TRANSEND

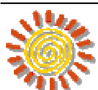
APPENDIX 8

Harding Katz, *Regulatory treatment of equity raising costs*, December 2008

Regulatory treatment of equity raising costs

Report prepared for Transend Networks Pty Ltd

31 December 2008



Harding Katz
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1. Introduction and Purpose

Transend's revenue proposal for the regulatory control period from 1 July 2009 to 30 June 2014 was submitted to the Australian Energy Regulator (AER) on 31 May 2008. The revenue proposal included an operating expenditure allowance for equity raising costs of $2.4 million per annum (in 2008/09 prices), totalling $12 million over the 5 year regulatory period. Transend's proposed allowance for equity raising costs was supported by a report from Competition Economists Group (CEG)[1], which was included as Appendix 19 of the revenue proposal.

The AER's Draft Decision on Transend's revenue proposal was published on 28 November 2008. It concluded that Transend should not receive any operating expenditure allowance in respect of equity raising costs.

Following the Draft Decision, Transend engaged Harding Katz Pty Ltd (Harding Katz) to comment on the AER's conclusion that equity raising costs in relation to the opening asset base should be disallowed. For completeness, this report also briefly discusses the broader equity raising cost issues in the Draft Decision noting, however, that CEG has been commissioned by Transend to provide a detailed response to these matters.

To address the above terms of reference, the remainder of this report is structured as follows:

- Section 2 summarises Transend's proposal and the supporting advice from CEG in respect of equity raising costs;
- Section 3 summarises the AER's Draft Decision on equity raising costs;
- Section 4 provides Harding Katz's comments on Transend's proposed equity raising cost allowance and the AER's Draft Decision; and
- the Appendix sets out a chronologic summary of regulatory developments that have occurred since 1999 regarding the provision of an allowance for equity raising costs for electricity TNSPs.

2. Transend's Revenue Proposal on equity raising costs

Section 6.9.3 of Transend's revenue proposal presents the company's justification for its equity raising cost allowance. The proposal distinguishes between the following two elements:

- an allowance in respect of the opening regulatory asset base; and
- an allowance in respect of equity to be raised to finance the proposed capital expenditure program.

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[1] Competition Economists Group, *Nominal risk free rate, debt risk premium and debt and equity raising costs for Transend*, May 2008.

In relation to the first element, Transend commented that regulatory decisions on this issue had varied significantly since 1999. Importantly, the AER's most recent decisions for SP AusNet and ElectraNet concluded that equity raising costs in respect of the opening regulatory asset base should be provided.

Transend noted that the ACCC's 2003 revenue cap decision disallowed equity raising costs on the company's opening regulatory asset base. However, Transend argued that the ACCC's 2003 revenue cap decision for Transend stands apart from other ACCC decisions at that time. Furthermore, Transend asserted that its circumstances prior to the ACCC's 2003 revenue cap decision were identical to those of ElectraNet and SP AusNet (both of which were given allowances for equity raising costs in ACCC Final Decisions in December 2002). Therefore, Transend stated that it should receive equity raising costs on the opening regulatory asset base to re-establish consistent regulatory treatment between Transend, SP AusNet and ElectraNet. Transend stated[2]:

> "In light of these recent AER decisions, Transend's view is that it should now be treated on a comparable basis to SP AusNet and ElectraNet in relation to the recovery of equity raising costs. In particular, there is no reasonable basis for the AER continuing to disallow Transend's recovery of equity raising costs in respect of Transend's initial asset base."

In relation to the second element of the equity raising cost allowance, which relates to the costs of financing the future capital expenditure program, Transend explained that its proposed methodology was consistent with that applied by the AER in its recent revenue cap decisions. Transend engaged consultants CEG to conduct a comprehensive survey of the literature relating to the costs of raising capital.

CEG argued that the AER should recognise both the direct and indirect costs of raising equity. In particular, CEG noted that the magnitude of the underwriting fee on new equity raisings will depend on the price that is set for the equity. The lower the price set for the equity, the lower will be the underwriting fee the company has to pay. In the extreme, CEG argued, if the business sets a low enough price for the equity it would not need to pay any underwriting fee because, at a low enough price, the investment bank being paid to market the capital would not need to incur any marketing costs to find buyers for that equity (or, potentially, would willingly purchase it all itself).

CEG referred to numerous academic studies that examined average underwriting fees (the direct costs) and the discount to the existing share price (the indirect costs) in initial Public Offerings (IPOs) and Seasoned Equity Offerings (SEOs). CEG found that the AER's approach to equity raising costs had only addressed the direct costs, effectively ignoring the indirect costs. In particular, CEG concluded that the AER's estimated costs of 3% could not be supported by empirical evidence from SEOs as shown in Table 1 below, which is reproduced from CEG's report.

[2] Transend's revenue proposal, page 124.

Table 1: Bortolotti, Megginson and Smart results

	Mean underpricing	Mean underwriting	Total
Global	4.48%	4.58%	9.06%
US	2.54%	2.53%	5.07%
Europe	7.32%	7.07%	14.39%
Rest of the world	6.48%	6.51%	12.99%

CEG concluded that the cost of raising equity should be set at 7.6 per cent of the amount of equity to be raised.

To calculate the cost of raising equity to fund Transend's proposed capital expenditure program, CEG applied the AER's methodology for estimating cash flows with an assumed dividend yield of 8% per annum based on ACG recommendations and based on Transend's forecast capital expenditure. CEG noted that the AER's Draft Decision for ElectraNet had concluded that the cash flow approach was considered to be reasonable.

Based on the analysis and calculations set out in the CEG report, Transend's equity raising allowance in its Revenue Proposal was summarised in Table 6.19, which is reproduced below:

Table 6.19: Benchmark equity raising costs ($m 2008–09)

Category	2009–10	2010–11	2011–12	2012–13	2013–14	Total
Equity raising costs	2.4	2.4	2.4	2.4	2.4	12.0

3. AER's Draft Decision on equity raising costs

As noted in section 1, the AER's Draft Decision for Transend is to disallow equity raising costs in relation to the initial asset base. The Draft Decision comments specifically on the following three aspects of the equity raising cost issue:

- Indirect cost of raising equity;
- Equity raising requirement to fund new capital expenditure - cash flow analysis; and
- Equity raising costs for the opening regulatory asset base.

The AER's findings in relation to each of these aspects are summarised below.

