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New Zealand Commerce Commission

Submission on Chorus' initial regulatory base Draft Decision

New Street Research, Australia and New Zealand

A first principles approach to pricing risk is required by s162

We estimate the real value of Chorus RAB at NZ$7.7bn including the value of the Fixed Loss Asset at $3.5bn. This value reflects the risk faced and managed by the company and its equity investors through the build period and the cost of capital at the time the commitment was made.

The value derived through the application of the Input Methodologies of $4.5bn is grossly inadequate and does not reflect the objectives of s162 of the legislation. In particular it doesn't meet the requirements of 162(a) that regulated providers have incentives to innovate and to invest, including investing in upgrading and replacing existing assets, and purchasing new assets.

Nor does it meet the assurances given by the New Zealand Government on 13 October 2011, two weeks before Telecom equity investors committed to support the UFB project and structurally separate Chorus. The Government then directed the Commission that its economic policy was that businesses have incentives to innovate and invest in UFB infrastructure. It further directed the Commission that objective will be achieved by:

- Regulatory stability, transparency and predictability.
- Regulation taking full account of the long term risks to consumers of under-investment in UFB.
- Ensuring that any price regulation that may occur in future recognises that revenues cover efficient operating cost and a normal return on and recovery of capital invested.
- Ensuring that any future price regulation takes into account the start-up risks associated with introduction of new technology.

We consider that direction was relied on by equity investors when they voted to commit to the UFB investment and separation. In its approach to measuring the FLA component of Chorus' UFB asset base the Commission has failed to meet any of these four directions.

Nor does the replacement of Schedule 3 with Schedule 6 absolve you of those responsibilities and commitments. That would be considered by investors that have relied on that direction and invested in good faith to be a form of sovereign risk and an appropriation of value.

If you continue along this path having revising risk after the event and apply such a valuation approach to Chorus PQ regulation we consider it will undermine investor confidence in regulated assets in New Zealand, and would undermine efficient investment in the emerging digital economy.

We consider s162 and the commitment given by Government requires a first principles approach to risk assessment and evaluation of investment in the FLA and the UFB asset. That is that you are required to consider the risk to expected return on UFB investment and separation within a reasonable range of variations to possible outcomes. This is what investors faced in October 2011, for instance, as indicated in the Independent Expert's report of September 2011.

The alternative of using a benchmark approach for the FLA risk assessment is wholly inadequate to the requirements of s162 and commitments given by Government. There is an appearance of thoroughness through the extent of work done in compiling a large comparator set, some discussion of comparability which seeks to minimise substantial differences and measuring asset beta through relative share price movements and variance. However, the comparators do not come close to reflecting the risks faced and managed by Chorus through the UFB build period. Rather than discovering for yourself the extent of those risks and their possible impact on outcomes, as long term value investors would do in a primary equity commitment, you have instead found the answer you seek; that risk faced by Chorus in building a UFB is little different to risks faced by a preferred set of benchmarks in the ordinary course of their business operations. That has led you to materially under value risk during the build period.

As a general point we consider the long-term benefit of end-users (LTBE) of telecommunications services is enhanced where investors have confidence in the underlying regulatory model as this has a significant impact on investor perceptions of related investment risk which in turn affects the cost of capital. We think this calls for a high degree of rigour and consistency in such regulation. In particular, we are concerned that key factors that affect regulated outcomes are consistent on an ex ante and ex post basis including key cost of capital parameters such as asset betas.

We make several points in this submission:

- Not honouring previous commitments is not consistent with promoting certainty.
- A pattern of behaviour in not honouring commitments represents an appropriation of equity value.
- Asset beta should reflect the period of equity commitment rather than the short term equity trading becnhmarks relied on by the Commission

Not honouring previous commitments is not consistent with promoting certainty

The Commission recognises that the "FCM is a forward-looking concept" and that "while the FCM principle can assist us in promoting the s162 purpose and outcomes going forward, there are limitations to its use as a tool for the calculation of the FLA in the pre-implementation period, for the following reasons …".

However it says that incentives that operated during the pre-implementation period were more likely to have been influenced by other factors such as the competitive tendering process. This does not mean that the determination of the initial RAB value does not have potential implications for incentives going forward. However, we consider that such risks are mitigated by the IMs, the purpose of which is to promote certainty under s174. (paras 2.110-2.116).

