Electricity Transmission Revised Proposal

2008/09 – 2013/14

Appendix O

ACG Letter on Equity Raising Costs

SP AusNet
A member of Singapore Power Group

12 October 2007

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Dear Charles

SP AUSNET DRAFT DECISION: TRANSACTION COST OF RAISING EQUITY

Background

You have asked us to comment on the Australian Energy Regulator's (AER) use of our previous work when deciding on the merits of including an allowance for equity raising transaction costs in SP AusNet's revenue cap. That previous work was a report we prepared for the AER on debt and equity raising transaction costs in 2004.[1]

The AER's interpretation of our previous advice is commented upon below. First, however, the principles that are raised in this matter are discussed and the key findings of our 2004 report reviewed in this context.

2004 Report into Equity Raising Costs – Principles and Findings

A key finding of our 2004 report was that the cost of raising equity finance differed materially depending upon whether that equity finance was raised through an injection of funds from external sources, or whether it was raised from internal sources. In particular, while we found that equity finance from internal sources – that is, retained cash flows – created no additional transaction costs, equity finance obtained from external sources imposed material transaction costs.

- Using listed entities as the benchmark, our analysis suggested that transaction costs equated to 3.8 per cent of the capital raised at the time that an entity is first listed (an 'initial public offering', or IPO), and 3.0 per cent of capital raised for an existing listed entity seeking an equity injection (a 'seasoned equity offering', or SEO).

[1] Allen Consulting Group, 2004, Debt and Equity Raising Transaction Costs, Final Report to the ACCC, December.

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The question of whether it would be appropriate to provide an allowance for the transaction cost of raising equity finance for part of all of the equity share of the regulatory asset value turned on what it was most reasonable to assume about how that finance was raised: if it was reasonable to assume that it could be raised internally, then no allowance was required, but if it was reasonable to assume that a firm would be required to raise the funds externally, then an allowance would be justified. If an allowance was justified, then a further issue to consider would be whether it would be raised by a new firm (i.e. an IPO) or an existing firm (i.e. a SEO).

On this matter, we noted that whether the transaction cost of raising equity is relevant to the setting of a regulatory asset value depends upon the methodology used to set that value, and made two further specific observations.

- Where the ODRC method is to be used to set the regulatory asset value, we observed that the objective of the method is to replicate the cost structure of a hypothetical, efficient new entrant into that market, and it was reasonable to assume that the hypothetical efficient new entrant would need to raise equity capital from external sources (i.e. that these funds could not be assumed to come from retained earnings).[2]

- Where an initial regulatory asset value has been locked-in and is then updated over time using the roll forward method (i.e. where actual capital expenditure is added to the previous regulatory asset value), we noted that there need not be a transaction cost associated with raising the additional equity finance associated with capital expenditure over time.[3] This is because once a firm has been created and capitalised, most or all of the equity finance required for capital expenditure can be sourced from retained earnings (or, more accurately, retained cash flow). We noted that whether all of the equity share of the regulatory asset base could be met through retained cash flow is an empirical matter that can be tested.

A further issue that we addressed is whether an allowance should be made in respect of equity raising costs in situations where an initial regulatory asset value for the relevant assets had already been locked-in some years previously (i.e. the initial value set combined with a commitment to apply the 'roll-forward' approach thereafter). The particular circumstance considered was where the initial asset value was set at an estimate of the then ODRC of the network, and so the omission of equity raising costs from the initial asset value would have been an error according to the principles set out above.

While we viewed this matter as raising complex issues,[4] our advice was that it would be inappropriate to include such an allowance in the regulated businesses' revenue requirement even though this would remedy what would now be considered an error in the initial asset value. This reflected the fact that a central feature of the roll-forward approach is that an initial asset value is 'locked-in' and not reopened in the future in order to provide some certainty for investors, irrespective of whether refinements to the application of the ODRC method may mean that a different initial value would have been determined in the same situation today. We were also mindful of the potential for windfall gains and losses to be created where subsequent transactions have occurred on the basis that an initial asset value would not be reopened.