3.1. Indirect cost of raising equity

The AER commented that a government owned business should be treated the same as a privately owned business under competitive neutrality principles, and therefore it should be assumed to be an efficient listed private enterprise that can raise equity through seasoned equity offerings (SEOs).

The AER accepted that underpricing is likely to exist for both initial public offerings and SEOs but disagreed with CEG's proposal that underpricing or indirect costs need to be included in the benchmark equity raising (issuance) costs allowed in a revenue determination because:

- provision of compensation for such costs would be inconsistent with the benchmark regulatory framework applied to determine the WACC; and

- the efficient benchmark network service provider should be able to raise capital without incurring underpricing costs.

The AER argued that:

- The efficient benchmark firm is able to raise new capital with an SEO.

- Where a firm can undertake an SEO, it can use a rights issue where shares are offered at a discount to its existing shareholders. The AER claimed this is the most common practice for SEOs and that in a rights issue, even though the shares are offered at a discount, the firm's existing shareholders benefit from the entire discount and there is no true under-pricing cost from this practice (i.e. there is no wealth transfer to new shareholders or loss by existing shareholders).

The AER considered that:

- For traditional underwriting, where the underwriter effectively sells a put option to the issuing firm over some or all of the issue, there is likely to be an inverse relationship between the level of underpricing and the underwriting fee.

- However, having reviewed equity issuance allowances the AER considered that there are actually strong arguments that the option component of the underwriting fee should not be paid. This is because the underwritten firm should expect to get a payoff with a present value equal to the fair value of the option.

On this basis, the AER found that, if anything, CEG's argument appeared to support the proposition that the current estimate of direct equity issuance costs should be reduced by the fair value of the option component of the underwriting fee. The Draft Decision noted that these matters are the subject of further investigation by the AER.

The AER concluded that it is not satisfied that there is a need to take account of indirect costs of raising equity under the benchmark regulatory framework. Accordingly, the AER stated that it would maintain its current approach of using the direct cost of raising equity to determine a benchmark equity raising cost allowance, when a case for external equity financing associated with forecast capital expenditure had been established.

3.2. Equity raising requirement to fund new capital expenditure - cash flow analysis

The AER concluded that the cash flow approach applied by Transend was reasonable in principle, subject to the following two adjustments:

- 'Depreciation' should be referenced to nominal straight-line depreciation (as specified in row 322 of the 'assets' sheet of the PTRM).

- 'Interest payment' should be directly referenced to row 52 of the 'analysis' sheet of the PTRM which is labelled 'interest payments'.

The Draft Decision noted that the main issue in contention with the cash flow analysis is the assumed amount of dividend payments. The AER stated that it had previously assumed a dividend yield of 3.5 per cent, while CEG (on behalf of Transend) advocated a dividend yield of 8.0 per cent, based on the ACG methodology submitted on behalf of ElectraNet in their 2008 revenue proposal.

The AER commented that it has reflected on the use of the dividend yield in the cash flow analysis and notes the following weaknesses with making assumptions about the dividend yield:

- There is a lack of directly comparable firms from which to develop an average dividend yield. While the firms included in the UBS high yield utilities may bear similar characteristics to regulated TNSPs, it is not clear that they are all planning large capital works beyond normal capital expenditure levels. Further some of the sample firms employ trust company structures which are inconsistent with the benchmark company structure assumed for regulatory purposes.

- Dividend payments are made infrequently, generally only twice per annum. The dividend yield assumption is dependent on the market value of the company's equity. For publicly listed firms, this is taken to mean the share price. As the market value of equity may be volatile, reported dividend yields vary from day to day and are beyond the control of a company's management. Furthermore, dividend yields tend to be reported as the most recent 12 months of dividend payments divided by the current share price.

The AER commented that applying CEG's recommended dividend yield assumption to Transend's circumstances, the resulting payout ratio is unsustainably above 100 per cent of net profit after tax. The AER found that this reflects an unreasonable set of assumptions.

The AER therefore concluded that it should amend the cash flow analysis to rely on the assumption of a given dividend payout ratio rather than a given dividend yield. For the purposes of the Draft Decision, the AER argued that a 70 per cent payout ratio would be consistent with clause 6A.6.4(a) of the Rules, which deems the assumed utilisation of imputation credits to be 0.5.

Furthermore, based on the capital expenditure allowance in the Draft Decision, the AER's cash flow analysis indicated that Transend would be able to fund its capital expenditure program over the next regulatory control period with retained cash flows

and therefore will not require additional equity finance. Accordingly, the AER concluded that it would not provide Transend an allowance for equity raising costs for the next regulatory control period.

3.3. Equity raising costs on the opening regulatory asset base

In relation to equity raising costs on the opening regulatory asset base, the AER concluded that Transend should not be provided with any allowance. In reaching this conclusion, the AER argued that Transend's circumstances are different to those of ElectraNet and SP AusNet. The AER also commented that[3]:

> "For initial equity raising costs, the fundamental question is whether the RAB has already been determined."

The AER explained the rationale for disallowing Transend's claim for equity raising costs on the opening regulatory asset base, as follows:

- In the 2008 SP AusNet decision the AER allowed equity raising costs in operating expenditure relating to its initial asset base on the basis that new evidence presented by SP AusNet from ACG dated October 2007 suggested it was set exclusive of equity raising costs. Providing such costs in operating expenditure was also consistent with the ACCC's 2002 revenue decision which provided an allowance for such costs in perpetuity.

- The further ACG advice dated October 2007 followed the ACCC's 2004 engagement of ACG to undertake a review of the legitimacy of regulated utilities recovering equity raising costs and the benchmark value of such costs. ACG concluded in 2004 that where the initial asset base has already been established and has been used to determine revenues based on the building block approach, equity raising costs must be considered to already be included. The findings of this review have subsequently been consistently applied in AER decisions where the initial asset base has already been established and an operating expenditure allowance for equity raising costs has not been provided. ACG's further advice on SP AusNet in October 2007 was particular to its circumstances and stated that ACG "stand by the advice we provided to the ACCC in 2004".

- In the 2008 ElectraNet decision, the AER allowed equity raising costs in relation to the opening regulatory asset base in order to be consistent with the AER's 2008 SP AusNet decision. The AER noted that similar circumstances applied to both companies as equity raising costs had been allowed in the previous (2002) revenue cap decisions and the AER considered in both cases that the opening regulatory asset base excluded equity raising costs.

