion Paper, paragraph 93.
3 ATCO's 2022 response to ERA's Rate of Return Discussion Paper, page 30.

ATCO recognises that international energy networks are a superior source of comparators as they allow inclusion of firms which perform similar services and are subject to similar regulatory regimes. However, other domestic infrastructure firms are an alternative way of expanding the comparator set and represent the next best set of comparators."

ATCO encourages the ERA to provide further information and analysis on why other domestic infrastructure companies are not suitable comparators.

Question 4

Do you support the ERA's continued consideration of select international firms? Are there any new international firms that may be appropriate to now include?

A large sample is crucial for unbiased, reliable and stable estimates of Gas Rate of Return Instrument parameters. Statistical estimates based on a single firm or a limited sample of firms may conflate systematic risk and firm specific factors, thereby compromising on robustness of the estimates. To ensure that network service providers are compensated for systematic risk, the ERA should use a large and representative sample which mitigates firm-specific bias and enhances validity of the estimates.

ATCO supports ERA's continued consideration to select international firms, especially with only one relevant firm left in the domestic comparator set. International firms operating energy networks in the United States, Canada, United Kingdom and New Zealand operate under similar regulatory regimes as Australia and deal with liquid, deep and large financial markets. As stated in ATCO's response to ERA's 2022 Rate of Return Discussion Paper for estimating beta based on international comparators:

"ATCO supports the ERA examining adding listed international firms operating energy networks in the United States, Canada, United Kingdom and New Zealand to the domestic comparator set. The fundamental advantages of including international firms in the estimation of equity beta process relate to the large sample of firms available:

Including a larger number of firms not only increases the statistical reliability of measures but also the impact of any one seemingly anomalous beta estimate, for example due to a firm specific event, is not significant when taking an average or median beta from all the firms in the larger sample.

Alongside the statistical advantages that using an international sample offers, it also allows greater flexibility when choosing comparators by allowing to focus on more relevant firms while maintaining a sample size less likely to be affected by outliers.

To the extent that there may be country-specific effects on beta estimates, these can be limited by using a sample of relevant firms from a cross-section of countries where possible."

Alongside the statistical advantages that using an international comparator set offers, it also allows greater flexibility when choosing comparators by allowing to focus on more relevant firms while maintaining a sample size less likely to be affected by outliers.

ATCO also recommends the ERA broaden the criteria for selecting international comparator firms (stated in Paragraph 99). To ensure business risk comparability for an energy firm, the company should be predominantly engaged in energy transmission or distribution, as identified by some threshold quantification of the proportion of revenue, cash flow, or asset value that is associated with regulated

business activities. As stated in ATCO's response to ERA's 2022 Rate of Return Instrument Discussion Paper to estimating beta using international comparators:[4]

> *"To ensure business risk comparability for an energy firm beta estimate, the company should be predominantly engaged in energy transmission or distribution, with, for example*:
>
> *At least 70% of revenues are in relevant regulated utility* businesses[5]
>
> *At least 50% of their assets dedicated to regulated utility* service[6]
>
> *Note that the particular thresholds established for revenue, cash flow, or asset value proportions may be tuned to strike an appropriate balance between obtaining a statistically adequate sample and selecting comparators that are as close as possible to pure play energy network operators*."

In the context of estimating beta, ATCO stated that the following criteria can be used to amend the international comparator set:

> *"A company must also have sufficient liquidity to allow its share price to move as its risk relative to the market changes. This could be measured by the percentage of the company's shares traded over, say a week on average or require that the companies have an investment grade credit rating, and more than $US300 million in revenues to ensure liquidity. QCA has found companies with a market capitalisation of over $US 150 million have sufficient liquidity for reliable beta estimation.*
>
> *Eliminate companies whose stock return data may have been affected by M&A transactions during the relevant beta estimation window; a threshold for the size of the transaction in proportion to the company's market cap (e.g., 30%) may be established to identify material M&A activity.*
>
> *Ideally observations for a company should be available for the entire observation period to avoid any issues related to listing or de-listing."*

Based on the criteria listed above, the ERA can consider new international comparators from the firms operating energy networks in the United States, Canada, United Kingdom and New Zealand.

2.2.2 Gearing

Question 5

Is gearing sufficiently stable to maintain the 55 per cent gearing ratio?

