



ENABLE NETWORKS LIMITED AND ULTRAFAST FIBRE LIMITED

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

1 OCTOBER 2020

1. Introduction

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

2. Definition of financial loss

2.1 A number of submitters urge the Commission to “define what ‘financial loss’ actually means”¹, include only “genuine losses”² or “consider a narrow definition of loss”.³ These submitters argue that other sub-sections of s177 require the reading down of the clear wording of s177(2) that the financial loss asset is equal to the financial losses incurred by the provider in providing FFLAS under the UFB initiative.

2.2 Spark, for instance, submits that “when you work through section 177 in its entirety [it]...directs the Commission to consider a narrow definition of losses.”⁴ In support of this argument, Spark submits that “section 177(4) makes it even clearer that losses should not be considered broadly, stating that it is not the intention that LFCs should be protected from all risk of losses”.⁵

2.3 This submission mischaracterises the purpose of s177(4). Part 6 of the Act creates a framework that specifies “the maximum revenues that may be recovered by a regulated fibre service provider” subject to PQR.⁶ S177(4) makes the obvious point that the maximum revenue figure is merely a regulated revenue cap, not a revenue guarantee. Market forces (such as, in this case, competition from fixed wireless access services) may prevent the fibre provider from achieving the revenue cap.

2.4 Spark further submits that s177(5) “requires that financial losses incurred relate to meeting specific requirements”, designed to ensure “that care is taken to reject costs that are not specifically incurred to meet specific UFB requirements”.⁷

2.5 We do not agree with Spark that s177(5) limits in any way the definition of financial loss. In this regard we agree with the Commission that s177(5) is not a restriction on ss177(1) or (2)⁸, but merely sets out for the avoidance of doubt some of the assets that must be included in the initial value.

3. Pre-2011 assets

3.1 Several submitters disagree with the Commission's view that “s177 permits (though does not require) pre-2011 assets to be included in the calculations of the FLA”⁹ on the basis that these assets were in place regardless of whether UFB services were to be provided.

¹ 2degrees FLA Submission, 10 September 2020 p2

² Vocus FLA Submission 10 September 2020 [33]

³ Spark FLA Submission 10 September 2020 p1 (**Spark**)

⁴ Spark [12]

⁵ Spark [21(b)]

⁶ Telecommunications Act 2001, section 194(2)(b)(ii)

⁷ Spark [30]

⁸ NZCC *Further consultation draft (initial value of financial loss asset) – reasons paper* 13 August 2020 (**FLA Reasons Paper**) p18

⁹ FLA Reasons Paper [2.22]

- 3.2 Trustpower submits that “reference to post-2011 assets in paragraph (a) [of s177(3)], with no corresponding reference to investments that were not made under the UFB initiative, implies that these pre-2011 assets must be excluded in calculating financial losses.”¹⁰
- 3.3 Chorus, in contrast, “disagree that the inclusion of pre-2011 assets is a matter of discretion for the Commission. Our view is it is required by section 177 of the Act”.¹¹
- 3.4 We agree with Chorus. The sole question to be determined is whether the asset in question is used by the regulated fibre service provider in providing fibre fixed line access services under the UFB initiative. Far from excluding pre-2011 assets by implication as Trustpower submits, section 177(1)(a)(ii) makes clear that pre-2011 fibre assets were intended to be included in the calculation of the fibre loss asset (**FLA**).
- 3.5 Whether existing assets are used, or new assets are created, is irrelevant. There is an opportunity cost associated with using existing assets for FFLAS and therefore an implicit investment which needs to be included in the FLA.
- 4. Treatment of Crown financing**
- 4.1 Chorus submits that the Commission’s revised approach to calculating Chorus’ benefit of Crown financing applies a rate that reflects the full project risk (i.e. the overall cost of capital) rather than the fundamental nature of the actual financing used (debt-like in Chorus’ case).¹² We agree with the principle that the benefit of Crown financing should be calculated using a rate that reflects the fundamental nature of the financing.
- 4.2 Chorus notes that the Commission’s proposed treatment of Crown financing for Chorus is inconsistent with its proposals for the other LFCs.¹³ The Commission proposes for LFCs other than Chorus that the “compounding factor” used to determine the present value of Crown financing applies a leverage ratio of:
- (a) 100% if the outstanding Crown financing is, in substance, provided by way of debt; and
 - (b) 0% if the outstanding Crown financing is, in substance, provided by way of equity.¹⁴
- 4.3 However, we note that this proposed approach is unsuitable for LFCs where Crown financing is a combination of debt and equity. In this case, it is not possible to characterise the financing as either one of debt or equity.
- 4.4 As previously submitted,¹⁵ the Commission should revert to the approach it originally proposed.¹⁶ 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.

