

2 December 2005

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Dear Dinesh

Cost of Capital

Thank you for the opportunity to comment on the Commission's draft guidelines for estimating the cost of capital. Our comments are set out below:

The Brennan Lally model

We support the use of the simplified Brennan-Lally model for calculating the cost of capital in a New Zealand environment. However, we have the following issues with the version shown in the draft guidelines.

The model calculates the cost of debt as $(R_f + p)(1 - T_c)$, where p is an estimate of the premium above the risk free rate required by holders of a firm's debt securities. It seems most likely that the estimate of $R_f + p$ will be the firm's actual cost of debt (where capital structure choices are within reasonable bounds). However, using a formula that allows p to be non-zero means the Commission is implicitly incorporating non-zero debt betas in the analysis as can be seen by the equivalence between:

$$K_d = R_f(1 - T_c) + B_d(\text{PTMRP}) = R_f(1 - T_c) + p(1 - T_c).$$

However the formula for moving between asset betas and equity betas does not reflect that at different levels of leverage, asset risk is being passed to debt holders (as reflected in B_d or p). The formula proposed by the Commission is:

$$B_e = B_a + B_a(D/E).$$



However if non-zero debt betas are incorporated into the WACC formula (as they are by the use of non-zero p), then the (de)leveraging formula needs to reflect this as follows:

$$B_e = B_a + (B_a - B_d)(D/E).$$

Failure to make an allowance for the B_d adjustment where p is non-zero leads to a WACC curve that is upward sloping – a clearly perverse result.

The estimate of B_d needs to be $p(1 - T_c)/(MRP)$ where MRP is the Brennan Lally MRP.

The Commissions approach of using a full WACC formula seems unnecessarily complicated. Most academics and practitioners in New Zealand would regard the WACC curve as being substantially flat through most reasonable levels of gearing and indeed, if the Commissions draft WACC formula was corrected for the debt beta issue raised above, this is the result.

Given this, it seems methodologically easier to use an all-equity cost of capital that ignores the issue of capital structure altogether. The formula is as follows:

$$R_a = R_f(1-t) + B_a (MRP)$$

Where R_a is the required asset (or all-equity) return, B_a is the unlevered beta and MRP is the Brennan-Lally version. This approach is fundamentally sound in New Zealand and reduces the range of issues that need to be debated and/or adjusted for standard confidence intervals.

Calculating the inputs

We believe that the proposals from the Commission in regard to calculating the various inputs into the cost of capital are reasonable with the exceptions of the points relating to debt premia, betas and capital structure noted above.

Other factors

We believe it is appropriate for the Commission to seek to promulgate a broadly accepted and fundamentally sound approach to calculating the cost of capital. We also accept that in the first instance this should be kept pure. However we are unwilling to comment on the proposals of the Commission of how this cost of capital may be applied to regulation (an outcome of commenting on what adjustments it is reasonable to make to the cost of capital). The Commission's draft is under-done in the analysis of these issues and any agreement in regard to calculating a basic cost of capital should not be taken to be an implicit acceptance of the approach to regulation implied by the Commissions draft.



Thank you for the opportunity to provide comment. Please don't hesitate to contact the under-signed if you would like to discuss any of this letter.

Yours sincerely

CAMERON PARTNERS LIMITED

Paul Dougherty

Partner