ATCO supports maintaining gearing ratio at 55% because it allows for efficient recovery of costs, consistent with revenue and pricing principles.

4 ATCO's 2022 response to ERA's Rate of Return Discussion Paper, page 32

5 Queensland Competition Authority, Rate of return review, Final report, November 2021, pg 74. Note that in some instances, it may be appropriate to replace or supplement revenue metrics with cash flow metrics (such as operating profit or EBITDA) in assessing the importance of regulated energy transmission or distribution operations to the company's business

6 Alberta Utilities Commission (AUC), 2021 Generic Cost of Capital (GCOC) Proceeding ID 24110 Responses on Evidence to: Alberta Utilities Commission (AUC), Exhibit 24110-X0077, Evidence of Bente Villadsen, pg 73

Question 6

Do you support the continued use of domestic energy networks to estimate gearing? If not, please explain why and your alternative approach.

ATCO supports the use of domestic energy networks to estimate gearing. Domestic firms provide a reliable benchmark for gearing as they operate under similar legal, regulatory and tax frameworks. As noted in the Discussion Paper, gearing levels of Australian energy networks will most closely reflect the regulatory and commercial risk involved in providing regulated services.

ERA should retain APA Group in the domestic sample, noting that the number of listed domestic energy networks have reduced to a single listed firm. ATCO does not support using DUET Group, Ausnet Services and Spark Infrastructure Group which have delisted in 2021 to estimate gearing. Including these firms in the sample does not provide any useful information as these firms would be delisted for approximately 5 years at the end of 2026, when ERA publishes the Gas Rate of Return Instrument.

Consistent with the 2022 Rate of Return Instrument Review, the ERA should adjust for any hybrid securities (which have characteristics of both debt and equity) when estimating gearing based on the APA Group and provide information regarding how these adjustments are made.

Question 7

If an international sample is to be used for estimating gearing, which jurisdictions and companies could be considered comparable and included as part of the sample? Please explain why.

ATCO supports the use of the remaining listed domestic energy operator, APA Group for estimating gearing. Since a large sample would provide a more reliable estimate for gearing, the ERA could consider gearing ratios (or trends in gearing ratios) of international comparators, however, this comes with the associated risks noted in the Discussion Paper.

2.2.3 Benchmarking credit rating

Question 8

Is credit rating sufficiently stable to maintain BBB+ credit rating?

ATCO supports the use of a benchmark credit rating of BBB+ for the 2026 gas instrument. If the ERA adopts AER's method for estimating the cost of debt based on the trailing average approach, as detailed below, the sample will have to be adjusted accordingly.

Question 9

Do you support the continued use of domestic energy networks to determine the benchmark credit rating? If not, please explain why and your alternative approach.

ATCO supports the continued use of domestic energy networks to determine the benchmark credit rating. This method has been used in prior instruments and presents a benchmark credit rating that represents the Australian context.

If the ERA adopts an alternative method to determine credit ratings, it must provide compelling justification. Unlike equity parameters, credit ratings are country-specific and cannot be reliably estimated by referencing international energy networks. Using such networks introduces factors like country risk and differing capital structures, which could distort the benchmark for WA.

2.2.4 Debt approach

Question 10

Do you support a change in return on debt approach to a full trailing average? If not, please provide your reasons.

ATCO does not support a change to a full trailing average for the return on debt. We support the current 10-year hybrid trailing average methodology. This is consistent with ATCO's previous submissions where we supported the hybrid approach for estimating costs. In our view, moving to a full trailing average would move away from regulatory certainty and should be approached with caution.

In ERA's 2022 review, the ERA was of the view that the hybrid approach to estimating the cost of debt meets the NPV=0 principle, reduces the ability of the firms to exploit the slope of the yield curve, reduce refinancing risk and minimises price volatility within an access arrangement. The ERA also stated that:[7]

> *"Compared to a full trailing average approach, it* (hybrid approach) better minimises interest rate risk by linking revenues to a five-year risk-free rate, which is reset at the end of the regulatory period. Interest rate risk can be further managed with the allowance for hedging costs."

