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L1 Capital appreciates the opportunity to make this submission following the release of the *Fibre PQID initial RAB draft decision*, ahead a final decision due in the December quarter of this year.

L1 manages money for a range of clients including large superannuation funds, global endowment funds, high net worth individuals and retail investors. L1 invests globally and has been a shareholder of Chorus since 2012. L1 would like to thank the Commission for the opportunity to present its views as an equity investor.

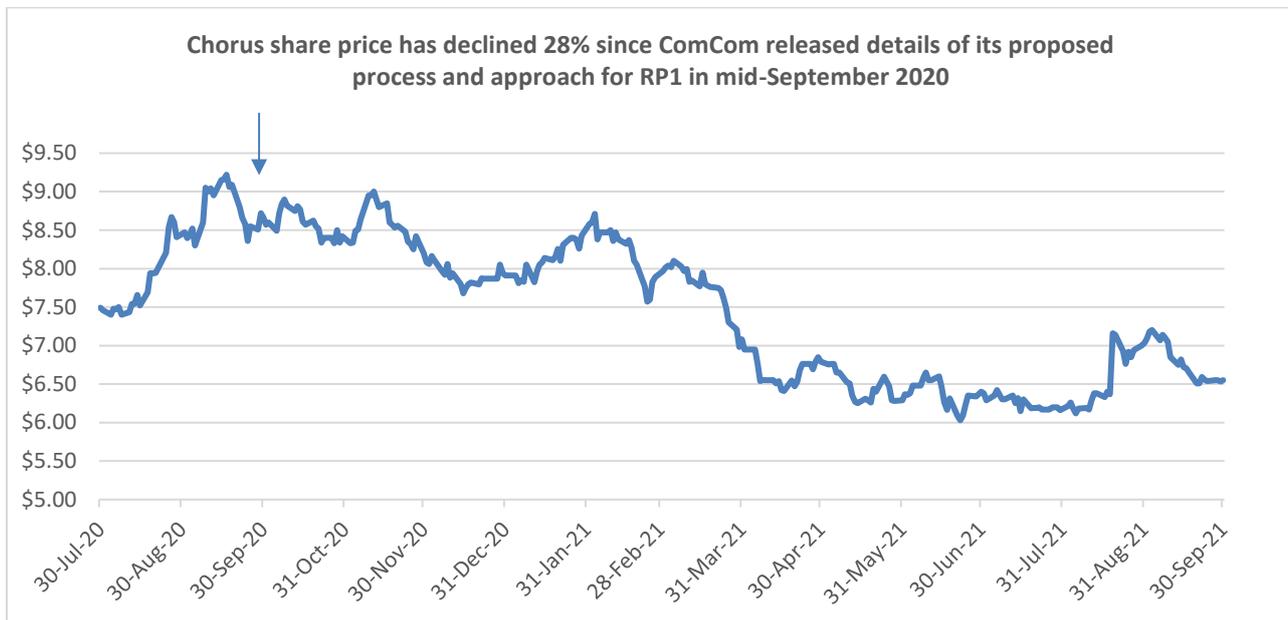
The Commission has acknowledged that the initial RAB value is an important consideration for both for end-users and investors. Particularly the Commission noted that “our decisions may affect investor expectations about future regulatory decisions. This matters for future investment.”

Confidence Has Been Lost by Investors

L1 agrees that it is crucially important to restore confidence in the regulatory process. Many investors have lost faith in the regulatory process, raising the cost of capital for Chorus at a time when it needs to continue to invest and innovate.

While section 162 refers to regulated fibre service providers being “limited in their ability to extract excessive profits”, the cumulative effect of the Commission’s RAB and WACC decisions to date have made it increasingly doubtful that investors can even earn a fair return.

Since ComCom released its initial paper outlining its ‘Proposed process and approach for the first regulatory period’ on 15 September 2020, the Chorus share price has declined by 28%. This decline is even greater when considered in the context of strong equity markets over the same period, with the ASX up 26% and the NZ50 up 9%.



