PARADICE
INVESTMENT MANAGEMENT

10th July 2019

Regulation Branch
Commerce Commission New Zealand

To Whom It May Concern,

We refer to your fibre regulation emerging view paper ("EV Paper") dated 21 May 2019. Paradice Investment Management ("PIM") is pleased to provide a submission in response to this release.

PIM is a Fund Manager with offices in Sydney, Denver and San Francisco that manages $16.5bn NZD in Equities in the form of 3 Australian based funds (with mandates to invest in Australian and New Zealand equities), a Global Mid/Small Cap Fund and an Emerging Markets Fund. PIM was established in March 2000 and is wholly owned by its staff members. We have a track record in all of our products of providing superior risk adjusted returns for our clients.

PIM has been an active investor in New Zealand equities for over a decade. We currently hold $368m NZD in New Zealand based equities, including an investment in Chorus. We have also been major investors in many Australian based regulated infrastructure assets.

Infrastructure assets are clearly an important part of any economy and are long duration in nature. In order to attract our investment dollars we feel that a number of factors are important for these assets:

- There must be certainty in the regulatory environment and outcomes.
- There must be consistency in the way that assets are regulated.
- Any regulation and reviews must be dealt with in a timely manner.
- When a regulatory process occurs for an asset it should not be politicised. Investors, who have effectively funded that asset, should not then have their funding gifted to consumers. In situations where this is seen to occur it has dire consequences for future investment in that country.
- They must generate a fair return relative to their true cost and market asset values. If an acceptable return on the assets is not allowed then as shareholders we would find it difficult to support ongoing investment in the assets by that entity.
- Most importantly, the assets shouldn't be subject to any major surprises or shocks which generate significant volatility around the market value of the asset.

PIM made an initial investment in Chorus after the release of the draft FPP prices in December 2014. Prior to this we did not view the stock as being investment grade due to the considerable uncertainty and ambiguity that we had seen in the regulatory process. This had been reflected in the huge volatility in the Chorus share price prior to that point. We applaud the move that was taken to a defined building block based model that provided a greater level of certainty and confidence to investors.

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In regards to the emerging issues paper we would make the following specific observations:

Real Financial Capital Maintenance

- We agree with the EV Paper's support of this concept (Section 115) and its importance in encouraging ongoing investment in the network.
- However, we find that the decision not to apply an uplift to the 50th percentile for Chorus' WACC (Section 550) is inconsistent with this premise. Further, it is inconsistent with the treatment of ALL other regulated utilities within New Zealand that have their WACC set at the 67th percentile. It is unclear to us as to why Chorus would be singled out for differential treatment and it discourages the company from investing in areas that are beneficial to the consumer, such as higher network capacity, 5G backhaul and increased redundancy overlays. Australian investors have seen firsthand, as recently as yesterday, the issues that telco network breakdowns cause for the broader economy particularly as we enter a more digitised environment.

Treatment of Crown Financing

- We do not agree that the cost of Crown Financing is zero (Section 539).
- This ignores the fact that there is an ultimate obligation to repay this funding and that serious financial consequences exist for failing to do so. The provision of Crown Funding also comes with a series of obligations in terms of rollout, restrictions on competition and the potential for penalties for failing to meet targets. This is not consistent with the perception of being free or without obligation.
- It also leads to an inconsistent approach where it potentially encourages the Company to refinance Crown Funding early on commercial terms, post which it would then earn a full WACC return on this portion of RAB.
- There are other costs associated with this funding (transaction costs, etc) that need to be accounted for also.

Calculation of WACC

- Prima facie we do not believe that the implied WACC for Chorus of around 5% (post tax) is sufficient. We note in this regard:
    - It does not sufficiently reflect the risk of a company that is effectively a greenfields startup in a new technology. Also, the business operates in an environment where it cannot compete with other LFCs and must compete for customers within its catchment with fixed wireless broadband networks (competition that is likely to increase further with the rollout of 5G networks).
    - Prior to the UFB rollout Crown Fibre holdings noted to parliament that an appropriate WACC for such an asset should be between 8 and 10% (albeit in a higher interest rate environment).
    - Our analysis and feedback from other companies suggests the Chorus network (and others like it) would not have been constructed for a WACC return of 5%. This lack of incentive is important in the context of attracting future development, and not increasing of sovereign risk around retrospective adjustments to return on sunk capital.
- We feel the estimated beta of 0.42 to 0.51 is simply too low. The assumption also relies on comparisons to tower and satellite companies. We feel that this is not a valid comparison given these companies tend to have long-dated contracts with large customers whereas Chorus deals with disparate customers that are able to leave the network at short notice. Additionally, it is entirely wrong to assume that the revenue cap imposed on Chorus will be fully achieved and account must be given to other restrictions that exist for Chorus, such as the need to provide anchor products.
- We consider that the recommended BBB+ credit rating proposed in the EV Paper (Section 490) is too high as it is a full 2 notches above the top average rating for both wholesale and integrated service providers.

PIM very much appreciates the opportunity to participate in this submission. Should you have any enquiries please contact me on [redacted] or [redacted]

Yours sincerely,

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