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Dear Keston,

Gas Pipeline and Electricity Lines Businesses Beta Analysis

This submission supports the suggestion that the Commission obtain a new expert opinion regarding analysis of the betas for gas pipeline and electricity lines businesses. It is submitted now because there is a narrow window of time in which such an analysis could be obtained without jeopardising the Commission's decision-making timetable.

For the avoidance of doubt, I am not acting on behalf of any party with an interest in the issue. I make this submission reluctantly but have concluded I should express a view on the process issue that arises in the current unusual circumstances where the Commission's expert adviser has reported there are errors in his earlier advice. This submission relates only to process. I am not opining on the numeric value the Commission should use for beta.

On 25 May 2016, the Commission published a report by its adviser on the cost of capital input methodology review, Dr Martin Lally, in which he reports that errors invalidate his earlier advice to the Commission that the beta for gas pipelines businesses should be set 29% higher than the beta for electricity lines businesses (i.e. at 0.44 rather than 0.34). To quote:

"HoustonKemp (hereafter HK, 2016, section 2) notes that Lally (2004, pp. 32-34) favoured a beta differential for gas over electricity businesses of 0.10 on the basis of differences in customer types and in the betas associated with those customer types, and that this margin was maintained in Lally (2008, pp. 62-64) but with the additional argument that growth options were more valuable for gas businesses, implying that the growth option argument was secondary, which contradicts the claim in Lally (2016a, section 2.1) that the growth options argument was the more important consideration in Lally (2008). I agree with this point, but it highlights errors in my earlier analysis rather than in Lally (2016a)."

It is commendable that Dr Lally acknowledges what he now considers to be errors and that he acknowledges that his earlier explanation of how his 2008 view relates to his current view was not valid. I have a high regard for Dr Lally's expertise and we all make mistakes.

This is a most unfortunate situation given the significance of the issue. The context is that very large transactions, namely the sales of New Zealand gas transmission pipelines to a new investor which has not previously owned assets in New Zealand, appear to have been

based on the Commission's earlier decisions. A "belts and braces" approach is warranted in these circumstances.

The Commission draft decision was issued shortly after Dr Lally's report, on 16 June 2016, as required by the previously announced timetable. The Commission has undertaken its own data analysis which is summarised in Figure 7 on page 98 of the draft decision. In Figure 7, the beta results for gas pipeline businesses are generally higher than for electricity lines businesses for the recent period and therefore higher than 0.34, which is the average for combined electricity lines and gas pipeline data set. The difference between the results for gas pipelines compared to electricity lines businesses is suggested to not have evidential value because the results prior to 2010 differ from the more recent results. The draft concludes:

"observed differences in asset betas between electricity and gas are more likely to reflect measurement error¹ than a systematic difference over time"

The draft then comments:

"Even if it is assumed that New Zealand GPBs face greater exposure to systematic risk than New Zealand electricity lines businesses, there are several possible scenarios which potentially imply different adjustments to the comparator sample estimate of 0.34."

Thus the earlier analysis, on which the Commission may have relied, is said to be erroneous, the results for recent years of the Commission's current analysis are said to reflect measurement error and the report suggests there are alternative responses to the results, leaving aside measurement error.

In these circumstances, where the key issues are data analysis, possible measurement errors or instabilities relating to international data and multiple possible interpretations of results, obtaining a new opinion from international expert consultants with in-depth knowledge of the relevant companies and beta data would be very valuable in terms of confidence in the regulatory process. The Commission used international consultants in regard to the beta for the telecommunications pricing decisions and for the cost of capital uplift review. It would be consistent with those precedents for the Commission to engage such consultants now on this beta issue.

The draft decision states the Commission is willing to convene a workshop on the gas beta issue. Such a workshop would be far more satisfactory as a mechanism for ensuring the issue has been addressed in a way appropriate to the issue's significance, if an independent

¹ I have a very high regard for the analytical abilities and quality assurance expertise of the Commission staff and I am therefore sure they have not made measurement errors in the everyday sense of making incorrect measurements. I assume the term "measurement error" refers to the beta results being unstable. The implications of such instability warrant further analysis. The draft decision could be read as taking as its starting point the position that the beta for gas pipelines and electricity businesses is the same with the onus of proof being imposed on the contention that they may be different. This would be a change from the Commission's earlier approach.

report by international consultants was available rather than a format in which the Commission's own data analysis and Dr Lally's analysis is the central focus of the discussion.

Accordingly, I believe obtaining a new expert opinion would enable such a workshop to better fulfil its role of ensuring a robust process underpins the Commission's decisions.

Regards,

A handwritten signature in black ink that reads "Pat Duignan". The signature is written in a cursive style with a horizontal line underneath the name.

Pat Duignan