Our 2004 report also noted that there are three mechanisms that could be used to deliver an equivalent allowance for equity raising costs, which were:[5]

- *mechanism 1* – convert the equity raising cost into a perpetuity-equivalent and provide as an annual allowance (it was noted that this was the ACCC's practice at that time);

[2] Allen Consulting Group, Op. Cit., pp.ix, 55.
[3] Allen Consulting Group, Op. Cit., p.ix.
[4] Allen Consulting Group, Op. Cit., p.ix.
[5] Allen Consulting Group, Op. Cit., p.56.

- *mechanism 2* – set a WACC that implicitly provides such an allowance; or
- *mechanism 3* – include the equity raising costs in the regulatory asset base.

The last of these mechanisms ultimately was recommended as the preferred future approach. However, the report did not conclude that the ACCC's previous use of mechanism 1 was inappropriate – such a conclusion would have been difficult to maintain given that the three mechanisms can deliver equivalent outcomes.

In summary, therefore, our conclusions were that:

- estimates of the ODRC of a network should include an allowance for the transaction cost of raising equity;
- where an initial asset value is 'locked in' and then updated by adding in actual capital expenditure, an allowance for the cost of raising equity for that new expenditure would not be required if the equity can be financed from retained earnings (which is an empirical issue); and
- if an initial asset value is set at ODRC and then 'locked-in', with a commitment made to update that value thereafter using the 'roll-forward' approach, then:
  - if the asset value did not include an allowance for equity raising costs, it should not be reopened to include such an allowance given that a central feature of the roll-forward approach is to not reopen the locked-in value; but
  - if the initial asset value did include an allowance for equity raising costs, then clearly that allowance should remain in the regulatory asset value – it would have been correct for the initial asset value to include an allowance for equity raising costs and, as discussed above, the value should not be reopened after it has been 'locked-in' in any event; and
- while three mechanisms were identified that could be used to deliver an equivalent allowance for equity raising costs (i.e. provide an annual allowance in operating expenses, by including an allowance in the WACC and adding the equity raising cost to the regulatory asset value), it was recommended that in future the allowance be delivered by adding an amount to the regulatory asset value (mechanism 3).

We stand by the advice we provided to the ACCC in 2004, and note that the ACCC and AER have relied on this advice when considering the question of whether allowances for equity raising costs. We turn to the Commission's consideration of the case of SP AusNet next.

Application of the principles to SP AusNet

Our understanding of the relevant facts for the case of SP AusNet in relation to this matter is as follows.

- An asset value (based upon an estimate of ODRC) was assumed when the first revenue cap for the Victorian transmission business was set (the valuation being as at 1 July 1994). However, this value was not 'locked-in'. Rather:
  - it is our understanding that the ACCC specifically considered whether the opening regulatory asset base for the Victorian electricity transmission business should be locked in (as proposed by the Victorian Government), and it rejected this proposal, signalling an intention to reset the regulatory asset value at a future review;[6] and

[6] ACCC, 1998, NEM Access Code decision, September, p.73.

  - we recollect that from our own experience that, around that time, the ACCC had a strong preference for resetting the transmission businesses' regulatory asset values at a new estimate of ODRC periodically, as reflected in its 1999 Draft Statement of Regulatory Principles.

- The ACCC redetermined the regulatory asset value for the Victorian electricity transmission business in 2002. As part of this process, the ACCC reviewed the studies that underpinned the 1994 ODRC estimate, and made a number of refinements to that earlier estimate (such as the inclusion of assets that had been omitted). Relevantly to this matter, the ACCC included an allowance for the transaction cost of raising equity in the calculation of the revenue caps for the business.

