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Dear Keston

**Re: Input Methodologies Review: Cost of Capital**

First State Investments (FSI) is pleased to make this submission on the Commerce Commission's (Commission) review of the Input Methodologies (IMs) for determining the weighted average cost of capital (WACC) for gas pipelines. FSI has a strong interest in the regulatory settings that apply to gas pipeline businesses in New Zealand through our ownership interest in First Gas Limited (formerly Vector Gas Limited and the Maui pipeline). We have reviewed and support the submissions made by First Gas and its expert economists, Oxera.

Assuming a Regulatory Asset Base for First Gas of \$1 billion, the reduction in asset beta amounts to a fall in annual revenue of \$7.3 million. At the current WACC,<sup>1</sup> such a change would reduce the value of equity in First Gas by around \$100 million (or 18% of shareholder funds assuming the rate of leverage historically applied by the Commission of 44%).

FSI maintains that reducing the gas asset beta as the Commission proposes in the draft decision is commercially unreasonable, out of market, and will produce outcomes that are inconsistent with the purpose of Part 4 of the Commerce Act 1986. In this submission, we focus on the adverse consequences of the proposed material reduction in the gas asset beta from the perspective of an investor in First Gas and other regulated businesses. In particular, we analyse what the Commission should infer about the gas asset beta from the transaction values in our recent purchases of gas pipeline businesses in New Zealand.

**RAB multiples of close to 1 are less consistent with the purpose of Part 4 than the values observed in the recent gas transactions**

We understand that the Commission faces a difficult task in estimating the appropriate WACC. While the Capital Asset Pricing Model (CAPM) is a widely recognised analytical tool, many of its components are not readily observable and the theoretical assumptions behind the model do not always hold in real world markets. Hence, we understand why the Commission would apply reasonableness tests to its estimates (as it does in Section 7 of Topic Paper 4). We also appreciate that regulatory asset base (RAB) multiples, if appropriately interpreted, can be a

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<sup>1</sup> Cost of capital determination for customised price-quality path proposals made by First Gas Limited for gas transmission services [2016] NZCC 12

helpful benchmark for assessing the reasonableness of WACC estimates. While there are a range of factors that influence any transaction value, the allowed regulatory WACC is clearly important.

However, the evidence presented by the Commission on RAB multiples for the Vector Gas and Maui pipeline transactions shows that the Commission's proposal to reduce the gas asset beta is not reasonable. Instead of deriving comfort from the test, the result should have led the Commission to question the appropriateness of reducing the asset beta for gas pipelines.

The Commission applied the lower asset beta proposed in the draft decision and found that the RAB multiples for FSI's investment in the pipelines previously owned by Maui and Vector would be 1.00 and between 1.17 and 1.32, respectively. On these results, the Commission draws the conclusion that, since the RAB multiples are at least 1, the reduced asset beta is reasonable. The evidence presented in this submission leads to a different conclusion for two reasons:

- A RAB multiple of 1 is not an appropriate benchmark for the gas transmission and distribution businesses that we purchased. In our view, a RAB multiple of less than about 1.25 after adjusting for the proposed WACC should be of concern to the Commission that its WACC estimate is less than the minimum the market would expect.
- The observed difference in estimated RAB multiples for electricity lines businesses and adjusted RAB multiples for the gas transmission and distribution pipelines previously owned by Maui and Vector clearly signals a market view that the cost of capital for gas pipelines is persistently higher than for electricity networks. By reducing the gas asset beta, the implied RAB multiples from the recent gas transactions are lower than RAB multiples for regulated electricity networks and airports (see Table 24 of Topic Paper 4).

#### **Regulatory certainty and predictability are important in achieving the purpose of Part 4**

FSI is attracted to the stable and predictable regulatory environment that First Gas operates in. Having made substantial investments in regulated gas infrastructure in New Zealand, FSI is understandably keen to see a stable and predictable approach to estimating the regulatory cost of capital applied to gas pipelines to continue. Regulatory certainty is important to achieving the purpose of Part 4, and is the purpose of the IMs themselves.

FSI understands that regulatory certainty does not mean no change. Rather, any proposal to adjust important elements that determine regulated cash flows (such as the asset beta) will need to be based on strong evidence that the IM is no longer appropriate (such as being not fit for purpose, or being at odds with strong empirical evidence). We do not believe this is the case for the gas asset beta. We agree with the arguments put forward in the First Gas submission on cost of capital, supported by the Oxera report.

