Vodafone New Zealand cross-submission on further consultation draft (initial value of financial loss asset)

1 October 2020

Thank you for the opportunity to provide a cross-submission on the further consultation of the financial loss asset (FLA). This paper focusses on support for Vector's submission that the local fibre companies (LFCs) should only be rewarded for actual inflation during the FLA, not expected inflation, as is currently the case. But first we provide some brief comments on other submissions.

The Commission received a large number of submissions from the LFCs and their investors aiming for a larger FLA. These submissions largely re-tread old ground that we have responded to in past submissions. We therefore only make the following brief comments:

- No new information has been provided to alter the Commission's view that there was no cost to the Crown financing.

- There has been no evidence provided that the terms of the UFB contracts were particularly onerous compared to typical investor requirements.[1] We continue to believe that the LFCs gained substantial advantages from the Crown financing, well beyond the interest free repayments. Other benefits included: protection from Commerce Commission investigation; allowing UBA to continue to be charged at the high retail minus prices for a three year transition period; delaying fibre unbundling; and the general protection afforded to government supported projects.[2]
- Despite arguments that the beta should be higher during the pre-implementation period, we have previously shown that the FLA provided full insurance against all risks during this period. We therefore support a beta of zero, and a small adjustment for future recovery risk.[3]
- We do not consider the arguments for treating the FLA as a single regulatory period have any merit. The purpose of a regulatory period is to provide the regulated firm an incentive to beat the benchmark and earn additional profits, which are then shared with consumers in the future. Since the FLA relates to costs incurred in the past this incentive mechanism does not apply.

We also note that submissions from parties representing a consumer perspective were unified in their view that an incremental cost approach to the financial loss asset is most consistent with the legislative intent. We support these submissions. The Commission has a duty to New Zealanders to ensure that there is no double recovery and that consumers are not burdened with an unreasonably large FLA.

[1] We have previously shown why these terms were not as onerous as claimed. See Vodafone *New regulatory framework for fibre: Cross-Submission on Emerging Views – Cost of capital*, 9 August 2019, pp14-15.
[2] Vodafone *New regulatory framework for fibre: Cross-Submission on Emerging Views – Cost of capital*, 9 August 2019, p15.
[3] [ref sub to Lally]

The financial loss asset must only provide a return on actual inflation

Vector's submission highlighted a key inconsistency in the application of the FLA. As currently proposed, during the pre-implementation period the LFCs will be provided a return based on expected inflation at the date the expenditure was incurred. This is inconsistent with how electricity distribution businesses, gas pipeline businesses, and even how Chorus itself will be treated after the implementation date.

In the Part 4 regime the Commission has made it clear that real financial capital maintenance can only be achieved by applying the actual inflation rate.[4] For example, this topic received considerable attention in the 2016 review of the input methodologies, where the Commission notes:

> *... our approach to RAB indexation for EDBs and GPBs protects them (and their consumers) from inflation risk by delivering real returns all other things being equal. Therefore, real FCM is maintained.*[5]

However, the Commission is now proposing to apply the expected inflation rate in calculating the FLA. This is because the nominal WACC includes an expected rate of inflation, and no adjustments are made to account for the inflation rate that the LFCs actually experienced.

This is in contrast to the treatment of Chorus after the implementation date. Going forward Chorus will be allowed to earn revenue consistent with the nominal WACC rate, which includes an expectation of inflation. This inflation return will then be reversed out by including a revenue line item based on expected inflation. The RAB will then be indexed based on actual inflation, resulting in the maintenance of real FCM.

[4] Commerce Commission, *Input Methodologies review decisions: Topic Paper 1: Form of control and RAB indexation for EDB, GPBs and Transpower*, 20 December 2016.
[5] Commerce Commission, *Input Methodologies review decisions: Topic Paper 1: Form of control and RAB indexation for EDB, GPBs and Transpower*, 20 December 2016, para 265.

In the 2016 review of the Part 4 input methodologies the Commission noted that that applying an expected inflation rate is akin to targeting nominal FCM.[6] We do not believe it was the policy intent to target nominal FCM in the pre-implementation period but that real FCM must be targeted after the implementation date. Instead, the Commission has repeatedly stated that real FCM is one of the key underlying principles for this regime. This must be applied consistently to the FLA.

Vector has demonstrated that this is not an immaterial issue. They calculated that this could reduce the WACC rate by 80 basis points, potentially worth hundreds of millions of dollars to the FLA. The Commission cannot ignore this issue.

We are unaware of any reasons to depart from real financial capital maintenance

Applying actual inflation will expose equity holders to some risk because debt is typically issued in fixed nominal terms. Therefore, if actual inflation is higher or lower than expected then the cost of repaying that debt is lower or higher. The Commission explicitly considered this risk in Part 4 and concluded:

> *Over the long-term this risk is small and will wash out over time if the forecast of inflation is unbiased; and*
>
> *the risk does not expose affect [sic] equity and debt holders collectively (ie, the total return to all capital is an ex-post real return) and suppliers can potentially manage any inflation risk to some extent through their debt financing practices.*[7]

We also note that the beta will already account for this risk. Firms in workably competitive markets routinely face inflation risk and manage that appropriately. Any residual risk will sit on the cost of equity. This will be true of the comparator firms used to determine the beta, and therefore is already accounted for in the LFC's WACC.

The only exception to the Commission's application of actual inflation is for Transpower. The Commission has allowed Transpower a return based on expected inflation because of practical implications, and a view to the long term.

---

[6] Commerce Commission, *Input Methodologies review decisions: Topic Paper 1: Form of control and RAB indexation for EDB, GPBs and Transpower*, 20 December 2016.
[7] Commerce Commission, *Input Methodologies review decisions: Topic Paper 1: Form of control and RAB indexation for EDB, GPBs and Transpower*, 20 December 2016, paras 257.1 and 257.2.

We agree that this it is a different approach to EDBs but consider that the increased compliance and complexity that would be required to change the approach for Transpower do not justify the benefits in terms of protection from inflation risk.[8]

This justification does not apply to the LFCs financial loss asset. The regime has not yet started, so there is no reporting inconsistency creating additional complexity. Furthermore, the switch in approaches between the pre-implementation and post implementation periods locks in any differences between expected and actual inflation. The long term levelling from an un-biased forecast has no time to take effect because there is no repeat game.

The Commission should apply a capital charge adjustment to the financial loss asset

There are a number of ways to account for the difference between expected and actual inflation. We favour the capital charge adjustment considered as part of the Part 4 input methodologies review.[9] This would ensure that real financial capital maintenance is preserved by deducting from the FLA an amount equivalent to the difference between expected and actual inflation.

A capital charge adjustment means all other modelling can remain the same, and retain the simplicity and transparency the Commission has achieved. Then either yearly, or a one off adjustment can be applied to true-up the calculation in line with actual inflation.

---

[8] Commerce Commission, *Input Methodologies review decisions: Topic Paper 1: Form of control and RAB indexation for EDB, GPBs and Transpower*, 20 December 2016, para 316.
[9] Commerce Commission, *Input Methodologies review decisions: Topic Paper 1: Form of control and RAB indexation for EDB, GPBs and Transpower*, 20 December 2016, page 72.