- The AER noted that the ACCC had determined the initial asset base for Transend in accordance with clause 6.2.3(d) of the Tasmanian Electricity Code in its 2003 revenue cap decision. The AER also noted that the valuation so determined was an acceptance of the Tasmanian Treasurer's valuation as at 30 June 2001. This sum was then rolled forward by a number of adjustments to a value of $570 million at 30 June 2003, and rolled forward to $604 million at 31 December 2003. The AER stated that this process is fundamentally different to the basis on which

[3] AER, *Draft decision: Transend transmission determination, 2009–10 to 2013–14*, 21 November 2008, page 192.

the determinations for SP AusNet and ElectraNet were made. The AER also commented that[4]:

> "The AER considers that Transend's valuation was made inclusive of equity raising costs. Also, at the time of the 2003 decision, the ACCC disallowed the proposed equity raising costs submitted by Transend. It should also be noted that in the 2003 Transend revenue proposal that Transend did not apply to the ACCC for equity raising costs in relation to the value of its initial RAB."

In light of the above observations, the AER concluded that it would not be appropriate to retrospectively provide Transend with an allowance for equity raising costs associated with the value of Transend's opening regulatory asset base.

4. Harding Katz assessment of equity raising cost issues

Before turning to a detailed examination of the differences between Transend's proposed assessment of equity raising costs (as supported by CEG) and the AER's conclusions, it is instructive to identify areas of common ground. In particular, Harding Katz notes that both Transend and the AER appear to accept the following propositions:

- The allowance for equity raising costs is a benchmark allowance, and does not necessarily reflect a forecast of actual costs that may be expected to be incurred. A benchmark approach should be independent of the ownership of the firm and its particular capital structure.

- It is appropriate to consider the equity raising cost allowance in two parts: firstly, whether an allowance should be made in respect of the opening regulatory asset base; and secondly, whether an allowance should be made in respect of the future capital expenditure program.

- It is appropriate to undertake a cash-flow analysis, using a combination of benchmark assumptions and company-specific capital expenditure forecasts, to determine whether an equity raising cost allowance in respect of the future capital expenditure program is warranted.

- The benchmark allowance for raising equity should be informed by underwriting and other direct costs that can be observed in the market place.

- Under-pricing is likely to exist for both initial public offerings and seasoned equity offerings.

- The AER's approach to equity raising costs should have regard to the desirability of consistent regulatory decisions, whilst recognising the need to have regard to the particular circumstances of each TNSP.

As a common understanding exists between Transend and the AER in relation to these propositions, Harding Katz does not intend to examine or comment on these matters any further. However, in discussing the equity raising cost issues, it may be useful to refer back to some of these propositions.

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4 *Ibid*, page 200.

The remainder of our assessment follows the structure adopted by the AER in its Draft Decision and summarised in section 3 above. This assessment is also informed by our chronological review of the recent regulatory developments regarding the treatment of equity raising costs, which is provided as an appendix to this report.

4.1. Indirect cost of raising equity

As noted in section 3.1, the AER's Draft Decision rejects CEG's and Transend's claim that the indirect costs of raising equity should be included in the benchmark allowance. The AER argues that the efficient benchmark firm should be able to raise new capital with an SEO using a rights issue where the firm would offer shares at a discount to its existing shareholders.

The AER concludes that, by offering shares at a discount to existing shareholders, under-pricing does not have any cost impact on shareholders, and therefore no allowance for under-pricing costs is required. The AER also comments that the existing allowance for the direct costs of raising equity, which is 3%, may be too generous and is under review.

Harding Katz notes that a rights issue can provide existing shareholders with pre-emptive rights to acquire the new shares on offer at a discounted price. The pre-emptive rights principle is intended to protect existing shareholders from wealth transfer and erosion of control (through dilution of their equity holdings) that may otherwise arise if capital were raised on a non-pre-emptive basis.

However, Harding Katz also notes that the pre-emptive rights principle does not imply that shareholders can exercise these rights without incurring indirect costs. Indeed, if this were possible underwriting costs could be avoided as companies would raise equity at deep discounts to the existing share price. In practice, however, deep discounting of this kind is avoided by companies, which reflects the commercial reality that it may impose substantial indirect costs on shareholders. A broader, related question arises as to whether an SEO using a rights issue is an appropriate benchmark for Australian utilities, given current market practice.

Harding Katz is aware that Transend has commissioned a further report from CEG to examine these issues in further detail. That further report is to be appended to Transend's revised revenue proposal.

4.2. Equity raising requirement to fund new capital expenditure - cash flow analysis

As noted in section 3.2, the AER concluded that the cash flow approach applied by Transend was reasonable in principle, subject to a number of adjustments. The main issue arising in the calculation of equity funding requirements for new capital expenditure is the assumed amount of dividend payments. The AER stated that it had previously assumed a dividend yield of 3.5 per cent, while CEG (on behalf of Transend) advocated a dividend yield of 8.0 per cent, based on the ACG methodology submitted on behalf of ElectraNet in their 2008 revenue proposal.

The AER commented that applying CEG's recommended dividend yield assumption to Transend's circumstances, the resulting payout ratio is unsustainably above 100

per cent of net profit after tax. The AER found that this reflects an unreasonable set of assumptions.

The AER therefore concluded that it should amend the cash flow analysis to rely on the assumption of a given dividend payout ratio rather than a given dividend yield. For the purpose of the Draft Decision, the AER argued that a 70 per cent payout ratio would be consistent with clause 6A.6.4(a) of the Rules, which deems the assumed utilisation of imputation credits to be 0.5.

Harding Katz notes that the cash flow analysis is intended to employ benchmark assumptions regarding the financing costs and decisions of the TNSP in order to derive estimated debt and equity raising requirements over the forthcoming regulatory period. The principal difference of view between the AER's Draft Decision and Transend's revenue proposal is in relation to the assumed level of dividend payouts. The AER proposes that a fixed payout ratio should apply, whilst Transend has adopted a fixed dividend yield.

The AER's Draft Decision raises concerns that applying a benchmark dividend yield creates difficulties, principally because:

- comparator companies are not available; and
- dividend yields vary with share price and therefore can be highly volatile.