Those points are wrong, and do not mitigate the need to set the FLA at the right level including risks faced by investors when they committed to the UFB investment and separation. The competitive tendering process may have mitigated some risk by contracting prices during the build period but key incentive that applied to the company and its equity investors during the pre-implementation period was the expectation that costs efficiently incurred and risks faced and managed would be properly considered in long term price regulation as directed by the government in 2011. The expectation of investment recovery and possibility of appropriate return was only ever expected to occur post completion and even then only if the company properly managed risks.

You can't 'wish' that expectation away by the spurious argument that "it is unlikely that in 2011 investors' expectations were framed in terms of what a BBM with a 10-year horizon might have delivered. Part 6 regulation did not apply at the time and was not discussed in detail until several years after the commencement of the UFB initiative." A direction from the Government did exist and was relied on by investors when they committed capital to the UFB and separation.

The view is also wrong that such risks are mitigated by the IMs, the purpose of which is to promote certainty under s174. It is wrong because if previous commitments to consider risk faced are not honoured then that will undermine investor expectations that forward commitments will be honoured. Dishonouring commitments does not promote certainty as required by s174, it promotes uncertainty and it promotes investor distrust of the regulatory process.

A pattern of behaviour in not honouring previous commitments

The point that trust in the regulatory process requires honouring of previous commitments is more pertinent in that your claim that providing certainty on a forward looking basis is more important than upholding ex ante expectations and commitments has been relied on previously by the Commission.

In 2014 the Commission reflected on the mis-setting of prices for copper local loop (UCLL) service and related services and indicated it would backdate final

prices to 1 Dec 2014. The interim pricing decisions were significant for Chorus costing around NZ$100m in lost cash earnings over two years, a present value of about $160m. The pricing decision caused Chorus to suspend its dividend resulting in material loss to shareholders, and caused the share price to weaken materially.

When final prices were set in Dec 2015, rather than backdate final UCLL prices as had been proposed, two Commissioners decided not to backdate prices considering "on balance … that backdating would not promote competition for the long term benefit of end users". That is the forward prospects for competition were considered, in the views of two deciding Commissioners, to have more merit than commitments or expectations given to investors.

We submit this predisposition to favour access seekers over access providers is a pattern of behaviour by the Commission and reflects a systematic bias against access providers with committed investment in favour of access seekers' claimed future prospects.

How should ongoing UFB investors now consider your claim that the IMs as you have applied them promote certainty for investors? When the next arbitrary claim comes along, it seems clear, you are more likely to favour forward views of access seekers than commitments made to access providers who have in turn committed investment.

Asset beta for the FLA should reflect the period of equity commitment rather than the short term, secondary market measures derived from traded equity benchmarks relied on by the Commission

The Commission's choice of asset beta for Chorus is based on equity beta's of a comparator set measured over short duration, and applies the same rate for the pre-implementation period as the post implementation period, that is a low rate of 0.50.

The estimates of asset beta were calculated using data from 2009 to 2019 "a similar timeframe to the pre-implementation period, and is therefore a reasonable estimate of asset beta and leverage for that time." Rubbish! Those measures are short run measures (weekly and 4-weekly) over a long period of time, and on most days reflected that comparator shares traded on a less volatile basis than the market.

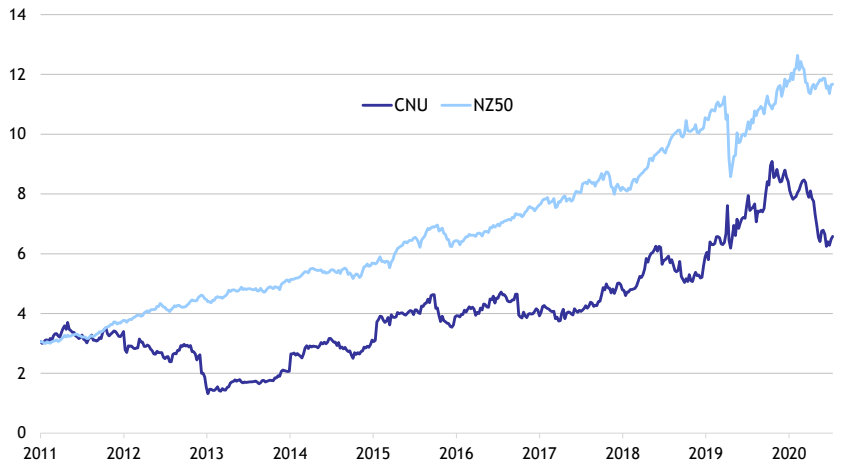
The capital commitment made by Telecom shareholders to UFB and separation and the risk faced in doing so was not made on a weekly or 4-weekly basis but made for the duration of the UFB project.

