Memorandum

To: AR – Transend Review

From: CEG – Asia Pacific

Date: 18 February 2009

Subject: **Ofgem treatment of equity raising costs**

CEG provided two reports for Transend in relation to the estimation of debt and equity raising costs.[1] In those reports we recommended the adoption of a 7.6% estimate of the total cost of raising equity. In doing so we responded to a number of specific issues raised by the AER in its draft decision.

However, one issue we did not respond to relates to a reference made by the AER to an Ofgem report in the Transend draft decision. In the AER Transend draft decision the AER states:

> "*Based on the information submitted, the AER is not satisfied that there is a need to take account of indirect unit cost of raising equity under the benchmark regulatory framework. Accordingly, the AER will maintain its current approach of using the direct unit cost of raising equity to determine a benchmark equity raising cost allowance when a case for external equity financing associated with forecast capex has been established.* ***The AER notes that claims for indirect costs of equity raising have been considered and rejected by the UK regulator Office of Gas and Electricity Markets (OFGEM).***[313]*"* (page 195, emphasis added.)
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> *[313] Office of gas and electricity markets, OFGEM, 'Transmission price control review: Final proposals', 4 December 2006, p. 59.*

The last sentence of the above quote refers to an Ofgem decision. From the drafting it appears that the AER regards the Ofgem precedent as supportive of its decision. We do not agree with this assessment. The relevant two paragraphs from the Ofgem report are:

[1] CEG, *Debt and equity raising costs: A response to the AER 2008 draft decisions for electricity distribution and transmission*, January 2009. And CEG, *Nominal risk free rate, debt risk premium and debt and equity raising costs for Transend*, May 2008

> *"8.36. The cost of equity issuance has two possible components: the direct costs of issuing new equity and the indirect impact on the share price. The Smithers report sets out that the direct cost of equity issuance is typically within the range of 5 to 12 per cent of the value of equity raised, although there are instances where the costs of raising new equity can be significantly higher. We also note that academic research suggests that large companies and utilities typically experience costs towards the lower end of the indicated range and have therefore selected 5 per cent as a representative cost.*
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> *8.37. Academic studies on indirect costs of equity issuance have indicated that the main accepted reason for the indirect effect is the information asymmetry that exists between the market and the company raising funds. In the case of network utilities, both the nature of the investment for which equity is required and the prospective return on that investment are clear to market participants. In the light of this, we do not consider it necessary to provide any additional allowance for the indirect costs of equity issuance."*

First, we note that Ofgem has set the direct cost of raising equity at 5% and that Ofgem selected this from the bottom of the 5% to 12% range as advised by Smithers and co. Despite 5% being the bottom of the range, it is almost double the allowance the AER has set (2.75%).[2] It appears that the AER is referencing the Ofgem report only in support of its view that indirect costs can reasonably be ignored. However, if Ofgem decisions are relevant precedent then one would expect the AER to also consider Ofgem's allowance for direct costs against the AER's allowance. To the extent the Ofgem precedent is relevant, it would appear to support the view that the AER's estimate of direct costs is below a reasonable range (ie, almost half the bottom end of the range Ofgem considered reasonable).

Second, when Ofgem refers to "indirect costs" it is **not** referring to the same concept that CEG has referred to and which is well established in the finance literature. The Smithers and Co report[3] on which Ofgem bases its conclusion only examines the 'announcement effects' associated with capital raising. As described by Smithers and Co:

> *The indirect costs represent "announcement" effects, whereby equity issues are deemed to represent a bad signal of underlying profitability, and thus stimulate price falls. Estimates of these price falls range from 1% to 3%, but, since these affect the entire equity issue they typically represent a much higher proportion – up to around one third, of the actual funds raised. This*

[2] The AER does not report a figure in the Transend determination but does report a 2.75% estimate on page 197 of AER NSW draft distribution determination 21 November 2008.

[3] Smithers and Co, Report on the Cost of Capital, A report provided to Ofgem, 1 September 2006.

> *figure does however appear to be distinctly lower for regulated utilities.* (Page 4.)

We agree with Ofgem's conclusion that announcement effects are not a good basis for determining the indirect cost of raising equity. If an announcement of equity raising signals to investors an unanticipated cash-flow problem at the firm then any consequent fall in the firm's share price *cannot* be presumed to be a cost of raising equity. If the fall in the share price simply signals 'bad news' that would eventually have been made public then the fall in the share price should not be causally ascribed to the equity raising but rather to the underlying bad news for which the equity raising announcement is simply a signal.

However, the basis of the empirical estimates of indirect costs in our report was, unlike the discussion in Smithers and Co, based on *underpricing* not *announcement effects*. That is, indirect cost estimates in our report were based on the difference between the price at which equity traded on the stock market and the price at which it was simultaneously issued to new investors. Thus, any 'bad news' associated with the announcement of an equity raising is already captured in a lower traded price and forms no part of the estimate of the underpricing required to sell new shares.

For example, when we report at paragraph 58 of our January 2009 report that the National Australia Bank (NAB) issued equity at a 9.7% discount to the traded price of NAB shares we are not reporting that the traded NAB share price fell 9.7% on the announcement of the capital raising. We are reporting that the NAB sold equity at a share price that was lower than the traded share price.

For the above reasons we regard the only relevant precedent from the Ofgem decision that precedent relating to the direct costs of raising equity – which Ofgem set at nearly double the allowance the AER is currently proposing.