

Chapter 4

COST OF EQUITY ESTIMATION FOR REGULATED ENERGY NETWORKS IN EMERGING MARKETS¹

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Introduction

Normally, it is considered that investments in emerging economies are riskier than similar investments in maturing economies. But, in recent years, this point of view has been questioned because the investment in an emerging economy is claimed to reduce the risk associated with an international firm's cash flows (McRae, 1996), and offers chances for diversification advantages for firms because of low correlation between maturing and emerging economies. Investors are able to diminish some of the risks that they would, otherwise, have to assume in a segmented market, by diversifying across countries whose economic cycles are imperfect. A diversified portfolio on a global basis will likely be less risky than a solely national portfolio. The reason for this is that a systematic risk in the United States market may not be a systematic risk in the global market (Shapiro, 2003).

Conservely, in essence, many firms add an extra premium to the capital cost or the discount rate employed to investments in emerging economies. Buckley (2004) criticizes that this raises the capital cost or discount rate, and by then the cash flows are discounted excessively and, as a result, investment chances are penalized. Nevertheless, as demonstrated by Harvey (1995), the CAPM does not often ensure a reply to describe the cross section of average returns in emerging economies, but often generates very low outcomes as per the linked risks.

It is clear that there are some challenges in DCF and CAPM implementations in global environments. As pointed out by Kennedy (2004), the key difficulties in implementing CAPM to emerging economies are the undeveloped capital markets and the shortage of required data sets. The risk free rate can be estimated on the basis of Eurobond spreads for countries that issue Eurobonds. Even though energy network firms in emerging economies usually do not issue bonds, there is enough data about lending rates to estimate the debt premiums.

The problem emerges when calculating the return on equity due to the lack of enough data sets to calculate the market risk premium in relation to the risk free rate, or the premium of the energy network companies in relation to the market,

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Summary and conclusions

Compared to developed economies, estimating a reasonable rate of return becomes more arduous, and this exclusive task is much more complicated for regulators in emerging economies. There is no mutual agreement between scientists, regulators, financial specialists and other practitioners to overcome the difficulties in capital cost estimation in emerging economies as these countries have relatively fewer liquid capital markets and higher levels of economic, financial, and political risks.

As has been classified and discussed above, numerous models and approaches have been proposed. In order to deal with the additional risk that emerging economies have, the suggested models involve adding a country risk premium, adjusting or modifying the beta, or using other risk parameters instead of beta in CAPM (Pereiro, 2006; Sabal, 2004; Bekaert & Harvey, 2002).

There is no general framework that can be used by the regulatory authorities in emerging countries to estimate the capital cost. In addition, with regard to the direction of research towards the estimation of capital cost, it is difficult to predict which model will be widely accepted in the near future.

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Economic And Administrative Sciences Volume II

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