Further, the proposed change to key inputs like the asset beta have significant impacts on both the value of our investment, and on the incentives for further investments in New Zealand's regulated infrastructure that would be likely to enhance efficiency. Without evidence of offsetting benefits from lowering the gas asset beta (such as clear evidence of excessive profits at the current level), we strongly believe that the purpose of Part 4 and the purpose of the IMs

to promote regulatory certainty are better achieved by retaining the current gas asset beta of 0.44.

We see no evidence pointing to excessive profits being earned by gas pipeline businesses at the current regulated WACC. The empirical evidence of gas pipeline betas submitted by Oxera provides a best estimate of around 0.44 (the current level). This is confirmed by the fact that the RAB multiples for the recent gas pipeline transactions are consistent with the RAB multiples found in other regulated industries in New Zealand when an asset beta of 0.44 is used. As described in detail below, reducing the asset beta for gas pipelines to 0.34 (as proposed in the draft decisions) would result in the RAB multiples in the gas pipelines sector being well below the average observed in other regulated industries.

### **Structure of this submission**

The substantive content of this submission is presented in the following two sections. Section 1 provides our interpretation of the Commission's analysis of RAB multiples, explaining why (contrary to the Commission's draft decisions) the RAB multiples observed in the recent transactions support the current gas asset beta of 0.44. Section 2 then presents our views on why, in light of the evidence, the purpose of Part 4 and the purpose of the IMs to promote regulatory certainty are better achieved by retaining the current gas asset beta of 0.44.

## **1. Analysis of RAB multiples**

A RAB multiple is the ratio of the enterprise value of a business (market value of equity and net debt) to the value of the regulatory asset base. It is a measure of the 'premium' over the RAB that an investor is willing to pay to acquire an asset and the returns it generates.

Under any incentive-based regulatory regime, the RAB multiple should be expected to exceed 1. To put it differently, a RAB multiple equal to 1 means that investors do not expect to achieve or capture any efficiency gains or growth opportunities after acquiring the asset.<sup>2</sup> In this section of our submission we review the factors that usually explain the RAB multiple and discuss how these factors applied to our acquisition of the Maui and Vector assets. Much of the information and strategic direction explained below comes from our application to the Overseas Investment Office. We then analyse the RAB multiples presented by the Commission in Section 7 of Topic Paper 4.

### **1.1 Explanation of RAB multiples and Analysis of the RAB multiples presented by the Commission**

The Commission acknowledges that a range of factors other than the regulated cost of capital can drive the value of a regulated businesses above its RAB (see paragraph 614 of Topic Paper 4). However, the Commission then draws comfort from a RAB multiple of precisely 1.00 when estimating WACC for gas pipelines.

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<sup>2</sup> A RAB multiple of 1 could in theory also be achieved if the purchaser of regulated assets did not need to reflect the expected value of future cash flows into its purchase price – for example, if the process for the transaction was not competitive. As we explain in this submission, such a situation certainly does not reflect our experience bidding for regulated assets in New Zealand, where several bidders participated in the sales process for the assets.

Our experience is that there are a number of very important reasons why all transactions involving regulated assets are currently being undertaken at RAB multiples in excess of 1:

- The nature of the transaction
- The inherent logic of incentive regulation
- Growth potential
- Intrinsic value to investors.

The asymmetry of consequences in setting WACC also means that policy should aim to set WACC so that RAB multiples exceed 1 rather than use 1 as a benchmark of reasonableness. We find it inconsistent for the Commission to aim high when setting WACC (by using the 67<sup>th</sup> percentile of its range of WACC estimates), and then expect RAB multiples of 1.

### 1.1.1 The nature of the transaction

The specifics of each transaction can justify paying above RAB since additional value can be held in things like:

