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Dear Mr Phillips

## **RECOMMENDATIONS IN THE ALLEN CONSULTING GROUP REPORT ON PROXY BETAS**

I refer to my conversations with Messrs Griffin and Walsh and note my earlier advice on this matter. You have asked for clarification of the advice to the Commission on the selection of a proxy beta value for regulated Australian gas transmission activities that was included in the report I co-authored entitled Empirical Evidence on Proxy Beta Values for Gas Transmission Activities (July 2002, the Allen Report). Clarification in particular is sought on the observations that were made in the Allen Report about the quality of the empirical evidence available on the proxy beta for regulated Australian gas transmission activities at that point in time and the consequent observations made about the extent of reliance that should be placed upon that evidence compared to other information on beta values, such as the assumptions employed by regulators in relevant recent decisions.

A caveat to this clarification is that the purpose of the report referred to above was to provide the Commission with empirical evidence that it could draw upon when deriving a proxy beta for the pipelines that it regulates across Australia.<sup>1</sup> Consistent with this, the particular circumstances of individual pipelines were not examined, and specific recommendations for individual pipelines were not provided.

Regarding the quality of the empirical evidence that was available at the time of the preparation of the report, the Allen Report did caution against the Commission placing *exclusive* reliance (or weight) on the empirical evidence on betas that it had compiled. The reasons for cautioning against exclusive reliance on that evidence flowed from a concern about the statistical precision of those beta estimates and a concern about a possible bias in the betas derived for foreign firms, coupled with a concern about the substantial reduction in the estimate of the cost of capital for regulated gas transmission entities that the use of this empirical information would imply. The relevant text from the body of the Allen Report is reproduced below (footnotes omitted).<sup>2</sup>

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<sup>1</sup> The Allen Consulting Group, Empirical Evidence on Proxy Beta Values for Gas Transmission Activities, Report to the Australian Competition and Consumer Commission (the Allen Report), July 2002, p.1.

<sup>2</sup> Allen Report, p.42. Substantially similar comments were made in the report overview (pp.5-6).

Exclusive reliance on the latest Australian market evidence would imply adopting a proxy equity beta (re-levered for the regulatory-standard gearing level) of 0.7 (rounded-up). Moreover, regard to evidence from North American or UK firms as a secondary source of information does not provide any rationale for believing that such a proxy beta would understate the beta risk of the regulated activities. Rather, the latest evidence from these markets would be more supportive of a view that the Australian estimates overstate the true betas for these activities.

That said, however, we would caution against exclusive reliance upon the latest market evidence at this point in time.

To date, most Australian energy regulators have used a proxy equity beta in the range of 1 (for the regulatory-standard gearing level of 60 per cent debt-to-assets) when assessing or setting regulated charges, and a substantially higher assumption has been adopted in a number of decisions (including those of the Commission). The use of a proxy beta of 0.7 would represent a substantial reduction in the estimates of the costs of capital compared to the assumptions previously adopted. While such a revision would be warranted in the face of reliable, objective evidence, it cannot be concluded definitively that this quality of evidence exists at this time.

First, the primary source of evidence – which derives from the listed Australian entities – consists of a group of only four firms. Moreover, only two of the firms have been in existence for long enough to permit the AGSM's-preferred four years of observations to be used, with the beta estimate of one of these – the Australian Pipeline Trust – being based upon only 21 observations (just above the cut-off that the AGSM Risk Management Service applies for providing beta estimates).

Secondly, we are concerned about the magnitude of the beta estimates derived for firms operating in other countries. The re-levered equity betas for the US firms, in particular, are substantially lower than the estimates that have been obtained from past time 'sampling windows'. It could be hypothesised that the recent events on US share markets – such as the large surge in the values of high-technology stocks and then their subsequent fall – may have affected the beta estimates, and which may have biased the estimate of the forward-looking beta risk of these firms if those events were not considered by investors to be normal events. However, it is impossible to prove or disprove such a conjecture.

In light of these concerns with the available empirical information and the significance of the assumption adopted for the proxy beta for a regulated entity, the Allen Report recommended that the Commission apply a degree of 'inertia' to the judgement it reaches on the proxy beta for the regulated activities of Australian gas transmission entities. The relevant text from the Allen Report is reproduced below.<sup>3</sup>

Accordingly, while it inevitably is a matter for the Commission to decide how it exercises its discretion, it is recommended that, in the near term, it adopt a conservative approach, and not assume a proxy equity beta that is too far from the range of previous, relevant regulatory decisions. As noted above, these decisions typically have assumed a proxy beta (for the regulatory standard gearing assumption) of around 1. That said, this report has demonstrated that no implication can be drawn from current market evidence that the proxy betas that Australian regulators have adopted are likely to understate the 'true' beta – rather, as noted above, the current evidence suggests regulators systematically have erred in the favour of the regulated entities.

It would be consistent with the advice in the Allen Report for the Commission to select a proxy beta value that was a weighted average of that implied by current Australian market evidence (0.7) and the proxy betas adopted in other decisions by Australian energy regulators (including the Commission's previous decisions), with the weights a matter for the Commission's judgement. It would be incorrect to interpret the Allen Report as advising the Commission not to place any weight on the empirical evidence on the proxy beta for regulated Australian gas transmission activities that was presented in that report.

The Allen Report also noted that the quality of the market evidence available for the proxy beta for regulated Australian gas transmission activities was likely to increase in the future and that, as a result, it should be possible to place greater reliance (weight) on empirical evidence on beta values over time. The relevant text from the Allen Report is reproduced below (footnotes omitted).<sup>4</sup>

In the future, however, it should be possible for greater reliance to be placed upon market evidence when deriving a proxy beta for regulated Australian gas transmission activities. There are currently six firms listed on the Australian Stock Exchange that could be used as comparable entities when deriving a proxy beta – AlintaGas, AGL, the Australian Pipeline Trust, Envestra, GasNet and United Energy. Beta estimates are already available from the AGSM Risk Management Service for four of these entities, and estimates will be available for all six within a couple of years. Moreover, should any of the currently-mooted stock market listings of energy utilities proceed, then the information available from Australian capital markets will expand even further.

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<sup>3</sup> Allen Report, pp.42-43. Substantially similar comments were made in the report overview (p.6).

<sup>4</sup> Allen Report, pp.42-43. Substantially similar comments were made in the report overview (p.6).

Assuming the Commission continued to update the empirical information presented in the Allen Report to take account of this additional information, it would be consistent with the advice in the Allen Report for the Commission to place greater weight on that updated information over time.

Yours sincerely

[Signed]  
Jeff Balchin  
**Director**