ENABLE NETWORKS LIMITED AND ULTRAFAST FIBRE LIMITED

SUBMISSION ON FIBRE INPUT METHODOLOGIES FURTHER CONSULTATION DRAFT (INITIAL VALUE OF FINANCIAL LOSS ASSET) – REASONS PAPER 13 AUGUST 2020

10 SEPTEMBER 2020

1. Introduction

1.1 This submission is made by Enable Networks Limited (**Enable**) and Ultrafast Fibre Limited (**Ultrafast Fibre**) (collectively referred to in this submission as **LFCs**) in response to the Commission's *Further consultation draft (initial value of financial loss asset) – reasons paper* dated 13 August 2020 (**FLA Reasons Paper)**.

2. Pre 2011 assets

2.1 We support the Commission's proposal to retain its draft decision to allow for pre-2011 assets in the calculation of the financial loss asset (**FLA**), where they have been used between 1 December 2011 and the implementation date to support the UFB initiative.

2.2 This is consistent with provisions for financial losses in section 177 of Part 6 of the Telecommunications Act 2001 (**the Act**). It is also consistent with the expectation that Chorus and the other LFCs would leverage existing infrastructure in delivering their obligations under the UFB undertakings.

2.3 We note that pre-2011 assets of the LFCs may enter the regulatory asset base (**RAB**) for UFB services where they are shared with other services (such as electricity lines services) through the asset allocation process. Other pre-2011 assets may enter the RAB as commissioned assets where they were purchased from related parties during the pre-implementation period for the purpose of the UFB initiative.

3. Discounted cash flow method

3.1 We acknowledge the challenges identified in paragraphs 3.2 – 3.5 of the FLA Reasons Paper when applying a building block method (**BBM**) to estimate the FLA. We therefore support consideration of alternative approaches for the FLA.

3.2 We are disappointed however that this final consultation phase did not include full consultation on the two options which have been developed during the input methodology (**IM**) consultation process – the BBM and discounted cash flow (**DCF**) options.

3.3 The Commission now considers that the BBM proposal it consulted on in late 2019 is conceptually flawed. This is because the unrealised returns were to be calculated and compounded forward to implementation date using a sequence of subsequent weighted average costs of capital (**WACCs**), rather than the WACC that occurred at the time the expenditure occurred.

3.4 The FLA Reasons Paper suggests that the BBM approach could be amended to address this issue, however an alternative DCF approach can provide equivalent outcomes, as follows:

> Different WACCs could be applied by maintaining separate RABs for each increment of capex in order to consistently use the WACC that applied to each increment. Instead—and equivalently—we propose simply to present-value each expenditure increment in the transition period at the WACC relevant to that increment.[1]

3.5 The Commission has not provided us with a corrected BBM option which addresses the issues identified in the earlier BBM proposal. It has therefore not been possible for us to confirm that the two options generate equivalent outcomes.

3.6 We acknowledge that a DCF approach may be easier to understand and apply than a BBM approach. We agree that if a DCF approach is adopted, a pragmatic approach is to define the UFB revenue and cost cash flows as proposed. However, we consider that the Commission's proposed approach to establishing the value of the benefit of Crown financing is incorrect. In

[1] NZCC *Further consultation draft (initial value of financial loss asset) – reasons paper* 13 August 2020 (**FLA Reasons Paper)** [3.5]

addition, we do not support the Commission's proposed approach to the WACCs to be used to compound the cash flows to the implementation date. We address each of these topics in the remainder of this submission.

