L1 CAPITAL

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The Commerce Commission has asked for submissions on the Main Consultation and Updated Draft Determination (excluding financial loss asset) paper from interested parties. As an independent fund manager with investments in New Zealand media, telecommunications and retail companies and as a substantial shareholder in Chorus since 2014, L1 Capital has followed the new regulatory process closely and is again thankful for the opportunity to present our views.

L1's submission is focused on the treatment of the benefit of Crown financing (section 3.08-3.64). The Commission's updated determination is that the benefit of this Crown Financing should be calculated as the regulatory WACC in the pre implementation period and a regulatory WACC less a modest discount of 25 bps in the post implementation period. This is a change from the draft determination and equates to a view that Chorus would have incrementally funded the project by accessing additional debt and equal in line with the CFH debt/equity mix from external providers.

L1 would note that under this approach the benefit of Crown funding is (a) completely unstitched from the rest of the UFB contract (b) overrides the concessional nature of the CFH funding since the new approach is designed to approximate cost of third party financing. This is despite the Commission's acknowledgment that the funding was intended to be concessional in nature and the Commission's stated intention that it does not wish to override the CFH contract, which was integral to Chorus's and other LFC's UFB investment.

3.08 "Chorus received finance from the Crown to assist in the construction of the UFB network under the UFB initiatives. Under the UFB agreements between Chorus and the Crown, ***favourable financing terms apply****. There are (or have been) similar financing arrangements between the Crown and other LFCs."*

3.48.3 "Finally, in addition to a sharing of the benefits between Chorus and end users we have also considered whether the benefit of Crown financing should be locked-in whether or not the Crown financing is repaid until the scheduled agreed repayment dates. ***However, we believe that this would undermine the contract between the Crown and Chorus given it allows for early repayment of equity securities. To the extent the contract would allow, or could be modified to allow for early repayment of debt, we do not believe we should override the contract."***

The original UFB interim agreement clearly envisaged that concessional funding would be required to incentivise private investment at a wholesale price for fibre services low enough adoption. We quote from the UFB Interim Period Agreement between Crown Fibre Holdings and Telecom Corporation of New Zealand dated 24 May 2011.

"The Government expects to achieve significant productivity benefits from the UFB network. However, these benefits would only be realised if ***wholesale and retail prices were low enough to encourage service providers and end users to migrate to the UFB network from the existing copper network****.* ***The Government's policy objective is that its investment of $1.35 billion will attract sufficient private investment to achieve deployment of a fibre-to-the-premises broadband network*** *to 75 percent of the population over 10 years.* ***Deploying this network successfully would require significant upfront investment from private partners in a new market, where only a small margin for return exists during the first eight-and-a-half years."***

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This concessional funding has now been removed under the draft determination and replaced with commercial cost of raising debt and equity to fund the project, effectively removing the benefit of at the conclusion of the build when the investment has been made.

Importantly acceptance of the CFH funding also came with a series of unique conditions including limits on business operations ownership holdings, governance rights, performance penalties and warrants that make it very unlike traditional debt and equity financing. We have talked about some of these in our July 2019 submission and reproduce them below.

Condition	Detail
Restrictions on business operations	CNU is subject to specific regulations. These regulations include: Open access undertakings with respect to CNU's copper and fibre networks and RBI products. These undertakings contain non-discrimination and equivalence of inputs requirements. Line of business restrictions on CNU prohibiting it from providing services to end-users, from selling services linking two or more end customer sites and from participating in services above Layer 2. Oversight on transitional and long term commercial arrangements between TEL and CNU to ensure these arrangements are on arm's length terms and unlikely to harm competition.
Limits on Shareholding	CNU's constitution includes ownership restrictions. The New Zealand Governments prior written approval will be required for any person to have a relevant interest in 10% or more of the shares in CNU, or any New Zealand national to have a relevant interest in more than 49.9% of shares in CNU. CNU has committed to the Crown that it will not remove these provisions form the
Chorus issuance of warrants to CFH	New Chorus will also issue CFH Warrants to CFH for nil consideration along with each tranche of CFH Equity Securities and CFH Debt Securities. Each CFH Warrant gives the holder the right to purchase a New Chorus Share at a specified date between 30 June 2025 and 30 June 2036, with the price of the New Chorus Share based on a total shareholder return of 16% per annum.
CFH oversight and control of fibre project	A Steering Committee of three members each from CFH and CNU and an independent chairman (Gavin Walker) are responsible for overseeing all material matters in relation to CNU deploying and operating the UFB network. In addition a Senior Committee comprising the CNU and CFH chairpersons and the independent chairman from the steering committee, has decision making rights around CNU's fibre business plan (investment in the UFB Network beyond the contracted specifications, promotion of the network and behavioural like obligations in respect of CNU's engagement with RSPs). CNU must consult with CFH on the appointment of the senior executive responsible for the fibre business and gain CFH's consent for the replacement of certain key personnel
Chorus must actively promote fibre services	CNU has commitments to prioritizing the fibre network, including obligations to promote fibre and support fibre uptake and restrictions on copper services and products. CNU has committed to seek to maximize uptake of the fibre network. There are a number of requirements of CNU under these commitments and these include a requirement for CNU to consult with CFH on further investments in the copper network
Financial Penalties and step in rights for failure to achieve delivery plans	If New Chorus does not perform its obligations under the UFB Agreements and is unable to rectify breaches within agreed timeframes, there is a range of remedies available to CFH, including various levels of liquidated damages, specific damages claims capped at NZ$350 million, and, for periods of prolonged or significant performance failure and in certain other limited circumstances, CFH has termination rights.
Requirement to maintain investment grade credit metrics through build period and requirements to suspend dividends.	Achieving an investment grade credit rating is also a condition precedent to New Chorus' access to the Government's UFB investment through CFH and in the event that New Chorus' credit rating falls below investment grade while CFH Debt Securities remain outstanding, New Chorus is prohibited from paying distributions on New Chorus Shares without CFH's approval. (Chorus demerger document). In order for CFH to provide funding: Chorus must not be in breach of the financial covenants in its banking facilities; from 2020 (or earlier if it does not have financial covenants in its bank facilities) Chorus must not have a sub-investment grade rating from both S&P and Moody's (or only one entity if that is the only rating entity) for a continuous period of four months; (UFB2 CFH Agreement)
Fees and additional costs of CFH	Draw down of CFH funding comes with various fees

