

“Draft tool to determine the weighted average cost of capital (WACC)” (Version 01)

SGS comments on the “Draft tool to determine the weighted average cost of capital” are as follows:

1. Step 2: Determine the status of the legal entity that will host the project activity assets.

- 1.1. *Page 3:* The current text left aside the projects that classifies as Case I in step 1, however step 2 should apply to case I and II.
- 1.2. *Page 3:* The phrase “*If case (a) applies, w_e and w_d will be determined based on the accounting books of the legal entity. If case (b) applies, the default debt-equity ratio should be applied*” is unnecessary because step 5 of the tool refers to the w_d and w_e determination.

2. Step 3: Determine the average cost of debt financing (k_d)

- 2.1. *General.* Besides stated conditions for whether to choose 3A,3B, or 3C the rationale is that it is always better to use the cost of financing closer to the specific project as a reference for k_d . This is because past k_d rates may not be good indicator of the k_d cost of the project in evaluation, and also other k_d rates may refer to other projects with different levels of risk and/or different profiles.
The most specific k_d rate could be found in a letter of intent for debt funding from the bank(s), or the loan contract specific for the project itself.
For Case (I) companies, the contract of lending between the parent company and the legal entity owning the assets of the project activity should be always preferred to other proxy estimations.
In other words, it could be useful to present the options to determine k_d in order of preference, from specific to general. Also for Case (II) companies up-to-date market values to old loan rates, or average commercial lending rates and so on.
- 2.2. An alternative approach that is not mentioned in the current version is to use peer companies k_d values obtained from financial sites, such as Bloomberg or finance.yahoo.com. This can be provided as an approach based on information from publicly available websites.
- 2.3. *Page 3 (foot note 2) and Page 4 (last paragraph on option 3B).*
The section refers to long-term debt and interest rate of long term. It would be useful to specify and suggest using a ten years or closed to ten years bond and loan to reflect the long project period.

3. Step 4: Determine the average cost of equity financing (k_e)

- 3.1. *Page 5, Option 4A.* It is defined PEG as “*Global equity risk premium*”, and it is defined as a default value 4.7%. Later in page 6, Option 4C the same parameter PEG is defined as “*General equity risk premium*” with a default value of 4.1%. If the parameter PEG has different connotation in both options it should be named differently, this would avoid confusion regarding the different default value for the same parameter.
- 3.2. *Page 5, Note close to the end of option 4A.*
It is not clear if the “project risk” expression refers to beta values, or to specific project risk factors such as size premiums, business cycle, etc like the ones used in the APT or Fama and French 3 factor models. In mathematical terms, not including the project risk means that all premiums which are not market premiums have $\beta=0$?
Moreover formulas 3) and 4) assume market equity premium $\beta=1$. This seems to be contradictory with add-tool 1.v5.2 annex 14.
Regarding other premiums, such as size premiums, growth premiums, and so on? Shall we consider all β factors=1? =0?
In all, is it or not possible that k_e considers different multibeta factors models?

- 3.3. *Page 5. Option 4A.* Please provide some guidelines on which methodology to use when re-leveraging betas will be useful. Hamada (1969) and Rubinstein (1973) and Modigliani and Miller with taxes proposition formulas are popular in the financial.
- 3.4. *Page 6.* Equity premium figure dispersion is huge in financial literature, and the suggested 4.1% figure seems a bit in the low side. An updated review on the matter can be found in Pablo Fernandez (2009). The equity premium from 150 textbooks. Available online at: <http://ssrn.com/abstract=1473225>
- 3.5. *Page 6. PEg.* It would be useful to clarify if PPs can still refer to other sources and figures as long they are within the reasonable range of dispersion and the quoted source is valid.

4. Step 5: Determine the percentage of debt financing (wd), and equity financing (We)

- 4.1. *Page 8.* Under step 5, two options are available: option 5A-use the latest balance sheet of under local fiscal/accounting standards and rules and option 5B-default value. Neither of the options considers the project-specific D/E ratio. The rationale in financial community is to use the weights which are closer to the actual ones to be used in the project.
In this sense, internal company weights may not be appropriate as they reflect the average weightings of all the projects in the company. A board decision document, stating the specific debt-to-equity ratio for the project should be preferred over other proxies. Perhaps this could be a new option 5C or combine in option A, that if the project achieves financial closure then the project's debt and equity ratio must be applied.
- 4.2. *General.* It is also common practice to refer to peer company's leverage ratios when validating the weights. This info is free and publicly available in several financial sites. Average D/E ratio for the industry is what most companies use as a target D/E ratio. Could this be an option when estimating weights?