MARINUS LINK

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2 September 2022

Mr Warwick Anderson
General Manager
Australian Energy Regulator
GPO Box 3131
Canberra ACT 2601

via email: RateOfReturn@aer.gov.au

Dear Mr Anderson

2022 Rate of Return Instrument – Draft Decision

Marinus Link Pty Ltd (**MLPL**) appreciates the opportunity to comment on the AER's Draft Decision on the 2022 Rate of Return Instrument. MLPL's concern relates to the exclusion of a weighted trailing average return on debt approach in the Draft Decision. To assist the AER, we commence this submission by describing the unique circumstances of MLPL that make it necessary to allow the weighted trailing average approach.

Project Marinus is included as an actionable project in AEMO's 2022 Integrated System Plan (**ISP**), being a proposed 1500 MW project comprising two 750 MW stages to further link Tasmania and Victoria in the National Electricity Market. The project is currently progressing through the design and approvals stage. Project Marinus consists of two components - MLPL will be responsible for the HVDC interconnector and converter stations, and TasNetworks will be responsible for the North West Transmission Developments.

MLPL will be established as a 'single project' transmission network service provider (**TNSP**) and its electricity transmission services will be regulated under Chapter 6A of the National Electricity Rules. MLPL's costs for the project are estimated to be in the order of $3 billion ($2021). The profile of this capital expenditure will be 'lumpy' as it will be driven by the project approval and construction timelines, including any project staging decisions.

In its Draft Decision, the AER proposes to maintain the 10-year simple trailing average approach with annual updates as adopted in the 2018 Instrument to determine NSPs' return on debt allowances. This approach assumes that the debt raising profile is evenly spread over time, being 10% of a company's total

debt portfolio each year over a 10 year period. If the debt raising profile is uneven, this approach will not deliver an outcome that is consistent with the NPV=0 condition, which defines the objective of revenue regulation (i.e. setting expected revenues to equal prudent and efficient costs). For uneven debt raising profiles, only the weighted trailing average approach will satisfy the NPV=0 condition.

Evidently, the simple trailing average approach that implicitly assumes a flat capital expenditure profile over ten years will produce a cost of debt allowance that is different to the company's actual cost of debt, and indeed, the profile of any benchmark efficient business in the same circumstances. MLPL therefore favours an approach that better reflects a new TNSP's capital requirements and resultant cost of debt so that customers or shareholders do not face a windfall loss produced by a poorly designed trailing average methodology.

The AER notes that it compared outcomes under the simple and weighted trailing average across a range of scenarios over the next 5 years, and subsequently noted that for the weighted approach to produce a materially different outcome there needs to be both a very large increase in capex and interest rates[1]. The AER does not define what it means by 'a very large increase'. For MLPL, the capital expenditure profile will not be spread evenly over a 10 year period, while interest rates are also likely to vary significantly. Accordingly, it is reasonable to assume that both conditions raised by the AER will be met in relation to MLPL.

In relation to the treatment of new entrants, the AER explains that new entrants may raise most of their capital in the early years of their determinations, and the current arrangement of placing greater weight on prevailing cost of debt on those early years works will tend to mitigate any potential difference between debt costs and regulatory return on debt allowance[2].

We acknowledge that placing greater weight on the cost of debt in year 1 of a determination will help align the benchmark and actual costs of debt, providing that the new entrant raises most of its debt in that year. In MLPL's case, however, it is likely that the majority of its debt will be raised in the first 4 years of the first regulatory period, as the project may not be commissioned until year 4 or 5. Accordingly, the relatively high weighting that applies to year 1 debt will not provide an appropriate benchmark cost of debt for MLPL, unless interest rates remain stable during this initial period. As already noted, however, there is no reason to assume that this will be the case.

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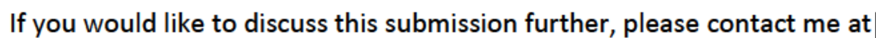
[1] Draft Rate of Return Instrument Explanatory Statement, June 2022, page 21.

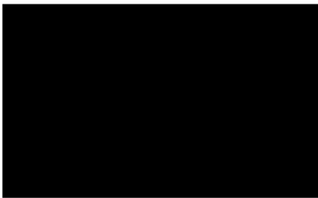
[2] Draft rate of Return Instrument Explanatory Statement, June 2022, page 231.

The AER's Draft Decision discusses a counter example that it believes may ameliorate the concerns that we raised in our earlier submission. Specifically, the AER suggests that a new company's gearing may be different to the benchmark gearing, resulting in an actual cost of debt that is better aligned with the allowed cost based on a simple weighting. While it is true that the actual gearing could differ from the benchmark, the Rate of Return Instrument should provide a cost of debt allowance that is appropriate for a company with the benchmark level of gearing. The simple trailing average approach fails this test in relation to a new business, such as MLPL.

MLPL therefore reiterates the view expressed in our previous submission that a weighted trailing average approach based on the capital expenditure profile should be adopted for a new TNSP such as MLPL. To maintain a level of simplicity, the weighted trailing average approach should transition to the standard 10% per annum refinancing assumption once the project has been constructed. This transition could occur on a similar basis as was applied when transitioning from the previous 'on the day' approach, but in the case of a new TNSP, such as MLPL, the transition could be from the weighted average cost of debt.

If you would like to discuss this submission further, please contact me at 

Yours sincerely



Heath Dillon

Executive Manager Customer and Revenue