Harding Katz does not fully accept the AER's criticism of adopting dividend yield assumptions for the purpose of estimating the level of new equity raising required. Firstly, comparator companies are available and were reported in ACG's recent advice to ElectraNet[5]. In this advice, ACG commented as follows:

> "In modelling cash flows according to the 'Pecking Order' theory it is necessary to either hold the payout (or retention) ratio constant or hold the dividend yield constant. ACG considers that it is more appropriate to hold the dividend yield constant, as there is more objective evidence on this variable. Thus, a key assumption in the modeling is the benchmark yield that should be applied. Accordingly, we have assumed that the benchmark entity will need to maintain a benchmark dividend yield of 8%. This benchmark has been calculated with reference to UBS regulated utility performance statistics shown in Table 2 below."

Table 2 from ACG's advice is reproduced below.

5 Allen Consulting Group, *Estimation of ElectraNet's equity raising transaction cost allowance*, memorandum to ElectraNet, 29 May, 2007, attached as Appendix N of ElectraNet's Revenue Proposal of 31 May 2007.

TABLE 2: AUSTRALIAN REGULATED UTILITIES – NET DIVIDEND YIELD AS AT 30 JUNE, 2006

Alinta Infrastructure Holdings	8.7%
Australian Pipeline Trust	5.6%
Babcock & Brown Infrastructure	9.1%
Challenger Infrastructure Fund	8.8%
DUET	8.8%
Envestra	7.8%
GasNet	7.0%
Hasting Diversified Utilities Trust	8.4%
SP AusNet	8.6%
Average	**8.1%**

Source: UBS Investment Research, Australian Infrastructure & Utilities Index, 6 October, 2006

Secondly, whilst dividend yields do vary with share price this is not relevant in terms of the benchmarking exercise before the AER. In this benchmarking exercise, dividend yield is determined with reference to the benchmark (40%) equity component of the forecast regulatory asset base value, which is stable and not subject to market volatility. Harding Katz therefore does not agree with the AER's criticism of the use of a dividend yield for modelling purposes.

Harding Katz notes that there is a substantial body of academic literature examining the determinants of dividend policy, partly as a response to the dividend irrelevance theory hypothesised by Modigliani and Miller in 1961. Whilst the academic literature cannot direct us to a particular benchmark approach for regulatory purposes, it is reasonable to conclude that using a single parameter to define the benchmark, such as dividend yield or payout ratio, is likely to be too simplistic. Our conclusion on this point is borne out by two observations;

- The AER's application of a 70% payout ratio is consistent with a dividend yield for Transend of approximately 2½%, which is substantially below the actual dividend yields observed for utility companies as noted by ACG; and

- Transend's assumption of a dividend yield of 8% is said by the AER to imply a payout ratio in excess of 100%. Whilst dividends of 8% should be sustainable given the expected return on equity, Harding Katz notes that the payout ratio (which is an accounting measure) is also relevant in determining a company's dividend policy.

In light of these observations, Harding Katz considers that it may be appropriate to adopt a dividend yield for Transend for the forthcoming regulatory period somewhat below 8%. Harding Katz is aware that Transend has commissioned a report from CEG to provide more detailed analysis and advice in relation to these issues. CEG's report is to be appended to Transend's revised revenue proposal.

4.3. Equity raising costs in respect of the opening asset base

As noted in section 3.3 above, the AER's Draft Decision concluded that Transend should not receive an equity raising cost allowance in respect of the opening regulatory asset base, principally on the grounds that:

- In contrast to the ACCC's 2002 revenue cap decisions for SP AusNet and ElectraNet, the ACCC's 2003 revenue cap decision for Transend did not allow equity costs.
- The circumstances surrounding Transend's 2003 asset valuation were different to those of ElectraNet and SP AusNet. In particular, differences relate to:
  - The regulatory framework that underpinned the regulatory asset value;
  - The basis of the asset valuation and whether it included an allowance for equity raising costs;
  - The extent to which the regulatory asset value was "locked in"; and
  - Whether a claim for equity raising costs was made in the 2002 and 2003 revenue proposals.
- ACG's advice is that even if a valuation does not include equity raising costs a "locked in" value of the RAB should not be reopened to include an allowance. For initial equity raising costs, the fundamental question is whether the RAB has already been determined.

Contrary to the AER's reasoning in its Draft Decision, Transend's revenue proposal essentially argued that:

- The ACCC's 2003 revenue cap decision for Transend does not provide an appropriate precedent on which to base the current decision;
- Transend's circumstances prior to 2003 were identical to those of ElectraNet and SP AusNet; and
- For the purpose of establishing an equity raising cost allowance for the opening regulatory asset base, Transend should be treated on the same basis as ElectraNet and SP AusNet.

In developing our recommended approach to establishing an equity raising cost allowance for the opening regulatory asset base, we have examined the following three questions that encapsulate the differences between the AER's Draft Decision and Transend's proposed allowance:

1. Does the ACCC's 2003 revenue cap decision for Transend establish a precedent for the current decision?
2. Are Transend's circumstances different materially from those of SP AusNet and ElectraNet?
3. Does ACG's advice in 2004 and 2007 indicate a definitive course of action for the AER?

Each of these questions is addressed in turn below.

1. *Does the ACCC's 2003 revenue cap decision for Transend establish a precedent for the current decision?*

To address this question, Harding Katz has undertaken a detailed chronological review of the regulatory developments relating to equity raising costs from May 1999 to the present. A summary of our chronological review is provided as an appendix to this report.

From this chronological review, Harding Katz has identified four distinct phases in the development of regulatory thinking on the issue of equity raising costs from 1999 to the present. These four phases are described in the table below.

Phases	Regulators' thinking
Phase 1: No recognition of issue From May 1999 to November 2002	The ACCC did not address equity raising costs and no allowance was provided in revenue cap decisions
Phase 2: Pre ACG 2004 Advice December 2002 to December 2004	The ACCC recognised and allowed equity raising costs in two revenue cap decisions (namely, ElectraNet and SPI PowerNet - now SP AusNet) and disallowed them for Transend, noting that the issue would be subject to further review.
Phase 3: Post 2004 ACG Advice December 2004 to September 2007	The ACCC and the AER relied on advice from Allen Consulting Group that appeared to suggest that equity raising costs should not be allowed in respect of the initial asset value if the RAV had been established. Equity raising costs were therefore disallowed during this period in relation to the following decisions: • TransGrid Final Decision; • Powerlink Final Decision; and • SP AusNet Draft Decision
Phase 4: Further ACG Advice October 2007 to the present	The AER allowed equity raising costs in the revenue cap decisions for ElectraNet and SP AusNet following clarifying advice from Allen Consulting Group that an "established" RAB was intended to mean a "locked in" RAB.