- **The value of existing and potential unregulated activities.** Since the RAB solely relates to the regulated arm of the business being acquired, an investor would be willing to pay above the RAB for the expected value of future returns from existing and/or potential unregulated activities. While the unregulated part of FSI's investment in Vector Gas is small, it is significant. Vector Gas came with operational capability as a system operator of other gas pipelines (including Maui Pipeline) and significant opportunities to apply this capability to other pipelines. FSI sees significant potential to develop this business, particularly given FSI's significant interests globally in gas pipelines, the scalability of this business, and the strategic alliance we have formed with OSD (an Australian expert in pipeline engineering, operations and maintenance).
- **Intangibles.** Apart from the physical assets, it is typical in acquisitions like First Gas that the buyer is also acquiring the people, systems, intellectual property, contracts and other intangibles. These are valuable in generating future revenues and potential outperformance to regulatory assumptions (for instance in gas distribution under a price cap regime).
- **Whether the investor acquires control of the regulated business.** It is well-understood in mergers and acquisitions literature that the acquisition of control—especially 100 percent of control—generally comes with the payment of a control premium. Between 1978 and 2009, the average control premium for US acquisitions of publicly listed firms was 43.3 percent.<sup>3</sup> While we acknowledge that the control premium for a regulated business would generally be worth less due to a ceiling on the overall profitability, we still perceive real value in control. Even if the bidder used exactly the same WACC as the Commission, a RAB multiple of 1 would be almost inconceivable given the circumstances of the transactions.

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<sup>3</sup> See Gaughan, P. (2010) 'Mergers, Acquisitions and Corporate Restructurings', accessible at [this link](#), at p.572.

It is difficult to be definitive about the size of these factors. Observing comparable transaction multiples, we typically see RAB multiples between 1.2 to 1.5, in situations where relevant regulators take different approaches to setting WACC. This suggests that buyers do allocate value to the above factors. Given the wide range of regulatory settings, there is no logical basis to consider that the WACCs for all such businesses were too high.

### 1.1.2 The inherent logic of incentive regulation

Incentivising regulated businesses to generate cost savings for consumers requires regulated businesses to be able to share in the efficiency gains they can generate. As the Commission has recognised in the past,<sup>4</sup> the extent to which an investor expects to be able to generate efficiencies justifies paying above a RAB multiple of 1.

The difficulty in setting allowances to enable regulated businesses to recover their efficient costs while at the same time incentivising further efficiency has always been a challenge in regulating natural monopolies. The Commission's approach to this challenge is one FSI supports. That approach is to set forward-looking cost allowances periodically at five-year intervals. This provides regulated businesses with the opportunity to outperform regulatory cost allowances and share in the efficiency gains from doing so during the relevant regulatory period. The supplier's share of efficiency gains provides the incentive to reveal efficient costs. At the next regulatory reset efficiency gains will be passed on to consumers—providing consumers with the lowest cost service over the long-term.

In an acquisition context, two forms of outperformance through efficiency are possible:

- **Outperformance through merger efficiencies.** Utilising experience and combining businesses that have synergies can reduce the costs of service in ways that previous owners of regulated businesses have been unable to achieve
- **Outperformance through other improvements in operations year to year.** Through the combination of experience and the application of new technological, managerial, and operational insights, regulated businesses can reduce costs in ways that previous owners have been unable to achieve.

Both forms of outperformance are relevant to FSI's acquisition of Vector Gas and the Maui pipeline. FSI's investments have brought New Zealand's gas transmission pipelines under common ownership for the first time. Through common ownership, FSI expects to be able to generate efficiencies, although they will take time to realise. Since the Commission maintains that regulated businesses should retain merger efficiencies in the relevant regulatory period,<sup>5</sup> part of the reason that FSI was willing to invest on the basis of a RAB multiple greater than 1 for both businesses was the belief that FSI would be able to share in the efficiencies it expects to be able to generate.

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<sup>4</sup> Commerce Commission 'Amendment to the WACC Percentile for Price-Quality Regulation: Reasons Paper' 30 October 2014, accessible at [this link](#).

<sup>5</sup> See, for example, Commerce Commission 'Input Methodologies for Gas Pipeline Services: Final Reasons Paper' 2 December 2010 at para 3.3.28, accessible at [this link](#).

### 1.1.3 Growth potential

To the extent a business has growth potential and can share in the gains from growing the business, this provides an additional source of value justifying a RAB multiple above 1. This logic applies to FSI's investments in both gas transmission and gas distribution—but in different ways.

**FSI benefits directly from growing demand for gas distribution, since it is subject to a weighted average price cap.** Given the relatively low penetration rate for gas distribution, we see great potential to expand the gas distribution network through new capital contribution policies and a dedicated and focused marketing program communicating the value of gas for customers. Our view is that under previous ownership full advantage was not taken of these opportunities in the past due to capital constraints. First Gas is planning to increase its total capital expenditure by approximately 30 percent over the next 10 years (a capital outlay of more than \$80 million), a significant portion of which is attributable to distribution network expansion and infill connection. The likelihood of expanding the RAB (such as re-investing in the distribution network or other large projects) also improves the ability of buyers like FSI to pay a premium above RAB, given any such re-investment into the business will be made at 1.0 RAB, allowing for the multiple to be “averaged down” over time.

