Cross-checks and overall rate of return

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What is the role of cross-checks?

- Check robustness of ultimate WACC/RoE that is implied by chosen WACC parameters
- Provide high-level counterpart to checks that are carried out at the level of individual parameters
- Alert AER to proposed WACC/RoE values that are anomalous from an overarching perspective
- Detect situations when measurement errors in CAPM parameter assumptions reinforce each other
- In some cases indicate misalignment in other regulatory building blocks

How can they be used transparently and predictably to promote confidence?

- Need to be clear about the logic of the proposed cross-check
  - Articulate how the cross-check identifies an anomaly
  - Can an anomaly on the cross-check be rationalised on grounds other than error in the regulatory proposal?
- Need to canvass the range of factors that affect the cross-check parameter
  - Have all relevant confounders been identified and controlled for?
  - How reliable is the estimate of the cross-check indicator?
- Need to communicate the use of the cross-check clearly
- Ultimately broad judgement will be needed to support the use of any cross-check—not realistic to think this broad judgement can be translated into a pre-determined, mechanical decision rule
- Use of broad judgement and changes in judgement should be explained

How can they be used transparently and predictably to promote confidence?

- The AER should continue to consider the use of cross-checks that appear to be informative
- The AER should not let "perfect be the enemy of the good" in deciding to take a cross-check into account nor though should it admit a cross-check for the sake of having one
- The interpretation of the cross-check needs to be clear
- Cross-checks should only be used for "sense-check" and not "formulaically"

What role can measures of financeability play?

- Over the last few year the interest rate on government bonds has fallen to historically low levels
- As a consequence of this the allowed nominal rate of return on equity is (Frontier Economics)
  - "Lower than any previous AER allowance"
  - "Lower than the allowances of comparable regulators"
  - "Lower than the allowances that would otherwise have been in the absence of the RBA's intervention"
- Frontier go on to cite "important practical implications for the networks" from this

Consequences of low interest rates

- Frontier says that "the current regulatory allowance for the benchmark firm implies a negative cash return to equity" and that credit ratings are at risk
- This may may well be true for a firm that did not hedge its exposure to the bond rate but it would not be true for a firm that did hedge its exposure
- What are the consequences of losses incurred?
  - The owner of a regulated asset that did not hedge will have lost equity and may need to recapitalise
  - In extreme cases the equity could be wiped out with losses incurred by lenders to the firm
  - But the regulated asset remains viable on the basis of forward looking revenue and cost streams
  - Losses on the financing strategy are sunk and have no bearing

Conclusion on financeability

- I am not convinced that the financeability concept can be operationalised as a meaningful cross-check
- The specific example discussed here shows the difficulties that can arise
- The terms on which firms can secure finance reflect both the attractiveness of the underlying regulated business and the legacy of past decisions—negative or positive—that were at the discretion of the firm
- One would need evidence that the core regulated businesses were unsaleable to be confident that there is a financeability problem (and this does not mean unsaleable on terms that the owner would like)

What information can be obtained from examining trading and acquisition multiples of the RAB?

- In an idealised world we could observe market prices of regulated networks in isolation—and excluding the legacy of past financing decisions—and compare them with RAB valuations
- Under certain assumptions an average multiple greater than (less than) 1 would suggest an overly generous (insufficiently generous) regulatory allowance
- High multiples lend credence to the idea that regulators have erred on the high side in past regulatory decisions—for instance because they have thought that the costs of error are distributed asymetrically
- But there are significant difficulties with measurement
- In practice market prices are available only for a small number of network firms and they do not support separate identification of prices against particular regulatory asset bases

What information can be obtained from examining trading and acquisition multiples of the RAB?

- A key requirement is that "The revenue and expenditure streams of the firm which is valued on the market must be the same as revenue and expenditure streams of the regulated firm for which the RAB applies" (Biggar 2018)
- Adjustments can be made to attribute a component of prices to regulatory asset bases e.g. the Enterprise Value concept but a judgement is needed about how robust the adjustments are
- If regulated and unregulated activities are bundled then the Enterprise Value calculation needs to exclude the value of unregulated components and it may not be possible to get a valuation that is reliable enough to support the analysis

What information can be obtained from examining trading and acquisition multiples of the RAB?

- It is not clear to me that "control premia" should be adjusted away: to the extent that there are control synergies then the benchmark efficient entity may structure itself to realise these synergies
- Even if a multiple indicates that the regulatory allowance is excessive (inadequate) it does not follow that the inadequacy is in the capital assessment
- If we are calculating multiples from market prices then the data will not give us a focus on which "building block" is wrong
- On the other hand if constructing Enterprise Value then the book value data may give some direction

What information can be obtained from examining trading and acquisition multiples of the RAB?

- These considerations suggest that RAB multiples are a useful cross-check
- They probably have given the AER reassurance over adjusting allowed rates of return down over successive regulatory decisions
- But those adjustments have ultimately rested on careful assessments of CAPM parameter values

Persistent outperformance against allowed return on equity: How might this be considered?

- Persistent outperformance is suggestive that the regulatory allowance has been too generous but a view is needed as to
  - whether the regulatory allowance has been too generous; or
  - whether the outperformance reflects idisoyncratic return impacts that one cannot expect to be persistently repeated
- For incentive compatibility reasons any assessment like this should be considered at a whole-sector level and not at the firm level
- Although outperformance shows up in rate of return on equity, the regulatory misalignment may be in a building block other than return on capital
- If outperformance appears to be present an attempt needs to be made to sheet it home to the relevant “building block” of allowed revenue