The 2003 revenue cap decision for Transend occurred during the second of the four distinct phases identified in our chronological review. Specifically, the 2003 revenue cap decision occurred prior to the initial ACG advice to the ACCC on equity raising costs, at a time when the ACCC had identified the need for further work to determine its regulatory approach to equity raising costs.

Harding Katz notes that the ACCC's 2003 revenue cap decision did not seek to rationalise the variability of its conclusions on equity raising costs. To illustrate this point, it is useful to quote the 2003 revenue cap decision in full[6]:

> "In its draft decision the ACCC provided an allowance of $3.2m over the regulatory period to cover costs associated with raising equity.
>
> In its first two revenue-cap decisions, concerning Queensland and NSW/ACT transmission networks, the ACCC did not provide for equity raising costs. In the last two decisions, concerning Victoria and South Australia, the ACCC provided an allowance for equity raising costs. In these decisions the ACCC stated that it would review this matter in future decisions.
>
> The ACCC now considers that equity raising costs should not be allowed for Transend because:
>
> - it is unlikely that Transend would incur equity raising costs during the regulatory period, therefore any provision will have to be notional
> - return on equity is a benchmark return calculated by using the CAPM."

The above quotation illustrates that the ACCC's assessment of this issue during this period was in a state of flux. It is also noteworthy that the reasoning for disallowing Transend's equity raising costs in 2003 has not been repeated by the ACCC or the AER in any subsequent regulatory decision. Moreover, we note that the first reason given in the ACCC's 2003 decision is inconsistent with the principle stated in the AER's current Draft Decision for Transend (that competitive neutrality considerations require government owned business to be treated the same as a privately owned business for the purpose of estimating equity raising cost allowances). In view of these observations, Harding Katz does not consider the reasoning presented in the ACCC's 2003 revenue cap decision to be soundly based.

On this basis, Harding Katz does not believe that the ACCC's 2003 revenue cap decision for Transend provides a reasonable precedent for the AER's current decision. Furthermore, in our opinion the different treatment of equity raising costs adopted by the ACCC in its revenue cap decisions in 2002 and 2003 should be substantially disregarded by the AER in its current deliberations. Specifically, Harding Katz's view is that the AER should consider afresh the merits of Transend's claim for equity raising costs on the opening regulatory asset base, having regard to the approach the AER has adopted recently for other TNSPs, namely SP AusNet and ElectraNet.

2. Are Transend's circumstances different materially from those of SP AusNet and ElectraNet?

For the reasons set out above, Harding Katz does not accept that the ACCC's 2003 decision to disallow equity raising costs for Transend provides a reasonable basis for the AER continuing to adopt this position. In our opinion, any difference between the AER's approach to assessing an equity raising cost allowance for Transend and the approach adopted by the AER for SP AusNet and ElectraNet should be based on material differences in these companies' circumstances. In this regard we note that the areas in which potential differences could arise relate to:

[6] ACCC, Tasmanian Transmission Network Revenue Cap: Decision, 10 December 2003, section 5.7.5, pages 71 and 72.

(a) The regulatory framework that underpinned the regulatory asset value;

(b) The basis of the initial asset valuation and whether it included an allowance for equity raising costs;

(c) The extent to which the regulatory asset value has been "locked in"; and

(d) Whether a claim for equity raising costs was made in the 2002 and 2003 revenue proposals.

In relation to the first matter, Harding Katz agrees with the AER that Transend's asset valuation was conducted by the Tasmanian Treasury in accordance with the Tasmanian Electricity Code (TEC). In particular, the ACCC was bound by clause 6.2.3(d)(4) of the TEC in determining the regulatory asset base. This clause required the ACCC to value Transend's sunk assets at a value determined by the Tasmanian Minister, provided the value did not exceed deprival value. Harding Katz notes that the provisions in the Tasmanian Electricity Code governing asset valuation were closely modelled on (and indeed were effectively equivalent to) the National Electricity Code, which applied to SP AusNet and ElectraNet. Harding Katz therefore disagrees with the AER's assertion that the process for establishing Transend's asset valuation was fundamentally different to the basis on which the determinations for SP AusNet and ElectraNet were made.

In relation to the second matter, Harding Katz notes that Transend's asset valuation was conducted by SKM in accordance with the optimised depreciated replacement cost (ODRC) valuation principles. Meritec reviewed the valuation on behalf of the ACCC to ensure that it accorded with those principles. Harding Katz has reviewed SKM's valuation report and we note that SKM's valuation was carried out in accordance with principles and application guidelines outlined in a document titled the "Valuation of Electricity Network Assets – A Policy Guideline for NSW DNSPs", dated July 2001 and issued by NSW Treasury. These guidelines do not make any reference to equity raising costs. In fact, the guidelines strongly imply that any non-system assets included in the valuation must be tangible assets, as indicated in the following quotation[7]:

> "…the non-system assets are to be listed and classified as either Non-Specialised Assets or Specialised Assets.
>
> 1. Non-Specialised Assets are those assets that are not specific to the industry and would be readily acquired and disposed of in the ordinary course of business.
> 2. Specialised Assets are those that exist for a purpose which is of particular advantage and may be unique to the industry, and/or those assets which are not normally traded in a secondary market place (except as part of a total entity by reason of their physical characteristics)."

In our opinion there is no evidence to suggest that the opening regulatory asset base adopted by the ACCC in the 2003 revenue cap decision for Transend included any allowance for equity raising costs. We understand that Transend is seeking formal advice from SKM in relation to this issue.

7 NSW Treasury, Valuation of Electricity Network Assets – A Policy Guideline for NSW DNSPs, July 2001, page 32.

In relation to the third matter, we note that the ACCC only concluded that it preferred the "lock-in" approach to asset valuation in its Statement of Regulatory Principles (SRP) in December 2004, some 12 months after its 2003 Final Decision for Transend's revenue cap. Furthermore, asset revaluation remained a live option even in December 2004 as the background paper that accompanied the SRP explained (on page 42) that:

> "The ACCC's preferred approach to asset valuation will be to lock in the RAB. This approach involves locking the value of the opening asset base of the prior regulatory period but adjust for inflation and depreciation, and assess capex incurred during the regulatory period on the basis of the capex regulatory arrangements set out in chapter 5.
>
> The ACCC recognises that the code provides the discretion to revalue assets and hence, if TNSPs propose a revaluation, the ACCC will consider the proposal on its merits having regard to all relevant matters at that time. The onus is on the TNSP to make a case for departing from the preferred principle of locking in the asset base. If it were to consider revaluing the asset base, the ACCC's preference would be to reopen the entire valuation and consider every element of the asset base."