**FSI benefits from growing demand for gas transmission, since it reduces risk and increases opportunities to provide unregulated services.** While the gas transmission assets FSI invested in are subject to a revenue cap (and will therefore not be directly subject to demand risk), there are still significant benefits from growing demand for gas transmission. Increasing gas use, especially for users that are the backbone of the New Zealand economy like the dairy sector, can help decrease the risk of asset stranding and make our business more resilient. Increasing customer connections also offers the opportunity to grow the unregulated part of the business by increasing the number of commercial relationships that we have.

**FSI benefits from investing new capital to maintain the networks.** The nature and age of the networks means that they require a continuous program of capital investment into RAB to maintain system reliability and improve the service level provided to customers. A current example of such an upcoming capital requirement is the need to relocate both the Vector and Maui transmission pipelines in response to coastal erosion at Whitecliffs. Investing in projects such as this that were known and quantifiable during the acquisition due diligence phase contribute to the economics of paying a premium over RAB.

### 1.1.4 Intrinsic value to the investor

Ultimately, the market price of a transaction is influenced by the particular investor, and that investor may derive specific sources of value from the transaction. Since the WACC is not investor-specific and is designed to compensate an investor for their cost of capital within an efficient portfolio, the following specific sources of value can justifiably lead to a RAB multiple above 1:

- **Scarcity value.** Opportunities to deploy capital in high quality, core regulated infrastructure assets are rare and highly competitively contested. This may create a

scarcity premium for this type of asset for certain investors. The Commission may think that opportunities to expand the RAB simply provide the WACC and therefore do not hold additional value, but for investors like FSI, there are relatively few quality investment opportunities and the bid risks and costs involved in pursuing them are high.

- **Capital availability.** Access to capital differs among investors resulting in differential valuation of growth opportunities. FSI has access to capital which it is motivated to deploy resulting in it attributing a higher value to opportunities to deploy new capital than many other investors in the sector. Having the opportunity to place an additional \$80 million of capital into the RAB is valuable to FSI.
- **Investors having a greater risk appetite than the benchmark efficient capital structure.** For example, a more aggressive capital structure with greater debt may lead to higher equity returns (albeit more volatile). FSI has accepted higher gearing in First Gas than the capital structure assumed by the Commerce Commission. It was able to secure competitive lending terms through its strong relationships with lenders, as well as the benefits of the combined business of Vector Gas and the Maui pipeline. This contributes to the premium paid above RAB.
- **Strategic value.** A fund may attribute value to an acquisition for the benefit of its incumbent position in the market which may lead to further investment opportunity. In this case, FSI believed that the acquisition of Vector Gas would significantly better position it to acquire the Maui pipeline which was subject to an almost simultaneous but separate competitive sales process. This indeed proved to be the case with the successful acquisition of the Maui pipeline by First Gas on 15 June 2016.
- **Portfolio benefits.** An investment fund may be underweight in a particular sector or country. In FSI's case, First Gas represents its first significant investment in New Zealand, which brings diversification benefits to its portfolio.

### 1.1.5 Conclusions on benchmark RAB multiple

As an investor, FSI had legitimate commercial reasons to pay a multiple of the RAB for the gas transmission and distribution assets. The reasons for the multiple are also the reasons why our purchase of Maui and Vector assets was of significant benefit to New Zealand. We are bringing a renewed focus on growth and efficiency to the operation of the gas transmission network and the central North Island gas distribution network.

We believe that ignoring these reasons and using a RAB multiple of 1 as the benchmark for checking the reasonableness of proposed changes in WACC has the effect of removing a legitimate source of potential value to investors. This is not in the long-term interests of consumers. In effect, calibrating WACC to produce the RAB multiple of 1 (or only slightly above 1) implies that investors would have no ability to capture the gains that they legitimately expect to earn under the New Zealand regulatory framework and share these with customers over time.