4. Treatment of Crown financing

4.1 The Commission proposes that the benefit of Crown financing is calculated as the sum of the present value (**PV**) of net drawdowns less the sum of net drawdowns. The PV is derived by compounding the net drawdown relating to a specific loss year forward to the implementation date using the WACC prevailing in that loss year. According to the FLA Reasons Paper, this is equivalent to the previous proposed approach for determining the avoided cost of financing:

> Calculating the benefit of Crown financing in this way is equivalent to calculating the present value of the annual (or part year) avoided costs of Crown financing, where the avoided costs are calculated by multiplying the opening value of the accumulated Crown financing by the WACC for the relevant period.[2]

4.2 We do not agree with the Commission's view that the new approach and the previous approach (implemented as described above) are equivalent. They are equivalent only if the WACC is constant throughout the pre-implementation period, which does not hold if a variable rate WACC is being used as the Commission proposes.

4.3 The proposed approach, which is to calculate the difference between the PV of the net drawdown and the net drawdown, effectively assumes that:

(a) the net amount drawn down in a given year will remain outstanding until the implementation date; and

(b) the cost of financing that applied in the year of the net drawdown will apply each year until the implementation date, regardless of any repayment.

4.4 Given that the risk-free rate (and therefore the WACC) has been falling over the pre-implementation period, the proposed new approach overestimates the benefit of Crown financing where advances were received earlier in the pre-implementation period and repayments were made later in the pre-implementation period. These circumstances apply to UFF and Enable.

4.5 In our view, the Commission should revert to an approach similar to the one it previously proposed.[3] The avoided cost of financing in a given year should be determined by applying the appropriate cost of debt and/or equity to the outstanding Crown debt and/or equity balance in that year. Under a DCF approach, this would effectively represent an incremental cash inflow, which can be compounded to the implementation date at the appropriate WACC to determine the PV.

4.6 We also note that in determining the avoided cost of financing, the outstanding balance in a given year should be determined by taking the average of the opening and closing balances, consistent with normal practice. Taking the opening balance is not appropriate because the balance can vary throughout the year, and significant changes in Crown financing can occur during a single financial loss year.

5. WACC for the financial loss asset

5.1 For the purposes of computing the PV of cash flows as at the implementation date, the Commission proposes a variable fixed-term WACC with a term of five years. This includes adopting five-year terms for both the risk-free rate and the debt risk premium (**DRP**).

[2] FLA Reasons Paper, footnote 88

[3] NZCC *Fibre Input Methodologies, Draft Decision Paper*, November 2019, Box 3.1, p119

5.2 We disagree with this approach. We reiterate our previous view[4] that the pre-implementation period is economically equivalent to a normal regulatory period, justifying a single term to the implementation period for the WACC. We do not believe that the FLA Reasons Paper adequately responds to evidence presented in support of this view:

(a) The Commission argues 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."[5] However, even if some uncertainty about the precise form of the future regulatory regime did exist, there was still a clear expectation in 2011 that prices were fixed for the period until 2020, making the pre-implementation period economically equivalent to a normal regulatory period. We support the analysis provided by Sapere on this point in previous submissions;[6]

(b) As we have submitted separately,[7] section 177 of the Act itself necessitates that the pre-implementation period be treated as a single regulatory period. The UFB contracts committed the fibre providers to a 10 year+ capital expenditure programme and investors must therefore have formed expectations about the target return on that capital expenditure in 2011. Section 177(3) requires the Commission to use the target return on investment figure in its determination.

5.3 Without prejudice to this view, we submit that should the Commission choose to move to a DCF approach with a variable WACC, it should follow the expert advice provided by Dr Lally to use a WACC consistent with the remaining term to the implementation date.[8] A variable fixed-term WACC is conceptually flawed and inconsistent with the DCF approach.

5.4 Under the DCF approach, the discount rate applied needs to be consistent with the cash flows being discounted. If variable discount rates are being used for cash flows occurring in different years, then those discount rates need to have a term that matches up with when the cash flows occur. For example, a cash flow occurring in 10 years should be discounted to the present using a 10-year discount rate. The same argument applies when cash flows are being compounded forward, as is the case here.

