ABN 14 078 030 752

Level 24, 25 Bligh Street, SYDNEY NSW 2000
PO Box H104 Australia Square SYDNEY NSW 1215
1300 551 132 Ph +61 2 9232 7500 Fax +61 2 9232 7511

www.iml.com.au

Tristan Gilbertson
Telecommunications Commissioner
Commerce Commission
Wellington 6140

telcofibre@comcom.govt.nz

9 September 2020

Dear Mr Gilbertson

Investors Mutual Limited (IML) is an Australian based fund manager with over AUD 6 billion that it manages on behalf of a wide range of investors including many retail investors. IML takes a long-term approach to investing and we look to invest in companies which generate a high level of recurring income, have competent management, and that can grow their earnings and dividends over time. Since our inception in 1998, we have been a long-term shareholder in many New Zealand listed companies, including Sky City, Fletcher Building, Trade Me and Chorus.

The lengthy nature of our investment horizon is reflected in the fact we have been shareholders in Chorus since very early in the UFB project. This means we have a deep understanding of the risks the company has faced in delivering this project and the returns that investors have received to date. We have made submissions in various regulatory processes over the years, including the copper pricing review, the development of the new fibre regulatory framework and this current implementation phase. We are attracted to New Zealand because of its relatively stable economy and its generally predictable and transparent regulatory system.

The financial loss asset

Ten years ago, commitments were made to split Chorus from Telecom and build a fibre network that many nations would now give their eye teeth for. It was an ambitious project and required an element of government commitment – the Crown funding – to get it off the ground. The Government said in its policy statements that in return for this risky new investment Chorus would have the opportunity to earn normal returns.

The financial loss asset is an important contributor to our ability to earn a return on the fibre asset that has now been largely built and is delivering great benefits for New Zealand consumers today. It is our strong view that the Commission's proposed approach to the financial loss asset does not fairly reflect the public private partnership agreement. Chorus and its investors have delivered on their part of the bargain, but the Commission's interpretation of how the loss asset will be determined appears to be retrospectively undervaluing the contribution we have made.

A fair rate of return during the build period

While we do not take issue with the Commission's proposal to introduce a discounted cash flow approach for the financial loss asset, we continue to question the justification for the proposed adoption of annual risk-free rate calculations through the loss period.

It seems that the Commission is in effect trying to apply a forward-looking regulatory solution typical of a mature regulatory environment, where regulated returns are established in advance, typically for 4 or 5 year periods. In that situation the regulated business has the opportunity to hedge its finance costs and determine a capex program in light of this knowledge.

Chorus has shown in its recent financial results presentation the implied WACC and cost of debt that would apply based on the Commission's proposals. There is something fundamentally wrong if the Commission's indicated parameters are suggesting outcomes below Chorus' actual costs.

As we have submitted previously, it is our belief that the WACC for the entire construction period must be calculated on the market's forward view of interest rates at the time Chorus made the original commitment. This reflects the investment world reality of public private partnership financing decisions. It is supported by the following facts of the UFB agreement:

- In 2011, Chorus signed a 10 year commitment to build its share of the UFB network,
- The agreement included 10 years of fixed pricing, based on CFH's WACC estimates (CFH Response to Select Committee Questions, 2011) at 9%,
- Chorus quite sensibly aligned its initial debt financing to this 10 year period,
- Subsequent capital expenditures were contractually committed and were not separate investment decisions, and
- Chorus' cost of finance increased during the build period because of regulatory uncertainty relating to copper pricing.

We cannot understand how the Commission can consider a year-by-year WACC during the UFB construction period as a fair outcome when the company had no chance to reduce its financing costs commensurately, or to alter its investment decisions during the construction period.

The unfairness of this academic WACC construct is made obvious by the two years when Chorus could not have raised more debt because of the Commission's own copper pricing review. As investors during this period we remember only too well that dividends were stopped, the Crown was being asked to provide backstop emergency funding and the company's financial security was under threat.

