Target return and inflation

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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 1\textsuperscript{st} question
  • No, to the 2\textsuperscript{nd} 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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