

ElectraNet SA Public Forum

**Comments on ACCC's Draft
Decision on Cost of Capital**

4 October 2002



SPI POWERNET

A subsidiary of Singapore Power International

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Introduction

- ◆ SPI PowerNet acknowledges the inherent difficulty in setting an appropriate WACC
- ◆ Within the ElectraNet draft decision, the ACCC has done little to aid in resolving a number of outstanding issues
- ◆ SPI PowerNet, ElectraNet SA and GasNet recently sponsored a WACC forum in an attempt to address these
- ◆ It is disappointing to see that the expert presentations made at the forum appear to have had no impact



Risk free rate - term

- ◆ ACCC has argued for a 5 year term for the risk free rate
 - by itself this reduces WACC by ~25bp
 - all other Aust regulators use 10 years
- ◆ According to Prof Officer, 5 years would be correct if ACCC provided a capital guarantee
 - this is the critical assumption in the Lally paper commissioned by ACCC
- ◆ However, ACCC cannot and does not provide this, indeed no one can



Risk-free rate – term (cont)

- ◆ There are many well established reasons in favour of 10-years:
 - long term nature of infrastructure investment
 - consistent with the estimation basis for the MRP
 - market in 10-year bonds is much deeper and estimates more reliable
- ◆ Overall, ACCC's position on using a term equivalent to the regulatory period is unsustainable



Risk-free rate – sampling period

- ◆ ACCC has decided to adopt a 40 trading day sample for the risk free rate
- ◆ SPI PowerNet believes that this is too long and a 5 to 10 trading day sample would be more appropriate
 - more tractable should the utility seek to hedge over the sample period
 - does not unduly distort the information value of the sample, relative to the theoretical ideal of taking a one day sample
- ◆ Ultimately, ACCC should be flexible