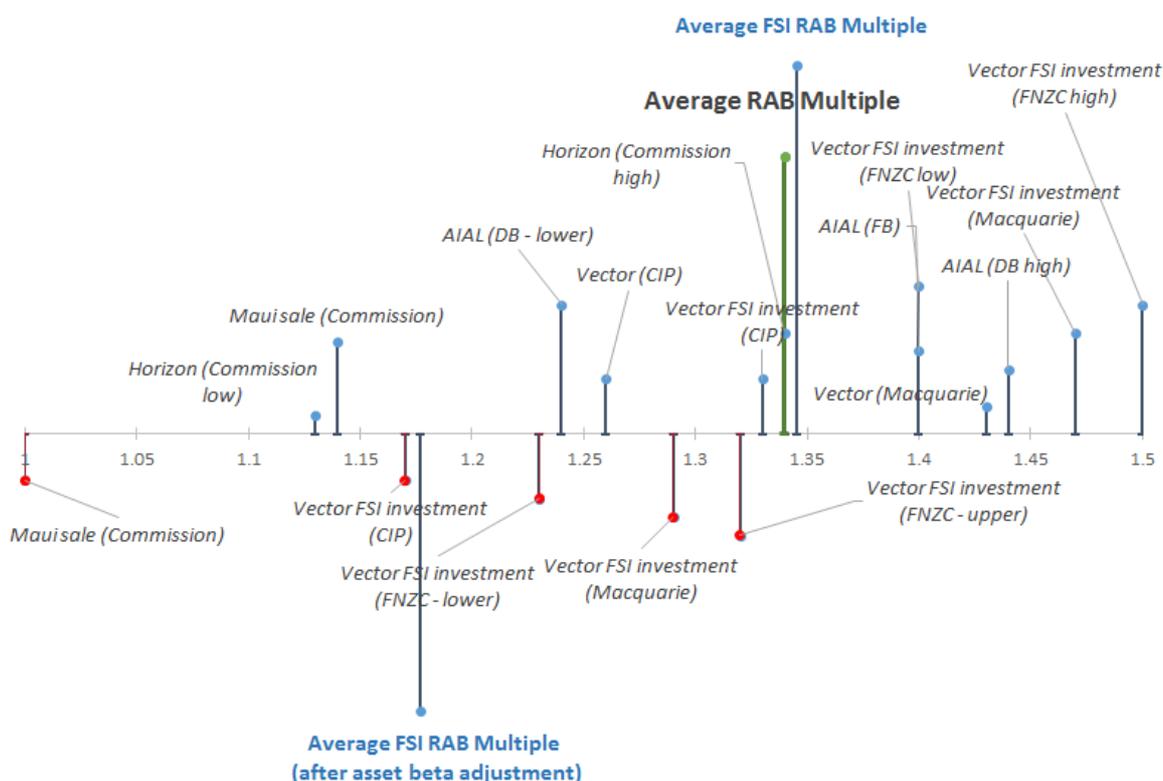
## 1.2 Comparisons with other transaction multiples

The Commission's own analysis demonstrates both the factors discussed above and the out of market consequences of reducing the asset beta for gas pipelines. The top half of Figure 1

shows the distribution of RAB multiples that the Commission has found (applying the current IMs). All transactions are being undertaken at RAB multiples above 1, and the average RAB multiple is 1.34. We estimate the average RAB multiple for the gas pipelines transactions as being 1.35,<sup>6</sup> very close to the average for all of the regulated businesses in the Commission’s analysis. This evidence firmly supports our explanation of the factors that increase RAB multiples.

The bottom half of Figure 1 shows the RAB multiples implied by the Commission’s proposed reduction in the asset beta for gas pipelines. The reduction in asset beta clearly introduces a significant divergence between the RAB multiple for FSI’s investments and the cluster of comparable transactions. The average estimated RAB multiple for the gas transactions (using the approach set out in footnote 8) becomes 1.18. If there was no difference in the cost of capital for gas pipelines and electricity distributors, the Commission ought to expect to find that the reduction in gas asset beta brings FSI’s investments back into the cluster of comparable transactions, which is clearly not the case.

**Figure 1: The Commission’s Analysis of RAB Multiples (Topic Paper 4, Table 24 & 25)**



Notes: AIAL = Auckland International Airport Limited, CIP = Craigs Investment Partners, DB = Deutsche Bank, FB = Forsyth Barr, FNZC = First New Zealand Capital, FSI = First State Investments

<sup>6</sup> This estimate is obtained by taking a simple average of the 3 investment analyst estimates of the RAB multiple from the Vector Gas transaction (1.43), and then weighting that RAB multiple with the estimated RAB multiple from the Maui pipeline transaction (1.14), assuming Vector Gas and Maui RABs of \$700 million and \$300 million, respectively.