Applying these facts to the principles summarised above, we would observe that:

- while an asset value was derived in 1994, this value was not 'locked-in' and no commitment was made to 'roll-forward' this value thereafter, rather explicit statements were made that the regulatory asset value would be reset in the future; and

- while it may be valid to infer an intention on the part of the ACCC to lock-in the 2002 regulatory asset value (we assume this to be the case), an allowance for the transaction cost of raising the equity finance for those initial assets was included in the determination that set the 2002 regulatory asset value:

  - we note that an allowance for equity raising costs was included as an operating allowance in accordance with mechanism 1 rather than in the 2002 regulatory asset value directly (as would be implied by mechanism 3). If the ACCC had been aware of our 2004 report at the time of its 2002 decision, then it may have elected to adopt mechanism 3, which would have led to an allowance for equity raising costs being included in the 2002 regulatory asset value. In the event, the ACCC selected an alternative mechanism (mechanism 1) that will deliver an equivalent allowance if applied in a consistent manner in future regulatory periods; and

- applying the principles set out in our 2004 report would lead to the conclusion that the allowance provided for equity raising costs in respect of the initial (2002) assets should continue into the future.

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:[7]

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

From the discussion above, it should be clear that this interpretation of our report needs to be qualified.

- First, 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.

[7] AER, 2007, SP AusNet Transmission Determination 2008 09 to 2013 14, Draft Decision, p.176.

- Secondly, consideration must also be given to the full circumstances of regulatory decision that established the initial regulatory asset value. In particular, the discussion above noted that an allowance for the cost of raising the equity associated with the initial assets can be delivered through any of three equivalent mechanisms, only the third of which would result in an allowance being added to the regulatory asset value. It follows that the AER must consider whether an allowance for equity raising costs was provided through <u>any of these three mechanisms</u> when the regulatory asset value was first established.

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. While the AER's reasoning is not entirely clear, we note that the AER's reasoning may include three propositions, which are set out below with our response.

- *Proposition 1* – the regulatory asset value was 'established' in 1994, and this fact means that no future allowance for equity raising costs should be provided.

  - While an asset value was assumed for the purposes of setting the initial revenue for the business, it is clear that this value was not locked-in but was always intended to be reviewed, and indeed was reviewed in 2002.

- *Proposition 2* – the regulatory asset value was 'established' in 2002, and this fact means that no future allowance for equity raising costs should be provided.

  - We have assumed that it may be appropriate to infer that the regulatory asset value that the ACCC set in 2002 was 'established', or locked in; however, we disagree with the proposition that an allowance for the cost of raising equity for the initial assets was not derived and provided at the time that value was set. Our review of the 2002 ACCC decision is that, while the 'established' regulatory asset value did not include an allowance for equity raising costs directly, a separate allowance for equity raising costs was provided as an operating expenditure item. In effect, therefore, the ACCC has adopted mechanism 1 from the discussion above (i.e. a perpetuity equivalent was included in operating expenses), rather than mechanism 3 as we preferred in our later advice. Therefore, irrespective of whether the ACCC knew it at the time, its decision to provide an allowance in respect of the cost of raising the equity for the assets in place at the time was consistent with its review of the regulatory asset value against the principles of an ODRC valuation, and an application of the principles set out in our 2004 report would imply that such an allowance should continue.

- *Proposition 3* – even though an allowance for equity raising costs was included in the determination that established the 2002 regulatory asset value, the fact that the allowance was provided as a perpetuity equivalent (mechanism 1) rather than added to the regulatory asset value (mechanism 3) means that the allowance must now be discontinued.

  - 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 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 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.

- We also note for completeness that if a regulator wished to switch between mechanism 1 and mechanism 3 as a means of delivering an allowance for equity raising costs, then a compensating adjustment to the value of the regulatory asset value would be required to deliver the allowance that was originally intended. However, if the option of switching between mechanism 1 and 3 (and making the compensating adjustment) is not open to the AER under the new Chapter 6A rules, then the appropriate course of action would be to continue to provide the appropriate allowance under mechanism 1.

If you wish to discuss this matter, please do not hesitate to contact me (07 3016 3501).

Yours sincerely,

Jeff Balchin
Director