

20 August 2014

Keston Ruxton
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Dear Ms Ruxton

Submission to UCLL and UBA FPP: consultation on regulatory framework and modelling approach

We appreciate the opportunity to make a submission to the Commerce Commission's final pricing principle price review. We believe regulated prices need to be at a level that makes an adequate return on invested capital.

We are long-term investors on behalf of pension funds. Given the Commerce Commission wishes to address the reasonable expectations of investors, we thought it would be relevant to consider the perspective of at least one. As we are not regulatory or technical experts, we cannot comment on the various modelling inputs, many of which can have a range of values that only adds to the unpredictability of the current process.

For investors, an adequate return on investment is the first and most important consideration. We would only provide capital to Chorus or any hypothetical, efficient provider of equivalent services if there is an adequate return available. Without that, there would be no investment, regardless of how predictable that low return might be. The need for an adequate return is heightened in the context of telecommunications because of the added technology and demand risks.

We believe the current benchmark price settings do not allow an adequate return on investment, particularly when examined in the context of the values of other networks in New Zealand. For simplicity, consider a new competitor that is looking to pass 831,000 premises in New Zealand. It estimates that it will cost \$2.6-2.8b to complete the roll-out, including connections. The table below summarises the economics of this investment.

Table 1 – A hypothetical competitor's economics under the current regulatory settings

Economic driver	Value	Explanation
Cost to roll out to 831,000 premises	\$2,600- \$2,800m	
Maximum revenue allowable under current benchmark pricing	\$343m	\$34.44/month price, assuming full take-up of UCLL and UBA services
Operating costs to provide these services	\$192m	Chorus' FY13 operating costs before depreciation and amortisation, adjusted down for number of premises. It assumes the costs are completely variable, which is optimistic, and excludes any return of capital considerations
Operating profit before tax	\$151m	
Pre-tax return on investment	5.4-5.8%	

The resulting pre-tax maximum return of 5.4-5.8% is far below adequate given the risks involved. No private investor would invest in a project like this in today's environment. The capital expenditure figures are, however, Chorus' own estimates for their new fibre network. By keeping prices at the proposed benchmark-based levels, the Commerce Commission would have to believe that Chorus is building its new fibre network extremely inefficiently relative to a hypothetical efficient operator or that Chorus has extremely inefficient operating costs.

While it may be argued that the capital is sunk and that the new network will get built even under these conditions because it is contracted, investors have very long memories. The next time a regulated business needs capital, it may well find that investors will require a significant risk premium given the regulator's behaviour has been unpredictable. If not amended, the benchmarked pricing will certainly damage New Zealand's standing as a low risk destination for investors' capital which could have negative long term consequences for end-users.

Yours sincerely



Simon Marais
Managing Director

Who is Allan Gray?

Allan Gray is an Australian based investment manager. We manage money for retail and institutional clients. A large proportion of our institutional clients are pension funds.