As stated in ERA's Explanatory Statement for 2022 Draft Gas Rate of Return Instrument:[8]

> *"After considering the above information, on balance, the ERA considers that as a regulatory approach, the hybrid trailing average approach best meets the national gas objective.*
>
> *The ERA considers that this is an efficient and implementable debt strategy for a long-term asset. The ERA maintains that the use of derivative arrangements to adjust rates to lock in a five-year bill swap at the start of the regulatory period appropriately aligns cost of debt in the regulatory context."*

The ERA stated that:[9]

> *"Dr Lally's recent advice has reconfirmed that the hybrid trailing average approach satisfies the NPV=0 principle and allows firms to align their borrowing arrangements with the regulatory allowance"*

The ERA further stated that:[10]

> *"The ERA considers that this return on debt regulatory approach best approximates the NPV=0 principle while also recognising interest rate risk, refinancing risk and the staggered nature of debt portfolios.*
>
> *Departing from the current hybrid trailing average approach may be difficult as the benchmark service provider has:*
>
> *Established a portfolio of 10-year fixed-rate debt.*
>
> *Entered into derivative arrangements to convert part of these annual debt issuances to floating interest rate swap rates.*
>
> *Maintaining the current hybrid trailing average approach would promote regulatory certainty."*

7 ERA's Explanatory Statement for the 2022 Draft Gas Rate of Return Instrument, paragraph 321.
8 ERA's Explanatory Statement for the 2022 Draft Gas Rate of Return Instrument, paragraphs 325 and 326.
9 ERA's Explanatory Statement for the 2022 Draft Gas Rate of Return Instrument, paragraph 327.
10 ERA's Explanatory Statement for the 2022 Draft Gas Rate of Return Instrument, paragraphs 328, 329 and 330.

ATCO supports retaining the hybrid approach for the following reasons:

- **Regulatory Certainty:** Maintaining the hybrid trailing average approach promotes regulatory certainty and stability. The ERA's rate of return framework has employed a hybrid method historically (most recently in AA5 and now into AA6). Continuing this methodology sends a signal to investors that the regulatory regime remains predictable and stable.

- **Reflection of Current Market Conditions:** The hybrid approach reflects current market conditions in the allowed return on debt. Under the current approach, updating the risk free rate component of the cost of debt at the start of each access arrangements acts as a reset point for the upcoming access arrangement using current market conditions (through a five-year swap as the proxy). The five-year swap is a snapshot of actual market conditions just prior to an access arrangement starting, not outdated averages. Conceptually, this means that customers of the network within that access arrangement are paying a cost reflective tariff to access the network. On the flipside of this, moving to a trailing average comes with problems where new investments are not compensated at the current rates. For example, in an environment where interest rates are rising, a trailing average would lag behind, potentially leading to debt costs being too low as the utility needs to finance new infrastructure at higher rates.

- **Efficient debt management strategy of a benchmarked entity:** To meet the NGO and the RPP it is necessary to estimate the cost of debt that is consistent with the efficient financing costs of the benchmark efficient entity with a similar degree of risk to ATCO Gas. ERA's current hybrid approach for estimating cost of debt is a well-defined replicable debt management strategy. The cost of debt is estimated by reference to a well-defined efficient and replicable debt management strategy which satisfies the NPV=0 principle. ATCO uses the 5-year swaps as a debt management strategy and therefore supports the hybrid approach to estimate return on debt. In the Discussion Paper, the ERA has stated:

  "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. 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."[11]

ATCO notes that it does utilise 5-year swaps as a debt management strategy over the course of the access arrangement to achieve a fixed five-year rate. As stated in ATCO's response to the 2022 Draft Rate of Return Instrument:[12]

> *"Use of the five year bank bill swap rate is supported as an estimate of the debt risk free rate because:*
>
> *use of the five-year bank bill swap rate is consistent with the efficient and implementable hybrid trailing average debt strategy.*
>
> *under the hybrid approach the business will enter into swap contracts to hedge the risk free rate every time it is reset during the regulatory review process. This strategy facilitates the service provider's ability to repeat the process for the next regulatory period. The continued adoption of the five-year bank bill swap rate is necessary for regulatory certainty to support this financing strategy."*

The shift to a full trailing average also creates some additional problems, such as:

11 ERA's 2026 Rate of Return Instrument Review Discussion Paper, paragraph 151.

12 ATCO's response to ERA's 2022 Draft Rate of Return Instrument, September 2022, page 7.

- **Transition to a Full Training Average:** Shifting to a full trailing average return on debt is not just a parameter change (see response to Question 11 for more details). A multi-year transition path is needed to gradually replace the current hybrid compensation with the simple trailing average. Further, ATCO currently holds a portfolio of debt that has been structured under the assumption of the existing hybrid methodology. Moving to a full trailing average requires decisions on how existing debt should be mapped into the new trailing average series and how to treat historical refinancing decisions already made under the current regulatory incentive framework. There are also the administrative and financing requirements (and costs) that would need to be taken into account in order to transition the debt into the proposed new methodology.

