River Capital

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Response to Commerce Commission New Zealand "Further consultation draft (initial value of financial loss asset) – Reasons Paper"

Introduction to River Capital

River Capital is a privately owned investment manager with 25 years of experience investing in public equity and credit markets on behalf of Australian and international investors. Over that period, we have been active investors in several long-term capital projects and are currently investors in Chorus. We are firm believers that a fundamental principle of investing in long term capital projects is that we, as investors, are given certainty at the outset as to the rules governing our likely return, and therefore the compensation for the risk that we are taking. Throughout the investment we expect these rules to be administered fairly. Given our experience, we are well placed to provide commentary on the Commerce Commission's proposed approach to the financial loss asset.

Chorus is a great example of a successful public-private partnership

We see Chorus as owning essential network infrastructure that will deliver long term benefits for consumers and, for investors, the opportunity of a fair return over time.

We are further encouraged by the fact the fibre network was built as part of a public-private partnership with the New Zealand Government. The consumer benefits have become even more apparent in the last few months with the effects of coronavirus on societies and economies.

New Zealand's approach has delivered broadband outcomes we're yet to realise in Australia. Here, Australian taxpayers have footed a large and growing bill for speeds and data caps that pale in comparison.

It's in this context that we are concerned by aspects of the Commerce Commission's current proposed approach to the valuation of the financial loss asset.

Concern # 1: The Commission's proposal undermines the principles of certainty and fairness that are critical to investing in long-term capital projects

Firstly, we cannot follow the logic for the Commission's proposed reversal in its treatment of the government financing for the UFB project. The financing was a cornerstone requirement for the public-private partnership to get off the ground. It provided the basis for the agreement for Chorus to be split from Telecom and for investors to commit to a punitive contract (if Chorus did not meet its commitments) with the government.

The financing does not compensate investors for the risks they assumed under the project. Further, to suggest that assets funded with Crown financing will effectively attract no return on capital for about 15 years, feels like a deviation from the principles of certainty and fairness that underpinned the original funding of the project. Given the current proposal, it is our view that Chorus should repay as much financing as it can before January 2022. At least it will then begin earning a return on that amount.

The commercial imperative doesn't change with the Commission's suggestion of a 25-basis point 'return' on financed amounts from 2022. The rationale for only applying 25 basis points and then only doing so from 2022 onwards seems commercially inappropriate and does not reflect the risk investors have undertaken by funding the project. If the Commission's task is to identify the actual costs of Crown financing, this approach falls short on both counts.

Related to the above, the Commission has to date suggested it prefers a BBB+ credit rating in evaluating the WACC for Chorus. We question how this can be considered a fair approach when the Commission's proposal is incentivising the company to take on more debt to repay the government.

Concern #2: An annual update of Chorus' risk free rate is not a fair and reasonable approach

Secondly, it is concerning to us that the Commission seems to be persevering with its approach of using an annual update of the risk-free rate through the pre-2022 financial losses period. We cannot understand how this can be considered a fair and reasonable approach when, as Chorus showed in its FY20 results presentation, the Commission's implied WACC is more in line with the company's actual debt costs. The Commission's implied cost of debt was unachievable for the company and the annualised reset of the rate is contrary to standard commercial or regulatory practice.

Chorus did not take on new financing annually as it built the fibre network. It drew down on government financing when it was required, on the terms agreed back in 2010/11. The company locked in initial debt financing through to 2020 to meet government contractual requirements. The only commercially realistic approach is that Chorus took on long term project risk at the outset of the fibre contract. Applying a new five-year rate of return to the investment made each year, reflects a retrospective adjustment of the risks investors took on the project. The company did not have the opportunity to raise debt in 2013-2015 because regulatory processes meant it was reliant on shareholder funds (including no dividend payments) and higher cost bank financing to keep funding the rollout.

Concern #3: There is scope to consider a higher asset beta when estimating Chorus' WACC

Our third area of concern with the financial loss asset is the Commission's reluctance to consider a higher asset beta during the pre-2022 period. The Commission acknowledged the asset beta could be higher in its November draft decision but suggested there were difficulties with estimating it. The Commission is comfortable estimating other aspects of the Chorus WACC in the pre-2022 period using a range of different assumptions. We do not see how a clear acknowledgement of the potential for a higher asset beta during the construction phase can be discounted on this basis, particularly when the UK regulator has made a highly relevant estimate for Openreach. This is a wholesale network business very similar to Chorus. The Ofcom proposed asset beta is in the same range identified by the government's representative, Crown Fibre Holdings at the start of the rollout. This is more compelling and relevant than the asset beta of 0.49 currently derived from an estimate based on a sample of vertically integrated telecommunications providers.

Ultimately, the proposed changes do not adequately reflect the risks that investors have borne throughout the project

Finally, we do not agree with the Commission's draft view that the existence of the financial losses compensate investors for the risks they faced and continue to face through to 2022. If the fibre rollout was a sure thing, the government would not have transferred the risks on to its rollout partners in the way that it did. The financial losses have not offset every risk faced and incurred (e.g. a period of no dividends, the possibility of capital raising, fixed wireless substitution) and there is no guarantee that the losses will be recovered over the life of the asset.

If we were investors in Telecom/Chorus being presented with the same fibre investment case again in 2010 – and we were aware the Commission would apply the interpretations currently proposed for the key components of the loss asset – we would be strongly against investment in the project. We encourage the Commission to recognise the substantial contribution investors have made to New Zealand's fibre public-private partnership, by considering the broad implications of its approach to the financial loss asset. Infrastructure investment requires providing the opportunity for a fair return.

Thank you for your consideration. If you have any questions, please do not hesitate to contact us.

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