In light of the above comments, we do not believe that Transend's revenue cap in 2003 locked-in the regulatory asset base value in a manner that precluded any future revaluation.

In relation to the fourth matter, Harding Katz notes that page 84 of Transend's Revenue Cap Application of March 2003 stated:

> "Transend has included an allowance for benchmarked equity raising costs, after the precedent established in the Commission's revenue decisions for ElectraNet and SPI PowerNet."

It is noted that the ACCC's 2002 decisions for both ElectraNet and SP AusNet provided a benchmark equity raising cost allowance calculated with reference to the (40%) benchmark equity portion of the average RAB value over the period. Whilst these decisions (as well as the thinking generally at the time) did not clearly distinguish between the opening RAB and new capital expenditure, the clear inference from the ACCC's 2002 decisions is that an equity raising cost allowance was made in relation to the opening asset base. That said, Harding Katz does not believe that the question of the inclusion or otherwise of equity raising costs in Transend's revenue proposal is relevant to the AER's decision in 2008. In making this observation, we note that:

- ElectraNet did not request any equity raising cost allowance in its 2002 revenue proposal, and did not request an equity raising cost allowance on the opening asset base in its 2008 revenue proposal. However, in both instances the ACCC and the AER provided allowances. These points are illustrated by the following quotations:

  > "ElectraNet did not make a request for debt raising or equity raising costs in its application. As such, the Commission did not consider that it was a relevant issue for ElectraNet and hence no allowance was made in the draft decision… As with debt

raising costs, the Commission considers it is appropriate to provide a benchmark allowance for equity raising costs."[8]

"ElectraNet has not included the 2002 revenue cap decision's perpetuity allowance in its revenue proposal. The AER considers that it is appropriate to maintain the intent of the 2002 revenue cap decision by continuing the equity raising cost allowance for ElectraNet in this final decision."[9]

- As already noted, Transend's 2002 revenue proposal regarding equity raising costs reflected current regulatory thinking at that time. This is illustrated by the following quotation from the ACCC's Final Decision[10]:

  "*Equity raising cost*—in accordance with the ACCC's decisions for ElectraNet and SPI PowerNet, Transend has included an allowance for benchmark equity raising costs."

In summary, Harding Katz has examined the four potential sources of material difference between Transend on the one hand, and SP AusNet and ElectraNet on the other hand. Harding Katz does not believe that the differences between Transend's circumstances and those pertaining to SP AusNet and ElectraNet are sufficiently material to justify the AER's different conclusions on equity raising costs for those companies.

3. Does ACG's advice in 2004 and 2007 indicate a definitive course of action for the AER?

We have reviewed ACG's advice of 2004 and its further clarifying advice of 2007. It is self-evident from the chronologic review provided in the appendix that the regulatory decisions following ACG's advice in 2004 and its later advice in 2007 differ radically. In particular, the 2004 advice was interpreted as justifying the disallowance of any equity raising costs on the opening regulatory asset base if the value for such an asset base had been established. However, the decisions for SP AusNet and ElectraNet following ACG's further clarifying advice in 2007 allowed equity raising costs in relation to the opening regulatory asset base.

It is evident from ACG's further clarifying advice in 2007 that ACG's earlier work was open to misinterpretation. In particular, in 2007, ACG made the following observations[11]:

"Turning to the reasoning set out in the AER's Draft Decision on this matter, the AER has characterised our earlier advice as posing that, when considering whether an allowance for the transaction cost of raising equity finance should be provided, the relevant question is:

whether a RAB has been established in a previous regulatory decision.

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8 ACCC, South Australian Transmission Network Revenue Cap 2003-2007/08: Decision, 11 December 2002, pages 25 and 27. The Decision provided ElectraNet with an average equity raising cost allowance of $0.748 million over the regulatory period, in the form of an operating expenditure allowance.

9 AER, ElectraNet Final Decision 2008-09 to 2012-13, 11 April 2008, page 88.

10 ACCC, Tasmanian Transmission Network Revenue Cap: Decision, 10 December 2003, page 51.

11 ACG, letter to SP AusNet, 12th October 2007, page 4.

> From the discussion above, it should be clear that this interpretation of our report needs to be qualified. […] the term 'established' must be taken to mean that the regulatory asset value that was set in the previous regulatory decision was to be 'locked-in' and a commitment made to apply the 'roll-forward' approach to updating the value at future reviews. If the 'lock-in and roll-forward' approach had not been adopted or foreshadowed, then the concerns described above against correcting the earlier regulatory asset value to include an allowance for equity raising costs would not exist."

In addition, ACG explicitly disagreed with the AER's application of its 2004 advice:

> "In light of these comments, therefore, we disagree with how the AER has applied the principles and recommendations set out in our 2004 report to the situation of the Victorian electricity transmission business."[12]

In our opinion, it would be unreasonable in the light of ACG's clarifying advice of 2007 for the AER to continue to assert that the fundamental issue is whether a regulatory asset base had been established. ACG's clarifying advice explains clearly that the AER has misapplied its 2004 advice, as the relevant issue is whether the asset value has been *locked-in* rather than whether the asset value has been *established*. As noted above, at the time of the 2003 revenue cap decision for Transend it is clear that:

- Transend's regulatory asset base did not include equity raising costs. This is supported by the valuation methodology described in the SKM report at that time; and

- There was no commitment to 'lock-in' the regulatory asset value, as evidenced by the Statement of Regulatory Principles published in December 2004.

In our opinion, ACG's advice in 2004 and 2007 does not indicate a definitive course of action for the AER. Moreover, for the reasons outlined in this report, our view is that Transend should not be treated differently from SP AusNet and ElectraNet in respect of equity raising costs. Harding Katz therefore concludes that Transend should receive an equity raising cost allowance in respect of the opening regulatory asset base.

[12] Ibid, page 5.

