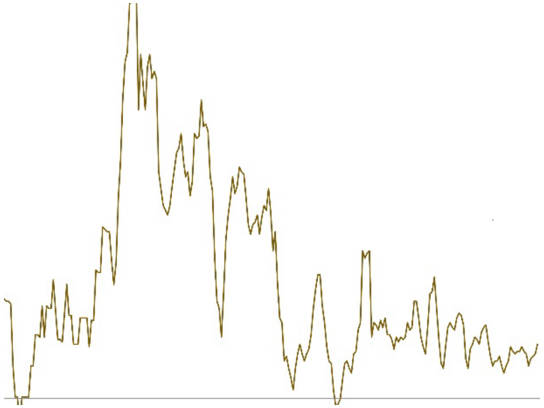
Target return and inflation

Vhari McWha, Kieran Murray, Dean Nutsford, Tony van Zijl

2 July 2020



Our report

- The AER asked us to consider:
    - Does the regulatory framework successfully deliver the current target—a real rate of return outcome?
    - Should the AER instead target a nominal or hybrid return?
- Our preliminary conclusions are:
    - Yes, to the 1st question
    - No, to the 2nd question
- This presentation provides an overview of our reasoning.

Analysis framed by the NEO and NGO

- Our analysis starts with national electricity and gas objectives (NEO and NGO)—

  promoting efficient investment and operation in the long-term interests of consumers.
- Investors in long-lived assets would expect real returns on capital ex ante, and that they can realize these returns ex post.
- If PV of regulated revenue equals PV of costs (including return on capital), consumers pay no more than is necessary to attract efficient investment.

AER approach meets regulatory objectives

- The AER targets a real rate of return on capital.
- The real rate of return is achieved through:
  - setting net ARR plus the AER's estimate of the revaluation gain equal to the nominal return on capital plus the return of capital;
  - substituting outturn (lagged) inflation for expected inflation in the annual price adjustment process
  - revaluing service provider's RAB using outturn inflation.
- The AER approach delivers the intended real total return and compensates for outturn inflation (deviation in 1st year of RP).
- This result is achieved regardless of whether outturn inflation is above or below the AER forecast of inflation.

Returns to equity

- The realised real rate of return on ***equity*** varies in the same direction as inflation outturns:
  - if outturn inflation is lower than expected, the realised real RoR on equity will be lower than expected;
  - if outturn inflation is higher than expected, the realised real RoR on equity will be higher than the expected.
- Negative cash returns to equity may occur with a low allowed nominal RoR on equity and/or high leverage.
- If outturn inflation is low relative to expected inflation, the total nominal rate of return on capital may be less than interest payments.

NB: The intended real total return on capital will be achieved.

We consider two hybrids

- Including interest on debt as an expense in setting the ARR—

  would make no difference to the cash rate of return on equity; therefore would not address the concern raised by stakeholders.

- Decomposing the expected revaluation gain into a revaluation gain for equity holders and an expense in setting the ARR—

  would shift the regulatory regime from targeting a total real RoR to targeting a real RoR on equity;

  would intervene in the capital structure decision and result in a less efficient allocation of the risk of financing decisions.

AER should continue to target total real returns

- We conclude that the AER should continue to target a total real return—that this approach better meets the NEO and NGO.
- We note that the sustained fall in inflation expectations imply a negative cashflow return on equity for a benchmark efficient entity regardless of the inflation outturn.
- We suggest that the AER consider whether a projected negative cash return on equity might indicate an underlying inconsistency in one or more inputs into its estimate of WACC and expected inflation.

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Kieran Murray

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