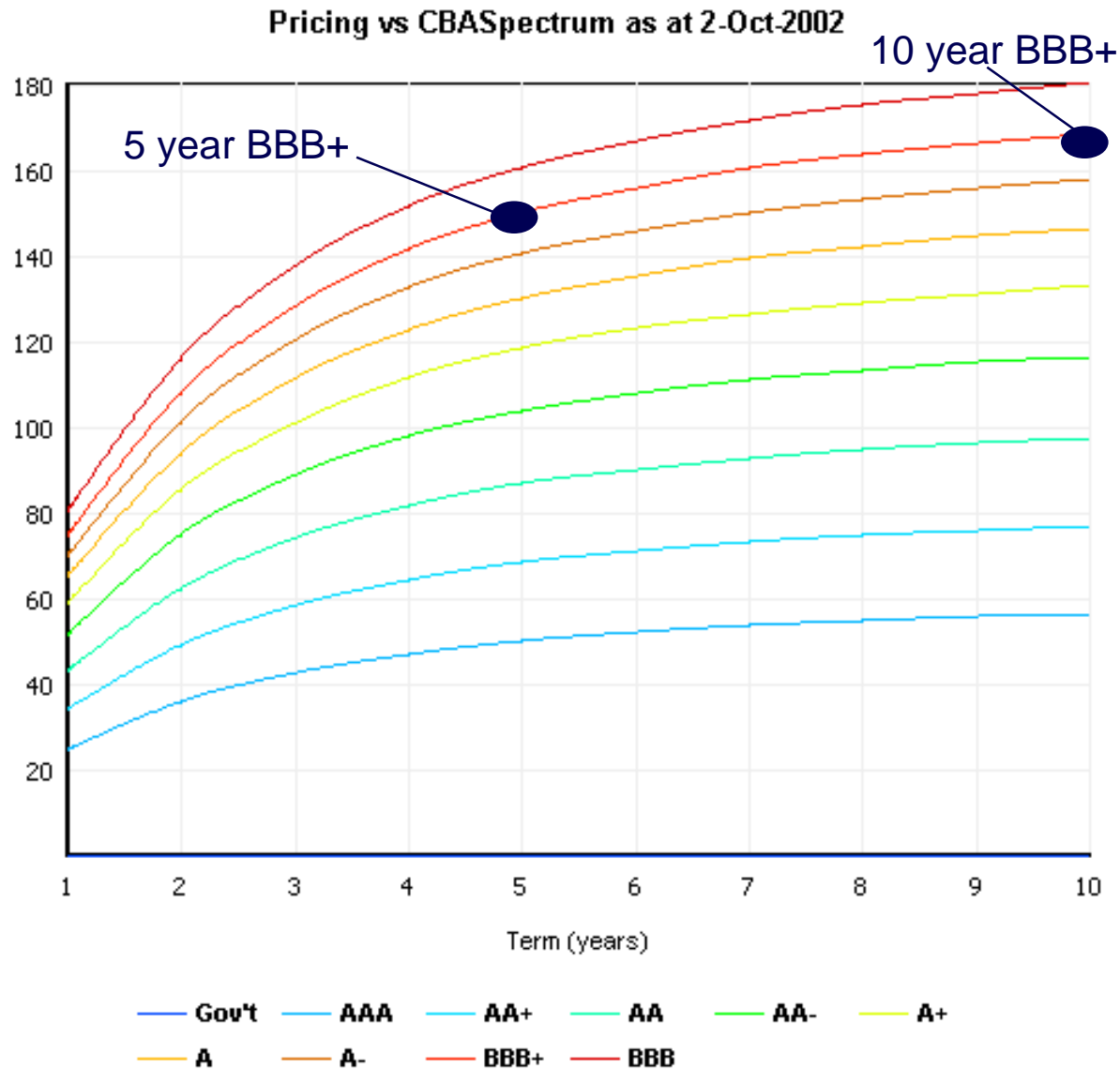


Debt margin

- ◆ Need to recognise that the debt margin is affected by the term chosen for the risk free rate
 - Choosing a five year rate therefore has a double impact
- ◆ Currently, BBB+ 5-year bonds are trading well above the 130bp allowed to ElectraNet
 - CBA Spectrum prices the margin at 150bp for 5 years and 169bp for 10 years
- ◆ SPI PowerNet will be submitting further information on debt margins



Debt margin (cont)



Source:
<http://www.cbaspectrum.com/pricing>



Debt and equity raising costs

- ◆ In its draft decision on GasNet, the ACCC allowed:
 - debt raising costs of 8bp
 - equity raising costs equivalent to 48bp on the cost of equity
- ◆ These same costs appear not to have been allowed to ElectraNet
 - there is no reason for this
- ◆ SPI PowerNet also notes that GasNet's response justifies debt raising costs of 30bp

Dividend imputation

- ◆ The appropriate treatment of dividend imputation is problematic
- ◆ While using 0.5, the ACCC contends that gamma should be close to 1.0
- ◆ However, this ignores key facts
 - official tax statistics indicate a figure of 0.5
 - in reality, few businesses pay out all their profits as dividends
 - franking credits are a wasting asset, so it is very unlikely that gamma would ever be at or even close to one



Dividend imputation (cont)

- ◆ More generally, allowing for foreign ownership in the current version of the CAPM is not straightforward
 - our capital markets are neither completely segregated from nor completely integrated with the world capital markets
- ◆ In the absence of a finance theory that adequately deals with this phenomenon, we need to compromise
- ◆ Advice from Prof Officer is to accept the current approach as a pragmatic means of approximating the actual situation

Approach to setting WACC

- ◆ Although the ACCC has varied little from its previous decisions, some of its language is concerning
 - “[t]he Commission’s regulatory regime attempts to ensure that the return on capital allowance in the revenue cap is equivalent, and only equivalent, to the risk adjusted market rate of return required to maintain investment.” (Draft Decision p.20)
- ◆ This position appears unenlightened in the context of the recent debate sparked by the Productivity Commission’s review

Concluding remarks

- ◆ SPI PowerNet believes that there are a number of outstanding WACC issues
- ◆ These issues are of such complexity that they are unlikely to be resolved through forums such as this
- ◆ SPI PowerNet believes that the ACCC should convene a roundtable of the relevant experts as part of finalising its decisions for ElectraNet SA, GasNet and SPI PowerNet