Those short term measures you have relied on are not consistent with the long term outcome that shows Chorus significantly underperformed the market, by more than 50% over ten years. On a long term basis Chorus faced considerably more systematic risk than the NZ equity benchmark and (if you did a similar comparison) we expect the so-called comparator set. To the extent share price performance reflects equity return, through the build period Chorus faced significant more risk than the comparator set, largely established companies with

established cashflow, and this difference is not captured by short term comparator measures of beta.

How does this equity price performance possibly reconcile with a view that Chorus UFB asset risk was so much less than the market through the build period? The indication is that it was more risky including as investors grappled with the inherent unreliability of the New Zealand regulatory process and what it might mean for return on UFB investment.

Table: Chorus share price relative to NZ50 benchmark



Source: NZX

In the long run, a start-up project such as UFB is materially more risky than indicated by your short term benchmark measures.

Short term asset betas (and equity betas) are also measured for small increments of assets to a portfolio, and may differ significantly from measures of large increments such as a primary equity commitment to a significant project such as the UFB. The direction made to you in 2011 specifically required you to consider that.

The long term asset beta of Chorus is significantly greater than 0.5, and was likely greater than 1 at the time of commitment and through much of the pre-implementation period.

One reason the Commission has opted for a low measure of asset beta is the claim that certain risks are "offset by the case for a lower beta due to the compensation for losses". (FLA reasons paper para 3.107) However, there is no compensation for losses and Chorus shareholders faced real risks through the implementation period and beyond that they may not be able to recover losses even where they managed certain risks effectively.

We note your dismissal of the views of equity analysts and investors on the value of Chorus' asset beta, and NSR in particular. "Overall, we consider that the market analyst reports are not inconsistent with an asset beta of 0.5, even though

we note that 0.5 is the lower bound of the estimates provided." (Fibre input methodologies: Main final decisions, reasons paper, paras 6.482-6.488.)

Analyst views should be your starting point for evaluation of risk and indications of the value of beta. That is one of the primary skills of equity analysts relative to benchmark assessors and why they are called on by institutional investors for views on risks to expected outcomes.

In particular you should consider what analysts advised about UFB risk and the cost of capital in 2011. You'll get a very different answer to the one you have contrived retrospectively.

We tend to use our DCF analysis and WACC estimates for primary equity raisings which occur from time to time and retain it as a valuation framework for ongoing advice on secondary market equity pricing. DCF and the WACC parameters are fundamentally long run average concepts while secondary market pricing is short run marginal in nature. For that reason we do not routinely publish our WACC or rely on DCF evaluation for secondary equity market advice.

Even in a primary equity event we would tend to focus our analytical effort on the numerator, that is the expected cashflow and possible variations in expected cashflow, rather than the denominator. Our intention in doing that is to help our clients evaluate risk so that they are better able to price it. It is our clients as equity investors after all that face that risk to expected cashflow and must decide what they will pay for it relative to other investment options. That long run evaluation and pricing of risk is not captured in the Commission's convenient benchmarking approach which relies on short run marginal measures. They are not appropriate to the task required of you in assessing the FLA.

Our question for the Commission is: how can you reasonably price risk when you haven't adequately evaluated it? You have instead sought ways to downplay it, or dismiss it, or avoid it. How does that approach possibly meet the purposes of s162, and the directions given by Government in 2011?

In closing if Chorus RAB is set so low because of misrepresentation of risk faced in the build period and a regulated return set at c4.5%, so far below the company's cost of capital, then the company should return UFB capital to shareholders as soon as possible (subject to meeting contractual commitments).

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