- **Slow to React to Market Changes:** in an environment where interest rates are falling, or rising, there is the issue of costs not being reflective of the variability in the financial market.

Further, the Discussion Paper does not mention how the trailing average will be estimated. For ATCO to provide informed comments on whether ERA should adopt a trailing average approach to estimate cost of debt, we require details about ERA's estimation methodology.

The AER and the ERA use different approaches to estimate the 10-year trailing average cost of debt.

The Discussion paper states that:[13]

> *"It should be noted that underlying the hybrid trailing average approach in the 2022 Gas Instrument is the full trailing average debt approach. The hybrid trailing average overlays derivative contracts on top of the full trailing average to lock in a part of the debt cost at the commencement of an access arrangement."*

This suggests the ERA may retain its current method, which is used for estimating debt risk premium, with the only change being the inclusion of the 10-year interest swap rate in the annual average. ERA's current method is based on Bloomberg data for BBB+ rating and uses curve fitting techniques to provide the average annual yield for cost of debt.

Although ERA's current hybrid trailing average approach is based on the full trailing average approach, it should be noted that this method is based on a narrow BBB+ sample. It cannot provide stable and unbiased estimates of cost of debt for non-linear curves or for bonds with longer maturities.[14]

The ERA should clarify its estimation method under the trailing average approach if it plans to depart from the hybrid approach.

Question 11

If a full trailing average debt approach is to be implemented in the 2026 gas instrument, are transitional arrangements needed and why? Please detail what transitional arrangements may look like.

Yes, a transitional arrangement would be needed to switch from the hybrid trailing average to a full trailing average.

Under the existing framework, the risk-free rate (RFR) is fixed using the 5-year swap rate, measured during an averaging period just before the access arrangement (AA) starts. Networks use derivative

13 ERA's 2026 Rate of Return Instrument Review Discussion Paper, paragraph 137.

14 CEG Report, ATCO's 2018 submission to ERA's consultation on implementation of the DRP estimation process

instruments to adjust rates from the efficient debt portfolio to lock in the 5-year interest rate swaps at the start of the AA using interest rate swaps, aligning the notional profile with the profile assumed by the regulator. In practice, this can be done by entering interest rate swaps for portions of debt for each day of the averaging period, which should result in a general alignment with the averaging period, keeping the network whole when it comes to their cost of debt. For example, ATCO nominated an averaging period for the 20-trading days in September 2024 ahead of the AA6 final decision. This resulted in a risk free rate of 3.759%, which is hedged out until 2029.

In practice, regulated networks raise debt in large, discrete tranches, not continuously. When a network issues a tranche of debt, for example a $100M bond, it is issued at the prevailing market interest rate on that day. Usually these tranches are long-dated, which means opportunities to issue debt are infrequent.

A prudent regulated business will therefore attempt to align its issuance strategy to the regulatory settings in place at the time that an AA begins. Under the current ERA hybrid approach and its five year risk-free rate, the business can broadly hedge the relevant parameters using swaps during the averaging period. As a result, regulatory compensation and financing costs can be kept closely aligned.

However, this alignment is not possible under a full-trailing average return on debt approach unless the business has already been issuing debt in a staggered pattern for many years. Therefore, a transition period is needed so that the compensation under the RORI matches the network's actual financing costs.

Competition Economists Group (CEG) provided the mechanics of how to transition from the hybrid approach to a simple trailing average in their submission to the AER in 2015.[15] CEG argues that the correct transition must start from the hybrid's actual position and then build a synthetic trailing average by entering 10 fixed-rate swaps covering 1 to 10 years. This leaves the business with a cost of debt equal to the historical 10-year DRP profile plus the appropriate swap rates for each remaining term, which is exactly how a trailing average behaves. From there, the portfolio rolls forward naturally. CEG also notes that transaction costs would also need to be added to this to compensate the network for the cost of switching over.