Unfortunately, we must agree with New Street Research that increasingly investors have taken the view that a **“...predisposition to favour access seekers over access providers is a pattern of behaviour by the Commission and reflects a systemic bias against access seekers with committed investment in favour of access seekers’ claimed future prospects.”**

This has been reflected in our experience as Chorus shareholders.

In 2015 the Commission dismissed investors’ legitimate expectation of backdating for copper pricing after it was determined copper prices should have significantly higher than suggested by initial benchmarking. The Commission’s approach meant Chorus lost hundreds of millions of dollars in revenue, laid off staff and delayed investment. Ultimately, the benefits of lower copper prices were not passed to consumers but ended up enhancing the profits of large RSP’s.



The draft RAB of \$5.4b is not in itself sufficient to restore investor confidence in New Zealand regulatory outcomes.

As we and others have submitted throughout the current regulatory process, the investment risks faced by Chorus investors haven't been adequately recognised. A \$5.4 billion RAB grossly undervalues the true investment that has been made. The need to rely on accelerated depreciation to support regulated revenues in the first regulatory period makes it abundantly clear that there has been a regulatory failure.

As we have pointed out in our July 2021 submission there are 8 key areas of concern by investors, which have cumulatively served to:

- (a) raise sovereign risk and Chorus's cost of capital,
- (b) significantly depress the IAV compliant RAB,
- (c) underestimate the allowable operating expenditure,
- (d) leave little incentive for investment going forward.

We reproduce these concerns in brief below.

- 1. Risks faced by Chorus in the early stages of the rollout have not been appropriately recognised by the Commerce Commission leading to an underestimation of the loss asset and RAB:** Chorus committed to its UFB investment a decade ago, facing a materially higher cost of capital than it does today, significant uncertainty over rollout costs and end user demand, and faced financial penalties if delivery milestones were not met. By not recognising the environment at the time the initial investment was made, the Commerce Commission has materially under-estimated the loss asset, and hence the RAB.
- 2. The capped MAR removes Chorus's incentives to innovate and invest:** The revenue cap means there is a disincentive to invest further in fibre take up or penetration. Our recommendation in the absence of a better regulatory outcome would be for Chorus to minimise future investment while it earns an incremental return well below its cost of capital.
- 3. The Commission's draft determination is significantly below the 8% to 9% WACC originally envisaged by CFH when the project was announced:** While we understand that there has been a structural shift in some elements of the project's cost of capital over this time, the Commission's approach completely ignores the cost of capital faced by investors at the outset of the project and represents a convenient change in return expectations only after private capital has vended in assets and taken on the majority of the implementation risk;
- 4. A WACC of 4.52% (post-tax) sets a rate of return that is one of the lowest returns for a regulated fibre network anywhere in the world.** This outcome suggests that investors are better off investing in other global fibre networks where risks are appropriately recognised. Although differences in risk free rates do impact the calculation of WACC, if we delve into the drivers of the WACC calculations we can see that the ComCom has under-estimated risk parameters relative to other regulators – specifically the asset beta and the WACC uplift;

- 5. Stranding risk has not been sufficiently allowed for in the WACC determination, meaning investors can seek similar returns via investment in less risky regulated assets.** We note recent commentary by Spark NZ, Vodafone NZ and Ericsson on the accelerating adoption and future growth prospects for fixed wireless broadband solutions, which represents a significant risk to network adoption. We do not see the 10bps WACC allocation as sufficient compensation for the associated risks, given lost revenues are at a high incremental margin due to the fixed cost nature of the business.
- 6. Depreciation tilting is being used to fill the revenue gap, but this does not bring any economic value to Chorus and is not in itself sufficient.** Implementation of depreciation tilting does not provide compensation for stranding risk, which should be addressed through the correction of the WACC estimates via the stranding allowance, or through recognition of the costs associated with Chorus' participation in the UFB contract.
- 7. There is an efficiency regime being applied to costs where no efficiency adjustment is necessary.** The Commission's suggested 10.7% cut in opex allowance implies the business is being run inefficiently today and that Chorus has not been upfront with its owners with regard to cost initiatives.
- 8. Private capital and public capital continue to be treated differently:** Fairness between public and private capital is at heart of sovereign risk and investing in NZ. The current fibre legislation makes a distinction between private capital (regulated through a PQ regime) and public capital (regulated solely through an ID regime). While both have invested in an equivalent fibre network, the legislation allows for wide latitude to determine key parameters under PQ regulation and imposes an impossibly high efficiency standard for private capital.

