

PC Data Request 21

RE: Direct Testimony of Kurt G. Strunk, Exhibit No. KGS-T1, p. 16, ll. 8-12.

- a) What market risk premium does the Australian Energy Regulator use, according to the Explanatory Statement cited by Mr. Strunk?
- b) If Mr. Strunk had used the same market risk premium currently employed by the Australian Energy Regulator, combined with Mr. Strunk's risk-free rate and beta, what CAPM cost of equity would be indicated.
- c) Does the Australian Energy Regulator use 30-year government bonds for the risk-free rate, or a shorter term government security. Why?
- d) How much did the Australian Energy Regulator raise its estimate of the current market risk premium? Please cite to the Explanatory Statement cited by Mr. Strunk in his workpapers.
- e) Did the Australian Energy Regulator reject reliance on DCF-driven estimates of the market risk premium? Please cite to the Explanatory Statement cited by Mr. Strunk in his workpapers to support your response.

Response to PC Data Request 21

- a) The Australian Energy Regulator (AER) guidance relies on estimates of the market risk premium that are derived from Australian capital market data and applicable to Australian firms. AER estimates a range for the market risk premium of 5 per cent to 7.5 per cent. As of the time of publication, the AER offered a point estimate of 6.5 per cent. However, the AER clarifies that this is not necessarily the market risk premium it will employ in future cases: "We intend to consider and review a range of material on the MRP, as it becomes available. We will draw on this material and will consider more up to date information when determining the MRP at each determination." (p.89)
- b) Mr. Strunk assumes that this data request is asking what the CAPM result would be if Mr. Strunk had used a risk free rate based on United States government bond yields and the market risk premium deemed by the AER to be applicable in Australia, applied to the betas of firms in the United States, each measured at a different point in time. Mr. Strunk supplies the data in the table below with the caveat that such a calculation does not rely upon a consistent set of inputs and consequently should not be expected to produce a meaningful result.

Risk Free Rate (US)	Market Risk Premium (Australia)	Beta (US)	Result
3.7%	6.5%	0.71	8.315%

- c) No. The AER uses a shorter-term government security. Use of the 30-year bond is not a practicable alternative for the AER because the Australian government does not issue 30-year bonds.
- d) The AER raised its estimate of the market risk premium by 0.5 per cent in the December 2013 guidelines relative to its market risk premium estimate of 6.0 per cent in the Victorian APA GasNet determination in March 2013. (p.89)
- e) No, it did not. As highlighted in Mr. Strunk's direct testimony, the AER relies on a DCF-based estimate of the forward-looking market risk premium in establishing the appropriate range for the market risk premium. This in turn is used as one of the inputs to the CAPM analysis that guides its establishment of an ROE for ratemaking purposes.

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