



24 March 2016

Keston Ruxton
Manager, IM Review
Commerce Commission
Wellington

By email: regulation.branch@comcom.govt.nz

Dear Keston

Asset beta adjustments and Black's SDR

We welcome the opportunity to respond to Dr Lally's expert advice on asset beta adjustments and Black's simple discounting rule (SDR), along with the accompanying suite of material released on 29 February.

We appreciate the update and clarification of the Commission's process for review of the Input Methodologies (IMs) and cost of capital. The main points that we make in this submission are:

- We agree with the Commission that there is no need to review the form of control for Transpower.
- We agree with Dr Lally (and the Commission) that no changes should be made to the asset beta for (theoretical) differences in risk between a revenue and a price cap.
- We also agree with Dr Lally that Black's SDR should not be applied, for either price control or information disclosure purposes.

ASSET BETA UNDER PRICE AND REVENUE CAPS

We agree with Dr Lally that while theoretically price-capped businesses may have higher asset betas than both ROR regulated and revenue-capped businesses, there is no empirical study that provides a clear conclusion on the effect of regulation on beta. Accordingly, we agree with Dr Lally's recommendation that the asset beta for regulated suppliers under a price cap also be applied to regulated suppliers under a revenue cap.

This is consistent with Transpower's earlier submissions. In particular we refer the Commission also to references to the Cambridge Economic Policy Associates' report to the Commission: International comparison of regulatory precedent on the weighted average cost of capital, December 2015. This has relevant material, not cited by Dr Lally, on asset beta under price and revenue cap regulation.

We consider it useful that the Commission has outlined, as an "emerging view", agreement with Dr Lally's assessment on asset beta, "and do not believe that there is sufficient empirical evidence to suggest that we should make an adjustment to asset beta for form of control".¹ This should help interested parties better understand the trade-offs between a revenue cap and a price cap when submitting on whether the form of control should be changed.

¹ Commerce Commission, Input methodologies review: Emerging views on form of control, 29 February 2016, paragraph 9.

We also consider it useful that, while the Commission is proposing the form of control for EDBs be switched from a price cap to a revenue cap, it has clarified “We are not considering changing the form of control for Transpower because the regime that Transpower is subject to is unique and there have been no issues raised with it.”² We agree that there is no reason to consider reviewing the form of control Transpower operates under and confirming this position removes a potential source of uncertainty. The draft view that EDBs should be switched to a revenue cap, and GTBs should remain on a revenue cap, reinforces the desirability of Transpower remaining under a revenue cap.

BLACK’S SIMPLE DISCOUNT RULE (SDR)

We agree with Dr Lally’s observation that Ireland Wallace’s paper on application of Black’s SDR “is limited to arguing that Black’s model can be used for valuation purposes, and has nothing to (directly) say about its application to regulation. Ireland Wallace (2015, section 6) imply that Black’s model has application to regulation, but provide no details on this”.³

It is far from clear how MEUG or Ireland Wallace envisaged Black’s SDR be used as a “cross-check” against the CAPM WACC.

While Dr Lally himself goes on to detail how Black’s SDR could potentially be applied for price control, we agree with the significant limitations he identified in attempting to do so:⁴

- “the model requires that the output of the regulated business be linearly related to the market return and no evidence has been presented on this matter”.
- “the regulator would have to estimate the probability distribution for output without assistance from the regulated business, because the latter would have a vested interest in the result”.
- “a process for estimating the crucial parameter in Black’s model that is referred to by Ireland Wallace would underestimate that parameter, possibly to a very significant degree”.

The last point, which Dr Lally usefully illustrates with a quantified example,⁵ is particularly concerning as it suggests use of Black’s SDR would undermine the ability of regulated suppliers to recover the cost of their prudent and efficient investment (“reasonable investor expectations”).

Dr Lally’s paper helps confirm our prior view that Black’s SDR provides limited useful information (if any), and the problems and limitations of Black’s SDR mean it should not be applied or considered further.

Please let me know if you have any queries regarding our submission. No part of the submission is confidential.

Yours sincerely



Jeremy Cain
Regulatory Affairs & Pricing Manager

² Commerce Commission, Input methodologies review: Emerging views on form of control, 29 February 2016, paragraph 6.

³ Dr Martin Lally, REVIEW OF WACC ISSUES, 25 February 2016, page 30.

⁴ Dr Martin Lally, REVIEW OF WACC ISSUES, 25 February 2016, page 4.

⁵ Dr Martin Lally, REVIEW OF WACC ISSUES, 25 February 2016, page 34.