

Lending analysis

Business



Utility services play a vital role in a nation's economic progress as cheap and abundant supply of power keeps the wheels of development rolling.

The increasing demand for utility services, particularly for electricity, is leading to the installation of large generation units. The power generators, in the wake of more stringent environmental regulations and restrictions, are gradually shifting their focus to renewable sources and natural gas to produce power. This is a welcoming sign for the industry and a positive step towards reducing the emission of greenhouse gases.

Diagram 1 shows the performance of the utility industry as a whole during the year 2009 to 2013. There is a quick drop in this industry during the year 2009 due to the lower export prices for bulk commodities.

Due to the decreasing demand from China, the major trading partner for Australia, caused a decline in the utility sector which is shown in the diagram above. There was also another drop during the year 2012 which is caused by the implementation of the carbon tax that aims to reduce emission from coal, oil and gas use, and this led to a decline in the share prices of the company and the industry performance.

Diagram 2: Australian Industry Sector Share Price There was an increase in share prices during year 2010 and 2011, from \$5.23 to \$7.05.

Diagram 2 illustrates that the utility sector has performed well due to the strong demand from most regions and coal, the second largest sector in this demand. However, in year 2012, the appreciation of Australian dollars

impacted the export perspective that makes Australian utilities export less competitive in the global market and led to lower value.

The industry is now on the eve of its largest change ever, a full transformation similar to the transformation of the telecommunications industry that started 20 years ago. It is also one of the last industries to face distillation, which is essential to manage the pressures of energy savings, climate changes and renewable energy policies. Underinvestment in the network meant that large investment increases were suddenly needed to upgrade the grid. Part of the problem has been the lack of proper government policies and regulations that could have stimulated these investments.

It was only in 2011 that the regulator admitted that there are problems that need to be addressed. In the meantime this situation has led to very steep increases in electricity prices, which is making customers far more vocal, and they will need better tools to manage their own energy use and carbon footprint. There is a significant absence of communication between the electricity companies and their customers and this has been aggravating the already difficult situation. For the PDP was given from IQ, GAL Energy Ltd is 0.24%. This indicates that there is only that shareholders might exercise the walk away option and leave the firm's assets for creditors.

Generally the energy industry performed well in post SGF period. This can be considered a good noninsured as a liable and confident client. Part 3 – Limitations and Improvements The Morton model used in this assignment also called as Black – Schools Morton model is a mathematical model of a

financial market containing certain derivative investment instruments, which is used worldwide.

However, there are some limitations that we should not overlook. As shown in the assignment, the model only used risk-free rate to calculate probability of default (PDP), which is clearly not the case in reality. The model fails to reflect the actual risk-return trade off experienced by the business.

Hence, the model should have a range of interest rates that correspond with the movement of the volatile market. Market risk should then be considered and incorporated in the model to accurately determine the PDP.

Taking in mind, market risk is the risk that cannot be eliminated through diversification and it is highly correlated with market prices. Furthermore, Morton model only assumes one-year horizon and that the previous years of default probability are not incorporated which then leads to the inaccuracy of the estimations projected by the model. Clearly, the liabilities figures used in the model is assumed to be the same or constant over time, which is not practical as debt structures of the firm changes over time.

In addition, there are various risk weighting in the section of liabilities that are different from one another.

The model should consider the complex debt structures to assess the different levels of risk of different kinds of liabilities. Companies should also be required to maintain a certain level of asset before the repayment is due. Thus, setting a threshold level to measure assets whenever it falls below an

acceptable level of default, which will then prevent business from defaulting on debts.

The probability of default's result based on the Morton model approach possibly give two types of errors comprising of type 1 which is failure to predict default when it did occur and type 2 which is predicting default when it did not occur. Moreover, there is also an assumption that in its calculation, it includes normal distribution which will not be appropriate from an economic perspective if Global Financial Crisis were to happen. This would cause the mean value of asset to be hanged, the normal distribution will no longer exist, and it might end up highly skewed to one side, given that circumstance.

Due to that, in order to improve, PDP should be used along with other information and occasionally modified to match the unique structure off particular client. Additionally, in the model, the historical volatility of the firm was used to ascertain a firm's value which would not accurately reflect the actual value of the firm. Therefore, more updated data should be collected from the dynamic market environment in order to improve the accuracy and to make the model more consistent.