Schroder Investment Management Australia Limited
Level 20, Angel Place,
123 Pitt Street
Sydney, NSW 2000
Phone: +612 9210 9200
www.schroders.com.au

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TelcoFibre@comcom.govt.nz

Via email

Submission on Commerce Commission Emerging Views Paper

In response to the invitation from the Commerce Commission for submissions on the Emerging Views Paper on the regulation of fibre input methodologies, we have highlighted several areas below that we believe are worthy of consideration in arriving at the final decision. To ensure full transparency, clients of Schroder Investment Management Australia Limited, for whom we act in an investment management capacity, are significant investors in telecommunications and infrastructure assets across Australia and New Zealand, including Chorus Limited.

Overall Regulatory Direction

The comments below should be considered in the context of what we believe to be positive moves in regulatory direction and a supportive view of the framework put forward in the proposed approach paper in November 2018. Whilst there will always be areas in which we will not agree with the approach suggested by the Commission, we have confined our comments to areas which we believe will be material in the context of investment decision making.

WACC Calculation

Our perception of the WACC which eventuates from the methodologies determined as reasonable in Commission's Emerging Views Paper is significantly below that which we could consider reasonable for an investment with the characteristics of Chorus.

Determination of WACC is invariably the matter with which we have greatest concern within most regulated asset frameworks, given the highly technical approach normally adopted by regulators. Asset beta and equity beta are variables which we believe are accorded far greater degrees of precision than can realistically be afforded in a practical investment context. We would observe that the asset and equity betas derived by regulators rely on equity market volatility as a proxy for underlying asset risk, while equity market volatility is obviously influenced by a broad range of factors beyond that of the underlying investment (e.g. investor panic and euphoria, liquidity, alternative investment opportunities). Should an investment not be listed on the equity market, exactly the same determinations on the level of risk inherent in the asset and the degree of financial leverage it should support would be required in order to arrive at a sensible required rate of return. The listed equity market merely provides a (very) rough proxy as to how assets with similar characteristics have behaved over time in a marketplace. Although we do not believe the comparator set used by Cambridge Economic Policy Advisors (CEPA) is representative, we believe this is a secondary concern given the flaws in the asset beta determination process itself.

We are particularly cautious of extrapolating the market behaviour of purportedly stable, but relatively highly geared assets given the majority of the past 25 years have seen an environment of consistently falling interest rates and exceptional monetary accommodation from central banks. This time period has therefore provided an abnormally asymmetric risk environment for investors. In short, there has been virtually no cost to investors in assuming excessive financial leverage. This has left most economies (including Australia and New Zealand) with interest rate levels far lower than would normally be expected in relatively buoyant economic conditions and with limited scope to reduce interest rates further.

We would also contend that most government bond rates are not at levels reflective of free market conditions given the significant intervention from large scale central bank asset purchases and the flow on impact to all other assets from these purchases. European bonds, for example, would not be offering investors a negative yield without significant price manipulation by the ECB. This has resulted in a distorted and artificially low cost of capital for all businesses, however, given the increasing scarcity of yield and the propensity of previously risk averse investors to seek lower risk assets to supplement yield, we believe the cost of capital for perceived low risk assets within the equity market has been distorted to the greatest extent. In a longer term context the observed cost of capital for almost all companies is artificially low.

As a result, we believe it is crucially important to consider the risk of an underlying asset from first principles and relative to assets of similar nature in determining the level of return a reasonably well-informed investor would seek. Whilst we expect a FFLAS provider should have relatively stable cash flows, we believe risks are undoubtedly higher than traditional utility businesses (power lines, gas pipelines) given the significantly greater risk of obsolescence and disruption, particularly from mobile technologies. Similarly, we would accept that risks are lower than traditional telco operations given lower competitive intensity. In comparing available returns on investments, should the WACC be set at or below that of utility providers, we would see little to no attraction in investing in FFLAS assets relative to utilities if we assessed the ungeared RAB of both businesses to be fairly determined. This view is consistent with Crown Fibre Holdings' assessment that LFC risk was somewhere between a utility and a traditional telecommunications company.

WACC Uplift

Whilst the WACC uplift is a technical factor and is only of concern to us in its use in determining the permissible WACC for the business overall, setting WACC at the 50th percentile, or providing no uplift to avoid the risk of under investment, further undermines the appeal of investing in a FFLAS asset relative to other stable regulated assets. Suppressing returns to levels which offer minimal or no compensation for risk exposes investors to asymmetric outcomes and removes the incentive to reinvest in a business. We would question whether the UFB network would have been built at all at the implied WACC. Investors are acutely aware of the potential for regulatory bodies to adopt a cynical approach where adequate returns are promised in encouraging the initial investment and then removed once the asset is built. If instances of this behaviour were to increase, there would obviously be a structural adjustment in required returns to compensate. European regulators have explicitly recognised the need for a WACC uplift for fibre networks and we would contend this is a logical response to an environment in which most developed markets are suffering from a lack of investment appetite for growth and productivity enhancing fixed assets. Whilst there may be no observable material asymmetric consequences of under-investment at present, the long-dated nature of the assets and the likely need to reinvest in the future dictate obvious potential for these consequences to occur.

There are obviously a significant number of technical arguments raised and thoroughly examined in both the Emerging Views paper and the CEPA report. As a long term investor (we have owned Chorus shares on an uninterrupted basis since demerger), we are concerned that pragmatism in the calculation of WACC has been sacrificed, resulting in unduly low targeted returns.

Please do not hesitate to contact me if you require any further clarification.

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Yours sincerely,

Martin Conlon
Head of Australian Equities