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Commerce Commission
Wellington

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

Dear Commission

Comments on Dr Lally's expert advice, 25 February 2016

Thank you for the opportunity to provide comments on Dr Martin Lally's paper, *Review of WACC Issues 25 February 2016*. It is positive to see the Commission engaging early on these issues with Dr Lally.

Overall, we are very encouraged by the balanced consideration of topics and submissions in this report and the addressing of both theoretical and evidence based views on subjects. This paper provides a useful platform for considering changes to the relevant IMs. We have provided comments below on specific topics, in summary:

1. We agree that the uplift in asset beta for gas pipeline companies is no longer required.
2. We believe Dr Lally's theoretical explanation of how asset beta should change with form of control provides enough grounds to for the Commission to make an adjustment to cost of capital with a form of control change.
3. We still see merit in considering Black's Simple Discount Rule further and encourage the Commission to discuss this and Dr Lally's comments further with the authors of research in this area.

We would be happy to discuss these further with the Commission.

Asset beta adjustment for gas pipeline businesses

Contact agrees with Dr Lally's conclusion in this area:

> *"..I do not favour a differential between the asset betas for the New Zealand electricity and gas businesses in the present regulatory situation"*[1]

As outlined in our earlier submission on cost of capital[2] our own analysis could find no support for the higher gas beta and as such we recommended aligning the beta for electricity distribution businesses (EDB's) and gas pipeline businesses (GPB's). We have considered the additional work and analysis completed by Dr Lally and other submitters and based on this evidence continue to support our original and Dr Lally's recently published conclusions on the subject.

Adjustment for form of control

We note in this section that Dr Lally has made two related conclusions, first regarding the asset beta to be used with different form of control and second regarding the comparator set to be used for wider cost of capital analysis. We comment on each in turn below.

Adjustment to asset beta for change in form of control

We agree with Dr Lally and other submitters that it is difficult drawing clear conclusions from empirical studies on this topic. However, we are pleased to see the theoretical conclusion that there is a risk trade-off being made between consumers and default price-quality path (DPP) businesses with form of control, and in theory the lower risk revenue cap should lead to a lower asset beta.

> *"I recommend using the same asset beta for the revenue-capped as for the DPP (price-capped) businesses. This recommendation matches the view expressed in 2010 by the Commerce Commission. Nevertheless, my recommendation arises in spite of my belief that there is very likely to be a beta margin (of unknown degree) for price-capping over revenue capping, because those businesses subject to it bear an additional source of risk (output) that would elevate beta."*[3]

In the Commission's previous decisions theoretical adjustments have been made to numbers in spite of evidence[4]. We see this situation as no different in principle to those. The change of risk is clear and even if a change in asset beta cannot be quantified, this should be considered as part of the Commission's overall thinking about appropriate cost of capital.

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[1] Lally, M., 25 February 2016. *Review of WACC Issues.* (http://comcom.govt.nz/dmsdocument/14108). Page 9

[2] http://comcom.govt.nz/dmsdocument/14066. Page 6

[3] Lally, M., 25 February 2016. *Review of WACC Issues.* (http://comcom.govt.nz/dmsdocument/14108). Page 4

[4] For example Para 6.5.29 of the 2010 reasons paper describes how theoretical adjustments were made in spite of contrary evidence found by the Commission. See: http://comcom.govt.nz/dmsdocument/6499, page 161

Selection of comparable companies

Dr Lally has raised the important consideration of appropriate comparator companies for use in the cost of capital IMs. While we understand these comments are in relation to the above form of control analysis, we believe a wider review of the comparable companies is warranted before making such one off adjustments. The Australian Energy Regulator (AER)[5] has provided extensive analysis and commentary on their concerns with the use of US based comparators and we have provided our own analysis on this topic in our prior submission[6]. We agree with Dr Lally that form of control should be a consideration in choosing appropriate comparators, but this is only one of many considerations that needs to be made in such analysis.

Black's Simple Discounting Rule

Our support for investigating Black's Simple Discount Rule (BSDR) as a cross check to SBL-CAPM has been driven by both:

1. The benefits of having a cross check to help with understanding and checking of results; and
2. The fact that BSDR uses a different approach to SBL-CAPM, focusing the analysis on cash flow risk, not beta estimation

All cost of capital analysis requires judgement and in theory if different approaches are based on sound theory and inputs, they should give the same answer. Dr Lally has raised some very useful concerns for application of BSDR, but has also noted that it could be applied. As per our prior submission, we encourage the Commission to use this information to discuss the potential merits and application of BSDR with the authors of studies in this area[7]. We expect the authors have considered the pros and cons of the model in detail, and would be best placed to consider application or adaptation of the model for these circumstances. The value of a cross-check should not be underestimated.

Thank you again for the opportunity to submit comments on this paper. We would be happy to discuss these comments further.

Yours sincerely

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[5] AER, *Explanatory statement to the rate of return guideline (appendices)*, December 2013, pp. 62–63, AER, *Preliminary Decision. Jemena Distribution Decision 2016 to 2020. Attachment 3 – Rate of Return*. October 2015 page 3-456-468.
[6] http://comcom.govt.nz/dmsdocument/14066.
[7] Claudio F. Loderer, John B. Long, and Lokas Roth