While the factors discussed in section 2.1 above are specific to particular businesses and therefore vary (which is why there is a distribution of RAB multiples in the top half of Figure 1), the RAB multiples of FSI's investments—particularly in the Maui pipeline—fall well below the cluster. This demonstrates the overall unreasonableness and out of market consequences of reducing the asset beta for gas pipelines.

### 1.3 Asymmetry of consequences

As a final point, we highlight that the Commission is proposing to reduce WACC when the consequences of getting WACC wrong are asymmetric:

- **If the WACC is too high**, this leads to monopoly rents and some wealth transfers
- **If the WACC is too low**, it reduces the incentives for investment, leading to lower service standards with more significant negative consequences for gas users and the wider economy.

The Commission already accepts this in setting the WACC at the 67<sup>th</sup> percentile of the WACC range.<sup>7</sup> Since the same logic applies here, the Commission should be cautious in the approach it takes to WACC, and a RAB multiple greater than 1 suggests that the balance may well be right (and that a RAB multiple of or close to 1 is likely to be too low). It seems logically inconsistent to consciously “aim high” when setting WACC, and yet expect to observe RAB multiples that are equal to 1.

## 2 The purpose of Part 4 and regulatory certainty

In reviewing the IMs, the Commission is looking for ways to better achieve the purpose statement of Part 4 of the Commerce Act. The Commission has stated that it will only make changes where the current IMs are not fit for purpose, and a better approach can be found.

### The purpose of Part 4 would not be achieved by reducing the gas asset beta

The Commission's decision-making framework for the IMs review places an onus on any party (including the Commission) wanting to change the IMs to demonstrate that the change would better meet the purpose statement of Part 4 of the Commerce Act (in section 52A). We have carefully analysed the proposed change to the gas asset beta against section 52A and cannot see how the material reduction proposed better serves the stated purpose:

- **A material reduction in the gas asset beta would weaken incentives to invest in regulated industries (section s2A(1)(a)).** As investors, FSI would be less likely to allocate capital to our gas pipeline businesses in New Zealand as a result of the proposed change as the return on that capital would not be sufficient to compensate for the perceived risk which is further elevated through the regulatory uncertainty arising from such a material adjustment. We also believe other investors would have concerns arising from this lack of stability in regulatory settings making allocations of capital to regulated assets in New Zealand more challenging and more expensive in the future. The lack of stability in regulatory settings and significant lower overall expected return that the reduction represents would also make us less likely to re-invest

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<sup>7</sup> Commerce Commission 'Amendment to the WACC Percentile for Price-Quality Regulation for Electricity Lines Services and Gas Pipeline Services: Reasons Paper', accessible at [this link](#).

in First Gas, or invest in further regulated assets in New Zealand, and we strongly suspect that other investors would have similar concerns. As a new owner, we are particularly keen to invest in expanding the gas networks to promote gas uptake in New Zealand. However, we will only invest if the investment provides an acceptable and predictable return for our investors. The proposed decision by the Commerce Commission fails to achieve this.

- **A material reduction in the gas asset beta would weaken incentives to seek out efficiency gains, particularly through the merger of regulated businesses (section 52A(1)(b)).** The transactions that created First Gas represent the most significant merger of regulated businesses since Part 4 was enacted. We saw value in bringing the gas transmission assets of Vector and MDL under common ownership; a view that is widely held in the gas industry. Yet (as we explain in this submission), by treating the adjusted RAB multiple of 1.00 as reasonable, the Commission's proposed reduction in gas asset beta implies that no efficiency gains should have been factored into the price paid for the Maui pipeline. There are also weaker incentives to seek out efficiency gains (and share these with consumers) over the long run, given the benefit that this brings to the owner will be eroded at the next reset if the regulator reduces the asset beta to bring the RAB multiple back to 1.
- **There is no evidence pointing to excessive profits being earned by gas pipeline businesses at the current regulated WACC (section 52A(1)(d)).** Firstly, we are not aware of any complaints from our customers about excessive profits. Secondly, the empirical evidence of gas pipeline betas submitted by Oxera provides a best estimate of around 0.44 (the current level). This is confirmed by RAB multiples for the recent gas pipeline transactions that are consistent with the RAB multiples found in other regulated industries in New Zealand when an asset beta of 0.44 is used. Further, as in the case of our recent acquisition of Vector Gas Limited and the Maui pipeline, these types of businesses are acquired in highly competitive bid processes which result in transaction pricing compressing returns to investors and therefore the absence excessive profits for the investor.