Under the hybrid approach the business will enter into swap contracts to hedge the risk free rate every time it is reset during the regulatory review process. This strategy facilitates the service provider's ability to repeat the process for the next regulatory period. The continued adoption of the five-year bank bill swap rate is necessary for regulatory certainty to support this financing strategy.

2.2.5 Refinement of market risk premium methods

Question 12

To update the dividend growth model, what are the more current real GDP growth parameters?

ATCO supports the principle that the Dividend Growth Model (DGM) should use robust macroeconomic inputs (historical and forward looking), including long run GDP parameters. In July 2021, the AER's *Equity Omnibus* paper noted that the dividend growth model provides a forward looking MRP estimate and that it is used by other regulators. However, the forecast used in the Discussion Paper should not be relied on.

[15] Attachment 10.22, The Hybrid Method for the Transition to the Trailing Average Rate of Return on Debt, Assessment and Calculations for AGN, A report by CEG submitted to the AER in 2015.

In its 2022 RORI review, the ERA commissioned Frontier Economics to provide a "calibrated DGM" model to arrive at a statistically robust estimate for long term growth rate. However, the ERA did not adopt a calibrated DGM in its Final Instrument because:[16]

> *"The ERA's analysis of the calibrated DGM found:*
>
> *Sensitivity of the market risk premium estimates to the time period that the forecast is made.*
>
> *L*arge variability of the market risk premium estimate.
>
> *Doubts that unbiasedness can be achieved without some transition process as it will be adopting the calibrated DGM late in the calibration cycle. The calibrated DGM is currently producing very high implied market risk premiums.*
>
> *Concern about the artificial static growth rate produced by the model and how actual changes in growth rates over the period may lead to distortions to the implied market risk premium.*
>
> *Concerns of whether calibration to a historical target reduces the usefulness of the calibrated DGM as a forward looking model."*

While the Commonwealth Treasury's *Intergenerational Report* provides useful long-term economic insight, it is important to recognise that it does not constitute a formal forecast of real GDP growth. Rather it is a projection from a simplified model. These projections are not intended to represent expected economic outcomes over the next decade, nor do they incorporate policy changes, or global shocks to conditions. Given this, relying on one source for real GDP growth parameters would be inappropriate. A single source estimate risks embedding the limitations of that model into the regulatory framework, particularly when the rate of return must reflect reasonable expectations of long run economic conditions.

Historically, real GDP has averaged approximately 3% since 1995, and outside of the impacts driven by COVID-19, real GDP has averaged 3% for most of the last access arrangement timeframe. Unless there are clear and immediate structural changes to Australia's economic outlook, ATCO considers it premature to reduce the long-term real GDP assumption below historical norms. A prudent approach would be to anchor the forecast to observed historical averages, supported by a range of credible sources, rather than relying on a single projection. This ensures the Dividend Growth Model reflects reasonable expectations of long-run economic conditions and avoids embedding undue model risk into the regulatory framework.

Given that growth rate forecasts used in DGM model are not fixed and subject to bias, ATCO reiterates that the calibrated DGM approach provides a stable estimate of the growth parameter and eliminates any systematic bias in the DGM estimates. From ATCO's submission:[17]

> *"In conclusion, the calibrated DGM provides additional confidence in the DGM for the following reasons:*
>
> *The long-run growth parameter is "calibrated" to the long historical MRP. There is a unique long-run growth estimate that equates the average of the DGM estimates with the average from the historical excess returns approach. Under this approach, there is no debate about what figure should be used for the growth parameter and no need for testing sensitivities to alternative growth estimates; and*
>
> *By definition, there is no bias in the DGM estimates relative to the historical excess returns estimates – both are constructed to have the same average. The only difference is that the historical excess returns approach is essentially constant over time, whereas*

16 ERA's Explanatory statement for the 2022 final gas rate of return instrument, paragraph 848.

17 ATCO's 2022 submission on the rate of return instrument focused consultation paper, page 11.

the DGM estimates will fluctuate around the average figure as market conditions change."

In case the ERA is concerned about an "*artificial static growth rate*", it should be noted that the MRP was fixed in 2022, and this assumes static growth during 2022 till the end of ATCO's sixth access arrangement. Therefore, the calibrated DGM approach offers a balanced and robust framework for estimating MRP, ensuring consistency, transparency, and alignment with historical evidence while accommodating market evidence.