Asset beta and percentile

As we have submitted previously, a key issue with the Commission's proposed approach to the financial loss calculation is the treatment of asset beta during the construction period. We consider it clear from the evidence to date that a much higher asset beta than 0.49 is an accepted commercial fact for the rollout of fibre networks on this scale. Asset beta estimates given by Ofcom, NBN and Crown Fibre Holdings, all indicate a higher outcome. The current approach taken by Ofcom in the United Kingdom is compelling because Openreach operates both copper and fibre networks, making it the closest comparator to Chorus. Ofcom say 0.65 is more appropriate for new fibre network operators because:

1. Fibre networks have higher operating leverage due to the operating and capital costs being higher relative to the immature revenue streams,
2. Fibre networks will face higher competition from copper and wireless networks than copper historically faced, and
3. High end fibre services, such as 1Gbps speeds, are viewed by consumers as luxury items which means fibre revenues will be more sensitive to economic conditions than historical copper network, or electricity utility, revenues.

The Commission has suggested there could be difficulties in estimating a pre-implementation period asset beta. We do not see why Ofcom's analysis cannot be relied upon when they were considering the same scenarios that would have applied to Chorus in 2011. The Commission also suggests the case for a higher asset beta may be offset by the compensation for losses. Yet, the financial loss asset was not formally introduced until 2018 as part of the new regulatory framework. The acknowledgment of the loss asset did not automatically magic away the risks and implied asset beta Chorus had operated under from 2011. As the Commission has itself stated, in the event that there is future stranding, the affected assets would be removed from the RAB.

The other major issue is that the WACC should be set at a percentile that reflects the risk of underestimating the WACC. Underestimating the WACC in the pre-2022 period is a very real risk, as Chorus has demonstrated with its chart showing actual versus implied WACC/debt. We therefore reiterate our prior submission view that, at a minimum, the 67th percentile should be used. At the very least, investors in fibre networks reasonably expect to be treated in a like manner to other regulated assets in New Zealand.

Crown funding

It is concerning that the Commission appears to be proposing to backtrack on its draft determination finding that the Crown funding should be treated as the equivalent of debt. As we submitted in July 2019, the CFH securities have their values defined in fixed dollar terms. They do not share in the risks and returns of asset ownership. From a shareholder's point of view, they add leverage and consume debt capacity in the same way as other debt sources.

Since the CFH securities carry debt like risks, the benefit to Chorus each year should be calculated as the difference between its cost of debt from traditional sources and the cost of the CFH funding, multiplied by the face value of CFH securities outstanding. This is relevant to the calculation of both past losses and future revenue caps.

The Commission's proposed treatment leaves Chorus in the untenable position of owning assets which carry downside risk but earn no upside return. How does the Commission reconcile this with the very plausible scenario that CFH funded assets become stranded by alternative technologies, but Chorus is still required to repay the full face value of the CFH funding over the next 15 years? And yet, under the terms of the PPP with the government, Chorus must issue ordinary shares to the Crown in the event that the UFB project is a runaway success.

The proposed treatment of the CFH funding makes it commercially rational for Chorus to now repay the CFH securities with traditional debt as soon as possible, so it can earn a return on the full asset base. This is patently absurd and reveals the degree to which the Commission's approach is

deconstructing the very foundations of the original UFB agreement. The Commission is itself acknowledging that a 25bps return may be required to try and stop this unravelling of the PPP, but there is no evidence as to how this value was derived, nor its commercial fairness.

Any suggestion that Chorus should not be able to repay its funding early is deeply concerning. The Commission should not be proposing to reinterpret the Crown's contract to prevent a scenario that its own proposal is creating.

We reiterate our comments from last year that investors will be watching this process closely to ensure that the returns they should be able to recover from their investment are not simply taken away by the Commission. The treatment of the CFH funding will have long lasting implications for the Crown's efforts to establish future PPPs.

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The coronavirus pandemic has shown just how essential the UFB network has become. It is providing socio-economic benefits above and beyond those envisaged back in 2011. We ask that the Commission take a balanced approach to ensure that there are no unintended consequences for the company, its investors and New Zealand, from this current review. We remember all too well the fallout from the 2013 copper pricing review, when international investor reaction sparked negative headlines overseas and Chorus was placed on negative credit watch.

Failure to adequately recognise the real costs and risks investors have incurred will tarnish what deserves to be New Zealand's greatest public private partnership success story.

Yours sincerely,

Hugh Giddy
Senior Portfolio Manager

Nigel Hale
Equities Analyst