The decision-making framework for the IMs review explicitly prioritises certainty, since the purpose of the IMs is to promote certainty for regulated suppliers and customers (section 52R). We strongly submit that significantly lowering the asset beta for gas pipelines now would reduce certainty given that the empirical evidence shows that asset betas have remained relatively constant since the IMs were first determined in December 2010.

## Reducing the gas asset beta would be contrary to the decision-making framework for the IMs review

The decision-making framework for the IMs review lists a number of questions (at paragraph 11) that the Commission might take into account when evaluating possible changes. In commenting on Dr. Lally’s “Review of WACC Issues” paper (25 February 2016) we evaluated a possible decision to change the gas asset beta against those questions.<sup>8</sup> We are interested to better understand the Commission’s views on how changing the gas asset beta as part of this IMs review would fit with its own decision-making framework.

As shown in Table 1 below, we firmly believe that a reduction in the gas asset beta would be contrary to the decision-making framework for the IMs review.

**Table 1: Responses to Questions Posed in Decision-making Framework**

Questions in Decision-making Framework	FSI Response on Gas Asset Beta
What was the IM attempting to achieve, either on its own or as part of the IMs as a package?	The cost of capital IMs aim to reflect the systematic risks facing regulated industries in New Zealand by estimating a forward-looking asset beta for each industry
Is the objective of the IM still valid and consistent with 52A, in light of the type of regulation where the IM is applied?	Yes
Has the relevance of the policy intent been questioned (either by stakeholders, the Court or the Commission)?	<ul style="list-style-type: none"> <li>▪ Neither the policy intent or application of the asset beta uplift was questioned during the merits review by stakeholders or the High Court<sup>9</sup></li> <li>▪ The only party that mentioned the gas asset beta in the IMs review problem definition phase was Transpower’s experts (Frontier Economics) in support of an estimate of 0.44 (while noting the limitations of comparable company analysis)</li> </ul>
Have external circumstances changed in a way that disrupts the assumptions underlying the original policy decision and therefore would cause a need for a change to the policy behind the IM?	No. There has been no change in circumstances between when the gas asset beta was first estimated in the 2010 IMs and today. As discussed in Oxera’s expert report, market estimates of beta and gas industry changes support an estimate of the gas asset beta of at least 0.44
Is the IM still required or could the policy intent be achieved without the IM?	We consider that the IM is still required and there are no better ways to achieve the policy intent

<sup>8</sup> See First State Investments, Comments on Professor Lally’s Review of WACC Issues, 24 March 2016, Table 3.1

<sup>9</sup> The asset beta uplift for gas pipelines was not one of the four areas for review of WACC recommended by the High Court. See Commerce Commission “Input Methodologies Review: Invitation to contribute to problem definition”, 16 June 2015, at paragraph 255

Is there other evidence that suggests that the original policy is no longer promoting 52A?

No. The original policy has facilitated investment and efficient mergers in the gas pipeline sector—which will ultimately benefit consumers. There is no evidence of excessive profits in the sector, and the observed RAB multiples for gas pipelines are consistent with those in other regulated sectors

### 3 Conclusion

Having recently made substantial investments in regulated gas infrastructure in New Zealand, we place a high value on commercially reasonable, stable and predictable approaches to estimating WACC. We welcome the Commission applying a market reasonableness test to its WACC calculations, but are concerned that in the absence of the full context of the facts and judgements exercised by the investor at the time of making the investment commitment, there is a risk that the Commission misapplies its own test and that it reaches a conclusion on reasonableness which is not supported by the evidence.

In fact, the evidence presented by the Commission itself strongly supports the beta differential being applied to gas transmission and distribution businesses and confirms that removing the differential would be out of market and unreasonable.

We urge the Commission to heed the results of carefully applying its own reasonableness test and to retain an asset beta for gas distribution and transmission businesses of 0.44. This would preserve the legitimate expectations of investors under New Zealand's incentive-based regulatory regime.

Thank you for the opportunity to make this submission. We look forward to continuing our engagement with the Commission on developing and applying the regulatory settings for gas pipelines in New Zealand.

Yours sincerely



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