L1 believes it is vital that the remaining decisions made by the Commerce Commission better reflect commercial realities faced by Chorus in building and operating the fibre network to restore confidence and allow Chorus to invest in what is a piece of essential infrastructure for NZ.

A key component of that is recognising there is a need to look at (a) alternative approach to RAB calculation to recognise past undervaluation, (b) to not impose impossible efficiency standards on Chorus in operating its fibre network and (c) to incentivise rather than penalise Chorus to continue to market take up of fibre services, which drive significant productivity growth for all of NZ through enablement of the digital economy.



RSP's claims that the asset base should be lower don't stand up to scrutiny.

Spark tries to suggest the Commission's \$5.4 billion valuation is so grandiose it "risks undermining innovation and driving out competition and competing investment."

If RAB returns are indeed too high, then Spark will surely have an even greater opportunity to promote uptake of its alternative fixed wireless services. Concerns about competition certainly don't appear to have held back their own recent media announcement about a 5G rollout partnership with Nokia. The only conclusion to be drawn is that access seekers are again focused on providing themselves with better margin, at the access provider's cost.

As Chorus' submission shows, the draft RAB decision has made assumptions that yet again undervalue the contribution Chorus and its investors have made to the UFB rollout. We are particularly concerned by the issues Chorus has identified regarding the Commission's treatment of common costs and ducts.

As recent market analyst reports have highlighted, there is an emerging view that fibre costs have not been adequately reflected in Commission decisions to date. This means that copper customers will ultimately be left to shoulder significant price increases in the near future, or the copper network will likely become uneconomic for ongoing investment. This assessment of commercial reality highlights the fundamental flaw in RSP claims that network analysis from the copper pricing process can be used as a benchmark for the RAB valuation today.

It is L1's view that Chorus' proposed alternative RAB of \$6 billion better reflects the true allocation costs to fibre, given the requirements of the UFB initiative. We strongly believe the Commission should consider Chorus' alternative RAB valuation to ensure copper consumers are not disproportionately affected.

L1 also agrees with Chorus' statements that the Commission needs to reconsider its proposed treatment of pre-2011 ducts. It is concerning that after consumers have already benefitted from these assets being artificially vended into the RAB below by the new legislative framework, at less than their commercial value, the Commission is potentially applying more optimisation assumptions in its RAB assessment. If this is the case, it would only strengthen investor concerns about the Commission's tendency to favour assumptions that do not reflect network costs and reality.

Finally, we note that RSPs suggest the wash-up process should not be clarified until nearer the implementation of the second regulatory period. As we've stated, investor confidence in the transition to the new regulatory regime has been severely dented. Any unnecessary delay in spelling out the details of the new framework will only add to investor concerns about future regulatory intent. Based on recent experience we want to know what rules will apply from the outset rather than being told what we should have expected in hindsight.



Conclusion

We thank the Commission for the opportunity to make a submission at this critical stage.

We remain passionate about the issues at hand given the impact for both Chorus and the New Zealand public, and remain concerned over the cumulative impact of outcomes reached thus far.

Given the findings of the most recent determinations, it is important to flag that every incrementally negative outcome going forward is likely to have an outsized impact on Chorus's ability to invest and innovate.

We encourage the Commission to weigh these considerations carefully if it is to encourage ongoing investment for the benefit of end users.

Signed:



Lev Margolin
Portfolio Manager