Relatedly, ATCO also reiterates that the MRP should be updated at the start of each access arrangement, rather than being fixed during the gas rate of return review. As stated in 2022:[18]

"It is important to update the MRP to produce results more reflective of market conditions at the time of an access arrangement determination and be less likely to produce the shocks and volatility in returns of an assumed fixed MRP."

Updating the MRP at the beginning of each access arrangement is essential to ensure that the return on equity reflects prevailing market conditions and mitigates volatility risks associated with fixed MRP.

ATCO also submits that the ERA uses a combination of geometric mean and arithmetic mean to estimate MRP using HER and that this is mathematically incorrect. ATCO reiterates that:[19]

"With regard to the use of the arithmetic or geometric average in estimating the historical average MRP this matter has been previously canvased extensively in the academic literature and service provider and industry body submissions. Overwhelmingly the evidence is only the arithmetic average should be used when estimating the historical average MRP. The geometric average should be given no weight. This was further confirmed by the discussion presented by Frontier at the ERA's recent webinar consultation on its focused consultation discussion paper. It is not the intention to reproduce these arguments here. A comprehensive discussion of the matter can be found in the ENA's submission to the AER regarding the equity rate of return."

The 2022 gas instrument uses a weighted average of geometric (40%) and arithmetic (60%) means without providing information about why the relative weights were chosen.[20] ATCO submits that the ERA should not include the geometric mean in the estimate of MRP and only uses arithmetic mean in its final instrument.

Question 13

Do you support discontinuing the use of conditioning variables to inform the ERA's decision on the market risk premium? Please provide reasons for your response.

ATCO broadly supports discontinuing the use of conditioning variables to inform the ERA's decision on the MRP, provided that the ERA maintains a transparent and robust framework for estimating the MRP. While conditioning variables can offer insights into market sentiment and risk pricing, their application does introduce complexity and maty not materially improve decision making. In ATCO's response to the focused consultation discussion paper in 2022, ATCO cautioned against the use of conditioning variables because it is not always possible to see how the ERA's judgements translates into a final MRP

18 ATCO's 2022 submission on the rate of return instrument focused consultation paper, page 12.
19 ATCO's 2022 submission on the rate of return instrument focused consultation paper, page 13.
20 By contrast, the AER estimates an unconditional MRP based on the arithmetic mean of historical excess returns (HER).

estimate. If they were to be used, they need to be transparent and show a mathematical relationship to the MRP estimate.

2.2.6 Equity beta estimation

Question 14

Do you support the ERA's suggested simplifications for the estimation of equity beta? If not, please provide your reasons and any other potential approaches that might be adopted instead for the 2026 gas instrument.

Yes, at a high level, the simplifications proposed appear to be reasonable.

Rounding gearing to the nearest percent to improve reproducibility (without materially changing outcomes) is unlikely to alter beta estimates significantly if comparator firms have gearings near the benchmark level. However, we suggest the ERA consider publishing both rounded and unrounded results for full transparency.

Regarding the removal of the portfolio approach, given the current market structure and with only one listed domestic comparator, the portfolio approach is no longer meaningful. We agree that its removal is appropriate, provided that the ERA continues to monitor the availability of new comparators and remains open to reinstating portfolio analysis should the sample expand in future.

Finally, ATCO considers consolidating M&A checks to focus on delisted firms and removing data up to two weeks prior to the announcement date is a pragmatic step. However, we would like the ERA to define when the "announcement date" is, as this is an important clarification point.

ATCO emphasises that, in the context of increased market volatility and regulatory uncertainty, it is essential that the equity beta estimation methodology does not systematically bias the allowed return downwards. The ERA should continue to exercise regulatory judgement to ensure the rate of return remains commensurate with the risks faced by service providers and is sufficient to attract ongoing investment.

APPENDIX A.