Appendix: Chronological summary of regulatory developments on equity raising costs for electricity TNSPs since May 1999

Document and Date	Nature of decision or advice	Excerpt from relevant decision or advice, including cross-references
Statement of Principles for the Regulation of Transmission Revenues, Draft, ACCC, May 1999	Equity raising costs are not discussed.	N/A
Queensland Transmission Network Revenue Cap, 2002-2006/07, Decision, ACCC, 1 November 2001	Equity raising costs are not discussed.	N/A
Victorian Transmission Network Revenue Caps 2003-2008, ACCC, Final Decision, 11 December 2002.	Allows equity raising costs as an operating expenditure allowance.	"The Commission considers that an average of these annual costs represents an appropriate Australian benchmark for the purposes of this decision. Accordingly, the equity raising costs of 0.215 per cent per year of regulated equity should be used. With a RAB $1835.6 million of the assumed benchmark gearing ratio of 60:40, this amounts to an average allowance of $8.19 million regulatory period (sic). This equity raising cost is in the opex allowance for the Commission's modelling purposes. As with debt raising costs, the Commission intends to undertake further research on this issue for future regulatory decisions."(Page 86)

Document and Date	Nature of decision or advice	Excerpt from relevant decision or advice, including cross-references
South Australian Transmission Network Revenue Cap 2003-2007/08, Final Decision, ACCC, 11 December 2002	Allows equity raising costs as an operating expenditure allowance.	"As with debt raising costs, the Commission considers it is appropriate to provide a benchmark allowance for equity raising costs. Equity raising costs must be paid by an entity when it raises capital. These costs are paid to equity arrangers for services such as structuring the issue, preparing and distributing information and undertaking presentations to prospective investors." (Page 27) "The Commission considers that an average of these annual costs represents an appropriate Australian benchmark for the purposes of this decision. Accordingly, the equity raising costs of 0.207 per cent per year of regulated equity should be used. With a RAB of $823.75 million and the assumed benchmark gearing ratio of 60:40, this amounts to an average allowance of $0.748 million over the regulatory period. This equity raising cost is in the opex allowance for the Commission's modelling purposes. As with debt raising costs, the Commission intends to undertake further research on this issue for future regulatory decisions." (Page 28).
Tasmanian Transmission Network Revenue Cap 2004-2008/09, Draft Decision, ACCC, 24 September 2003.	Allows equity raising costs as an operating expenditure allowance.	"As with debt raising costs, the ACCC considers it appropriate to provide a benchmark allowance for equity raising costs… Accordingly, equity raising costs of 0.212 per cent per year should be allowed. This amounts to an average of $0.565m per year over the regulatory period based on an opening RAB of $604m and (benchmark) gearing of 60:40." (Pages 77 and 78) "The ACCC notes that debt and equity raising costs have recently been included in revenue caps, and will analyse these issues further and may reconsider them in future decisions in light of new information and comments from interested parties." (Page 78)
Tasmanian Transmission Network Revenue Cap, 2004–2008/09, Final Decision, ACCC, 10 December 2003	Disallows any recovery of equity raising costs.	"In the last two decisions, concerning Victoria and South Australia, the ACCC provided an allowance for equity raising costs. In these decisions the ACCC stated that it would review this matter in future decisions. The ACCC now considers that equity raising costs should not be allowed for Transend because: • it is unlikely that Transend would incur equity raising costs during the regulatory period, therefore any provision will have to be notional • return on equity is a benchmark return calculated by using the CAPM." (Page 72)

Document and Date	Nature of decision or advice	Excerpt from relevant decision or advice, including cross-references
Statement of Principles for the Regulation of Electricity Transmission Revenues — Background Paper, ACCC, 8 December 2004	Approach is to include equity raising costs as an operating expenditure item. However, a further review of the issue will be undertaken.	"Given the relatively new nature of capital costs in the context of regulatory decisions, the ACCC has decided to undertake a review of this issue. The review is likely to consider issues such as: • determining which capital raising costs should be recovered • developing a benchmark which can be updated over time • determining the appropriate approach for recovering these costs. The ACCC will treat debt and equity raising costs as opex items and will undertake a further review of debt and equity raising costs and hedging costs." (Page 120)
Debt and Equity Raising Transaction Costs, Final Report to the ACCC, Allen Consulting Group, December 2004.	Advice to the ACCC that "established RAVs" will implicitly or explicitly include equity raising costs, and therefore an allowance for equity raising costs should only be included if a RAV has not been established.	"If an RAV has already been established for the regulated utility there is no case for now including an allowance for IPO costs. It must be assumed that such costs have already been included in the RAV, either explicitly or implicitly. For example, privatised entities have been sold either through: • *IPOs* — in which case, in most instances, the investors knew the RAV when subscribing for shares; • *Trade sales* — where assets are sold to trade buyers. We have already seen that the issue of equity raising costs has not arisen very often in the UK, and has not been allowed as a cost on the grounds that the UK government incurred IPO costs during the privatisation process. For government owned entities there is similarly no reason to allow initial equity raising transaction costs if there is an established RAV, as they can be considered to be implicitly or explicitly incorporated into it." (Page 54) "If an RAV has not been established and the regulator is approaching the issue of establishing an RAV for the first time, there is a strong case for including an allowance for IPO costs. In those cases, in the process of developing an Optimised Replacement Cost (ORC), and from it a Depreciated Optimised Replacement Cost (DORC), capital raising transaction costs should be incorporated, and depreciated over the life of the assets." (Page 55)

Document and Date	Nature of decision or advice	Excerpt from relevant decision or advice, including cross-references
NSW and ACT Transmission Network Revenue Cap, TransGrid 2004–05 to 2008–09, ACCC, Final Decision, 27 April 2005.	Disallows equity raising costs on initial RAV based on advice from Allen Consulting Group, December 2004.	"The recent consultancy undertaken by ACG, on behalf of the ACCC, considered the legitimacy of recovering equity raising costs and benchmark value for such costs incurred by an entity through initial public offerings (IPO) and seasoned equity offerings (SEO). ACG determined that if the RAB for a regulated entity has already been established, it is not appropriate to include an allowance for the cost of raising equity. However, where new stand-alone assets are built and a RAB is yet to be established, the opening regulated asset value should reflect all costs, including an allowance for the cost of raising the equity. This would be subject to how the assets are financed." (Page 146) "On the basis of ACG's findings, the ACCC considers that equity raising costs should not be allowed for TransGrid because: • TransGrid's RAB has already been established and would be rolled forward. Hence there is no case to now include an allowance for IPO costs. It is reasonable to assume that such costs have been included in the RAB, either explicitly or implicitly; and • it is unlikely that TransGrid would engage in raising equity to finance subsequent capital expenditure during the regulatory period as this would be an inefficient practice." (Page 147)
Powerlink Queensland Transmission Network Revenue Cap 2007–08 to 2011–12, AER, Final Decision, 14 June 2007	Disallows equity raising costs on initial RAV based on advice from Allen Consulting Group, December 2004.	"The AER is of the view that the relevant issue being considered is whether a RAB has been established. As the ACCC had already determined Powerlink's RAB in its 2001 revenue cap decision, and that the RAB is being rolled forward, there is no case to include an equity raising cost allowance in this revenue cap decision retrospectively." (Page 98) "The ACG concluded that when a RAB has already been established and has been used to determine revenues based on the building block approach, equity raising costs must be considered to be already incorporated in the RAB." (Page 98)

