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Keston Ruxton
Manager, Input Methodologies Review
Regulation Branch
Commerce Commission

25 August 2016

Dear Keston

Re: Cross-submission on Input Methodologies Review: Cost of Capital

First State Investments (FSI) is pleased to make this cross-submission on the Commerce Commission's (Commission) review of the Input Methodologies (IMs) for determining the weighted average cost of capital (WACC). As we stated in our submission, FSI is deeply concerned that the Commission proposes to reduce the asset beta that applies to gas pipelines without evidence to support such a change.

We have reviewed and support the cross-submission made by First Gas. In this cross-submission we respond to submissions made by other parties on the two issues that were central to our submission:

- First, that the RAB multiples observed from recent gas pipeline transactions are consistent with RAB multiples in other regulated sectors (so a lower gas asset beta is inconsistent with the evidence on RAB multiples); and
- Second, that regulatory certainty and predictability will be better achieved by retaining the current gas asset beta of 0.44.

The Major Gas Users Group (MGUG) was the only other party that commented on the Commission's analysis of RAB multiples (at paragraphs 48-55 of its submission). MGUG provides the view that RAB multiples are solely determined by any difference between the regulatory WACC and an investor's actual cost of capital. We strongly disagree, and refer the Commission to the numerous other specific factors clearly set out in our submission that encourage a buyer of regulated assets to pay more than RAB. Our submission highlighted that during pre-acquisition due diligence of the businesses we purchased, FSI identified a number of opportunities to which it was willing to attribute value. These included one-off items, unregulated opportunities, as well as sources of value unique to FSI/First Gas. These factors all had a bearing on FSI's willingness to pay a premium to RAB. This point does not seem to be understood by MGUG in its submission (at paragraph 39).

We also maintain that regulatory settings encouraging transactions at above regulated asset values are in the long-term interests of consumers. This differs from MGUG's view that regulatory settings that result in any RAB multiple of greater than one are "demonstrably excessive" (which flows from MGUG's view that RAB multiples are driven solely by WACC). If Part 4 aims to promote efficient mergers and acquisitions of regulated businesses, then the regulatory settings need to encourage parties that can own and operate the assets most efficiently to bid for regulated assets. In the case of our purchases of gas pipelines in New Zealand, this required us to value growth opportunities, efficiencies, unregulated revenues, and factors that are unique to FSI as an investor – all of which will benefit consumers over time through the regulatory price-quality resets and through enhanced or expanded services.

FSI has shown a positive intention to invest further in the First Gas business to maintain, enhance and grow its services where it believes that it is investing in a stable regulatory environment. On the issue of regulatory certainty and predictability, we were pleased to see that parties that are not directly affected by the proposed reduction in asset beta for gas pipelines support our position.

- We agree with former Commissioner Pat Duignan that the circumstances surrounding the Commission's draft decision are unusual in light of the Commission's expert adviser reporting errors in his earlier advice on why gas and electricity betas may differ. The former Commissioner's submission highlights the need for credible, international experts to help overcome this problem and provide a robust interpretation of empirical beta estimates for comparable companies. We agree that this would help to build greater confidence in decisions on asset beta.
- We also agree with Aurora that "the Commission may want to err on the side of providing or retaining a higher gas beta, even if the evidence on the matter is limited". Our understanding of the framework for reviewing the IMs is that changes will only be made where a problem has been identified with a current IM. At a minimum, we would expect such a problem definition to include evidence that market-derived estimates of gas pipeline asset betas have fallen since the IMs were determined. In fact, the reverse is true – gas pipeline betas have increased since 2010.

Thank you for the opportunity to make this cross-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

Gavin Kerr
Director
First State Investments