These debt terms are very different from the commercial terms available to Chorus when it raises debt and equity. In proposing to estimate that the benefit provided by Crown funding is equal to WACC (multiplied by the dollar amount) the Commission is explicitly assuming that the beta of the Crown equity-security funding equals the ordinary equity beta of the comparator sample (adjusted for leverage). Additionally, there is an assumption of CFH debt being equivalent to BBB+ rated investment grade commercial debt. These are clearly invalid assumptions.

In our June 2019 submission we have highlighted how some of these CFH restrictions increase risk for Chorus equity holders and what approach the Commission could use to estimate the additional costs imposed on Chorus equity holders. We have not seen the Commission address these issues yet in any substantive way. We reproduce these below.

Condition	Impact on Chorus/LFC's (where appropriate)
Chorus issuance of warrants to CFH	Explicit cost to Chorus equity holders. Limits upside for Chorus investors while fully exposing them to downside. Value of warrants can be estimated using binomial approach. (See Section A below)
Limits on Shareholding	Lowers pool of available international investors and stops Chorus investors form achieving a control premium for their investment. Results in higher cost of capital
Financial Penalties and step in rights for failure to achieve delivery plans	Penalties increase risk to Chorus equity holders. Conceptually Chorus investors have to estimate % chance of penalties being triggered and the penalty amount to derive expected loss. Chorus holders also bear of the risk of CFH terminating the fibre project early if it believes the fibre project milestones cannot be achieved, imperilling the value of investment already made.
Requirement to maintain investment grade credit metrics through build period	Requirement to maintain investment grade credit to draw down of CFH communal funding or pay dividends has the effect of raising equity beta by raising implied financial leverage. This is due to the fact that any cost overrun during the build period would have had to be met through equity issuance. (See Section B)
Fees and additional costs of CFH	Additional costs need to be borne by Chorus equity holders.

Importantly the additional risk these CFH instruments placed on Chorus equity and debt holders were highlighted by research analysts going as far back as June 2011 and the beginning of the UFB project.

Risk section of an initiation report on Chorus by Arrie Dekker(Jarden) from 12th Jun 2012	*"Risks associated with the UFB project including capex spend and failure to meet contractual obligations with CFH". CFH has delivery milestones for communal infrastructure (completed by CY19) and take-up requirements for fibre. Risks include cost overruns as well as failure to meet agreed milestones and service standards. The penalties associated with the latter include liquidated damages and potential for CFH to take management control to rectify. Under its agreements with CFH, CFH has governance rights which include input into CNU's fibre business plan, plans for its copper network and appointment of key executive positions. A breakdown in the relationship with CFH could lead to uncertainty with regards to CNU's ability to run aspects of its day to day operations"*
Risk section of an initiation report by Deutcshe Bank report on 1st December 2011.	*"UFB agreements require Chorus to pass with fibre within specified timeframe through to 31 Dec 2019. Chorus faces the risk of non-compliance due to factors such as construction risk and fibre installation risks. Non compliance with system and product plan delivery milestones will result in financial penalties. The UFB agreements require Chorus to maintain an adequate service levels relating to Chorus's operation and availability of the UFB Network and specified services. Failure to achieve and maintain an investment grade credit rating: As a condition precedent, Chorus must obtain an investment grade credit rating (BBB- or above) within two months after the date on which the Subscription Agreement is entered into. In addition, Chorus will be prohibited from paying dividends without CFH's approval if it fails to maintain an investment grade credit rating."*

L1 strongly believes that CFH debt and equity is a highly specific type of capital instruments with significant additional restrictions that makes it completely unlike traditional debt and equity financing.

L1 believes the correct approach is to either:

a) Consider the CFH funding benefit against the higher costs of equity and debt as a result of the CFH restrictions as addressed in this submission. In our July 2019 submission in a section entitled "Cost of CFH equity and debt instruments are not zero" we highlighted the possible approach the Commission could use to estimate the cost of these condition on Chorus equity holders. For balance sheet risks, L1 suggested the restrictions relating to CFH instruments should be reflected in a higher equity beta. For other risk factors we believe a combination of higher asset beta (construction risk, risk of penalties) or a WACC uplift may be more appropriate.

b) Compare the cost of CFH funding to other debt and equity instruments with ***similar conditions*** and ascertain whether the CFH funding cost was truly concessional and if so by how much. CFH funding bears some similarities to other development funding from sovereign government and development banks for the construction of infrastructure projects and it may be possible to draw up a comparison set of the funding against other government like concessional loans.

We do not believe the Commission has chosen either of these approaches although we await more colour on the calculation of the loss asset on 13th August.

We thank the Commission for the opportunity to comment and look forward to engaging further in the regulatory process

Signed:

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