Document and Date	Nature of decision or advice	Excerpt from relevant decision or advice, including cross-references
SP AusNet Transmission Determination 2008-09 to 2013-14, Draft Decision, AER, 31 August 2007.	Disallows equity raising costs on initial RAV based on advice from Allen Consulting Group, December 2004.	"In relation to equity raising costs associated with the initial assets, the AER does not consider that in SP AusNet's case there is an argument that equity raising costs should be allowed. Consistent with the ACG report and the recent Powerlink decision, the AER considers that the relevant issue is whether a RAB has been established in a previous regulatory decision. In this regard, the AER disagrees with SP AusNet, in that ACG's recommendation is not limited to whether or not an asset value was established in Victoria before the 2002 decision, but applies if a RAB has been established in a previous regulatory decision. As the ACCC had already determined SP AusNet's opening RAB, as at 1 January 2003, in the last Victorian decision, and that RAB is being rolled forward, there is no case to include an equity raising cost allowance in this revenue cap decision." (Page 177)
Clarifying advice re SP AusNet, letter from Allen Consulting Group, 12th October 2007	Advice explains that three alternative, equivalent mechanisms exist for recovering equity raising costs. It would be wrong for the AER to discontinue its earlier decision to provide an opex allowance.	"..the term 'established' [in relation to an established RAV] must be taken to mean that the regulatory asset value that was set in the previous regulatory decision was to be 'locked-in' and a commitment made to apply the 'roll-forward' approach to updating the value at future reviews. If the 'lock-in and roll-forward' approach had not been adopted or foreshadowed, then the concerns described above against correcting the earlier regulatory asset value to include an allowance for equity raising costs would not exist." (Page 4) "Our 2004 report did not conclude that an allowance for equity raising costs that was determined at the time of establishing the initial regulatory asset value should only continue if mechanism 3 [inclusion of costs in the RAV] was selected to deliver the allowance. This conclusion would have been difficult to justify, given that mechanisms 1, 2 or 3 can be designed to provide an identical allowance. To be clear, therefore, we consider it invalid for the AER to conclude that merely because the ACCC chose mechanism 1 [an opex allowance] to deliver the allowance for equity raising costs in 2002 that the previous decision to provide an allowance for equity raising costs can be ignored. Rather, the full circumstances of the 2002 asset valuation must be considered, which included an allowance for equity raising costs in respect of the assets in place at that time." (Page 5)

Document and Date	Nature of decision or advice	Excerpt from relevant decision or advice, including cross-references
SP AusNet Transmission Determination 2008-09 to 2013-14, Final Decision, AER, January 2008	Allows equity raising costs on initial RAV as an operating expenditure allowance	"ACG notes that whilst equity raising costs were not included in the 2002 RAB, a separate opex allowance for equity raising costs was granted in this decision. In effect, ACG argues that the inclusion of this opex allowance was analogous to including equity raising costs in the RAB, and on this basis that it would be appropriate to continue that allowance in this decision. The AER considers this a valid argument, and an appropriate application of the principles in ACG's original and updated advice to SP AusNet's specific circumstances." (Page 146) "Having adjusted the RAB and depreciated schedule discussed above, the AER is satisfied 21.5 basis point benchmark equity raising cost allowance, associated with the initial capital base and capex from current regulatory control period, in SP AusNet's revised proposal reasonably reflects the prudent and efficient costs of achieving the opex objectives. This decision has been made having regard to, among other factors, the ACG advice accompanying SP AusNet's revised proposal, and the equity raising costs that would likely be incurrent by an efficient TNSP under benchmark financing arrangements." (Page 147)
ElectraNet Transmission Determination 2008–09 to 2012–13, Final Decision, AER, 11 April 2008	Allows equity raising costs on initial RAV by increasing the RAV.	"The AER has also included $21 million to the opening RAB for the purposes of providing an equity raising cost allowance associated with ElectraNet's opening RAB—as at January 2003—and capex over the current regulatory period. The equity raising cost was provided in the ACCC's 2002 revenue cap decision as an allowance in perpetuity. The AER has converted the allowance from perpetuity to an amount capitalised in the RAB. This will improve transparency and aid administration." (Page 18) "The AER considers that it is appropriate to maintain the intent of the 2002 revenue cap decision by continuing the equity raising cost allowance for ElectraNet in this final decision." (Page 88)
Issues Paper, Review of the weighted average cost of capital (WACC) parameters for electricity transmission and distribution, August 2008.	AER describes its approach as only allowing equity raising costs on the RAV if previously provided as an opex allowance.	*"Initial RAB–*the approach taken by the AER to date is where the initial RAB has been previously determined an allowance for equity raising costs should not be subsequently included in the RAB. If on the other hand compensation has previously been provided (through an opex allowance), the AER's position is that equity raising costs will be included as part of the opex allowance over the life of the equity portion of the initial RAB (in the form of an annuity) rather than the first few regulatory periods." (Page 108)

Document and Date	Nature of decision or advice	Excerpt from relevant decision or advice, including cross-references
Transend transmission determination, 2009-2014, Draft Decision, AER, November 2008.	Disallows equity raising costs on initial RAV	“For initial equity raising costs, the fundamental question is whether the RAB has already been determined.” (Page 194) “The AER considers that Transend’s valuation was made inclusive of equity raising costs.” (Page 201) “The AER does not consider that Transend’s circumstances are identical to that of SP AusNet, for whom the further ACG advice was prepared, and ElectraNet. Neither has Transend provided any evidence to suggest that the initial asset base was not inclusive of equity raising costs. On this basis it is not appropriate to retrospectively provide Transend with an allowance for equity raising costs associated with the value of Transend’s initial RAB.” (Page 202)