Table 2 lists return on equity of the benchmarked entities in the international comparator sample for equity beta estimation. ATCO has collated the data from relevant regulator websites for all the firms. Country based averages for Canada and US were sourced from 2024 Concentric Energy Advisors report.[21]

Table 2: Regulated return on equity of firms in the 2022 RORI international comparator set for estimating equity beta

Country	Regulated entity	Regulator	Return on equity
Canada	ATCO Gas, Fortis Alberta, AltaGas Utilities,	Alberta Utilities Commission	9% (formula return of 9.28% for 2024)
	FortisBC Energy	British Columbia Utilities Commission (BCUC)	9.65%
	Enbridge Gas, Hydro One Gas, FortisOntario	Ontario Energy Board	9.21% (formula return in 2024)
	Algonquin Power & Utilities	New Brunswick Energy and Utilities Board	9.8%
	Emera	Nova Scotia	Not available
	Trans Canada		Not available
Canadian gas average rate			**9.48%**[22]
UK	National Grid Plc (Transmission)	Ofgem	11.6%-11.7% (Actual RoRE for 2023/24, allowed real ROE was 4.3%)
	National Grid Plc (Distribution)	Ofgem	9.6%-10.1% (Actual RoRE for 2023/24, allowed real ROE was 4.3%))
	SSE Plc	Ofgem	9.6%-10.1% (Actual RoRE for 2023/24, allowed real ROE was 4.3%))
New Zealand	Vector Ltd	Commerce Commission	5.0%-5.5% (real post tax) for 2022
US[23]	Spire Inc	Alabama Public Service Commission	9.75%
	CenterPoint Energy Inc, Atmos Energy Corp	Arkansas Public Service Commission	9.5%-10%
	PG&E Corp, Sempra Energy (SoCalGas, SDG&E), Southwest Gas Holdings Inc	California Public Utilities Commission	9.5%-10.5%
	Black Hills Corp	Colorado Public Utilities Commission	10%-11%

21 https://ceadvisors.com/economic-trends-shift-canadian-utility-roes/

22 https://ceadvisors.com/economic-trends-shift-canadian-utility-roes/

23 The US sample listed here does not contain all the firms in the international comparator set. Some firms in the comparator set were primarily electric utilities (like Exelon, Entenergy and Edison International). Some aggregation was also done by combining subsidiaries.

Country	Regulated entity	Regulator	Return on equity
	Eversource Energy, Avangrid Inc	Connecticut Public Utilities Regulatory Authority	9%-10%
	Chesapeake Utilities Corp	Delaware Public Service Commission	9%-10%
	Nextera Energy Inc, Chesapeake Utilities Corp	Florida Public Service Commission	9%-10%
	Southern Co/The	Georgia Public Service Commission	9%-10%
	Hawaiian Electric Inds	Hawaii Public Utilities Commission	9%-10%
	Idacorp Inc, Avista Corp	Idaho Public Utilities Commission	9%-10.5%
	Ameren Corporation	Illinois Commerce Commission	9%-10%
	NiSource Inc, CenterPoint Energy Inc	Indiana Utility Regulatory Commission	9.75%
	Alliant Energy Corp	Iowa Utilities Board	9%-9.5%
	One Gas Inc	Kansas Corporation Commission	9.75%
	Northwestern Corp	Montana Public Service Commission	9%-10%
	Unitil Corp	New Hampshire Public Utilities Commission	9%-10%
	PSEG, New Jersey Resources, South Jersey Industries	New Jersey Board of Public Utilities	9%-10%
	PNM Resources Inc, Atmos Energy Corp	New Mexico Public Regulation Commission	9%-10%
	Consolidated Edison Inc, National Fuel Gas Co, Avangrid Inc	New York Public Service Commission	9%-10%
	Duke Energy Corp	North Carolina Utilities Commission	9%-10%
	FirstEnergy Corp, NiSource Inc	Ohio Public Utilities Commission	9.6%-9.8%
	Northwest Natural Holding Co, Portland General Electric Co	Oregon Public Utility Commission	9%-10%
	Dominion Energy Inc, Duke Energy Corp	South Carolina Public Service Commission	9%-10%
	Atmos Energy Corp, CenterPoint Energy Inc, One Gas Inc	Texas Public Utility Commission	9.5%-10.5%
	Avista Corp, Northwest Natural Holding Co	Washington Utilities and Transportation Commission	9%-10%

Country	Regulated entity	Regulator	Return on equity
	WEC Energy Group Inc, MGE Energy Inc	Wisconsin Public Service Commission	9%-10%
	Black Hills Corp	Wyoming Public Service Commission	9%-10%
	Kinder Morgan Inc	Federal Energy Regulatory Commission	9.98%
US Gas Utility Average			**9.57%**[24]

[24] https://ceadvisors.com/economic-trends-shift-canadian-utility-roes/