5.5 In reference to Chorus' point that under a fixed-term WACC approach, a 10-year term is appropriate, the Reasons Paper states:

> This can be a useful simplification of the concept that the interest rate applied to a set of cash flows should reflect the term and the risk of those cash flows. This does not mean that where we are required to discount accumulated losses up to the implementation date (eg, as in the case of determining financial losses), such a simplifying assumption is appropriate.[9]

5.6 By adopting a fixed term of five years, the Commission is acting against its own assertion that the term of the discount rate should reflect the term and risk of the cash flows. Only if the term of the WACC matches the compounding period for a cash flow will it adequately reflect the expected return over the period.

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[4] Enable and Ultrafast Fibre, *Submission on Dr Martin Lally expert report – further issues concerning the cost of capital for fibre input methodologies*, 20 August 2020 [2.1] – [2.3]

[5] FLA Reasons Paper [3.29]

[6] Sapere, *Cost of capital for fibre input methodologies – response to Dr Lally (Prepared for Chorus)*, August 2020.

[7] Enable and Ultrafast Fibre, *Submission on Dr Martin Lally expert report – further issues concerning the cost of capital for fibre input methodologies*, 20 August 2020 [2.4] – [2.9]

[8] Dr Martin Lally, *Further issues concerning the cost of capital for fibre input methodologies*, 25 May 2020 (**Lally**) p3

[9] FLA Reasons Paper [3.31]

5.7 The Commission's proposed approach also deviates from Dr Lally's suggested approach of using a risk-free rate with a term from the loss year to the implementation date. The FLA Reasons Paper states that:

> While we can see the merits in Dr Lally's preferred approach of adopting a term to the implementation date, we do not believe that adopting an approach that will "produce more favourable results for firms than any other approach" best promotes the outcomes set out in s 162(a) and (d).[10]

5.8 Dr Lally did not recommend his suggested approach on the grounds that it may be more favourable to investors than other approaches. He explained why it was the preferred approach, and merely observed that it would also have that result.

5.9 As Dr Lally explained, there is a practical issue in obtaining Tax Adjusted Market Risk Premium (**TAMRP**) estimates for terms longer than five years, which have not yet been estimated.[11] He suggests a practical work-around which he describes as "the natural course of action"[12].

5.10 Finally, we also submit that should the Commission still choose to use a variable annual WACC with a fixed term, against the advice of Dr Lally, the principles of the DCF approach and this submission, it should use a 10-year WACC rather than a five-year WACC.

5.11 The FLA Reasons Paper bases the choice of a five-year term on "the term of debt that we observe occurs in practice among infrastructure providers including where they have employed swaps to change their interest rate pricing period."[13] This is not the appropriate reference rate to use in setting the WACC for a DCF approach. The WACC must reflect the term of the cash flows being discounted, not the financing being used. Furthermore, the FLA Reasons Paper refers only to the debt financing and ignores the equity component, for which the term may be expected to be much longer.

5.12 Ten years is a more appropriate term for a fixed-term WACC. It reflects both the long-term nature of the cash flows being compounded and common commercial practice.

6. Financial loss years

6.1 The annual cash flows during the implementation period are defined with reference to 12 month periods ending 30 June, other than the first period which commences on 1 December 2011 and ends on 30 June 2012, and the final period which ends on 31 December 2021.

6.2 At 1 July 2016, UFF switched to a 31 March balance date. The transition resulted in a 9-month financial year to 31 March 2017. Accordingly, for UFF the information required to implement the FLA method will not be readily available after 1 July 2016 in the format specified in the draft determination. The IMs will need to be amended to allow for flexibility in the definition of financial loss year to accommodate these circumstances.

6.3 This will also require WACCs to be determined as at 30 September, in addition to the 31 December estimates currently provided for, with appropriate variants for the first and last years of the implementation period, and the 2017 transition year. Appropriate amendments to the IMs are therefore required to reflect these circumstances.

[10] FLA Reasons Paper [3.14]

[11] Lally, p21

[12] Lally, p22

[13] FLA Reasons Paper [3.14]