¹⁰ Trustpower FLA Submission 10 September 2020 [2.3.2] (**Trustpower**)

¹¹ Chorus FLA Submission 10 September 2020 Chorus [24] (**Chorus**)

¹² Chorus [107]

¹³ Chorus [106]

¹⁴ NZCC *Fibre Input Methodologies Determination 2020, Further consultation – initial value of financial loss asset*, August 2020, IM clause 1.1.10 (5), p173

¹⁵ LFCs FLA Submission 10 September [4.5]

¹⁶ NZCC *Fibre Input Methodologies, Draft Reasons Paper* November 2019, Box 3.1, p119

5. WACC for the financial loss asset

Term of the risk-free rate

- 5.1 Chorus submits that the appropriate risk-free rate under the proposed discounted cash flow (DCF) approach should have a term equal to the expected term of the pre-implementation period.¹⁷ We agree with this view. This would respect investor expectations at the time of investment.
- 5.2 If the Commission were to decide to retain its planned approach of adopting a variable WACC with a fixed term, then we agree with Chorus that *“a risk-free rate term of 10 years is appropriate to reflect the expectation of investors in long-lived infrastructure”*.¹⁸ This would more closely align the discount rate with the nature of cash flows associated with long-lived assets. As Chorus notes, a 10-year term is also consistent with international regulatory practice.¹⁹
- 5.3 Spark submits that *“the Commission should look at re-setting the risk-free rate after 5 years.”*²⁰ Vodafone supports this view but submits that even shorter terms may be appropriate for resets occurring after confirmation of the implementation date: *“any financing that took place after 23 November 2018 may have been at a shorter term so that it finished at the same time the new regime started”*.²¹
- 5.4 We do not agree with these submissions. Such an approach would be inconsistent with commonly accepted principles of corporate finance and DCF analysis. It would contradict the principle of maintaining separation between the investment decision and the financing decision. Investment viability is established separately from analysing how the investment should be financed.
- 5.5 Sapere expressed the opinion that five years was likely to underestimate the relevant refinancing period for LFCs.²² They are correct. Enable’s network build was financed by a combination of Crown Infrastructure Partners Limited (CIP) funding and Christchurch City Holdings Limited funding both of which had a 10-year maturity. Ultrafast Fibre’s network build was financed by a combination of CIP funding and WEL Networks Limited/Waipā Networks Limited funding, both of which also had a 10-year maturity.
- 5.6 Vodafone’s suggestion that LFCs would have refinanced to align with the start of the new regulatory regime does not reflect reality. Neither Enable nor Ultrafast Fibre had any regard to the evolving regulatory framework in their financing decisions. In both cases long term funding was secured to reflect their obligations to construct the UFB network and provide services over the network; obligations that continue irrespective of the regulatory framework.

Vanilla versus post-tax WACC

- 5.7 Chorus submits that a vanilla WACC should be used rather than a post-tax WACC.²³ While it agrees with the Commission that the two approaches are identical if applied consistently, it disagrees that the post-tax WACC will be simpler to implement. Chorus submits that it would be more transparent to use the vanilla WACC approach when tax losses are being made.

¹⁷ Chorus [62]

¹⁸ Chorus [63]

¹⁹ Chorus [64-65]

²⁰ Spark [62]

²¹ Vodafone FLA Submission, 10 September 2020, p7-8

²² Chorus Appendix 4 [31]

²³ Chorus [138]

- 5.8 We agree that the uncertainty around the treatment of tax losses in the IMs is unhelpful and inconsistent with the objective of IMs which is to promote regulatory certainty. We consider that there are two possible approaches to resolving this issue:
- (a) include specific provisions in the IMs for the treatment of the tax loss issue which arises when applying a post-tax WACC; or
 - (b) adopt a vanilla WACC as suggested by Chorus.
- 5.9 As this is the final consultation before the IMs are determined, we recommend the vanilla WACC option because it has been considered in previous consultations.

Adjustment for inflation

- 5.10 Vector submits that the Commission's approach to treating inflation in the pre-implementation period WACC is not consistent with targeting the real return on investment: "The target real return on investment should be adopted for both the Pre-Implementation Period and in the forward-looking price setting process under Part 6 of the Act."²⁴
- 5.11 The WACC parameters relevant to the pre-implementation period are those that correspond to investor expectations formed at the beginning of the period. In our view, the Commission's proposed approach adequately reflects this.

6. Fair compensation for risk

- 6.1 Chorus and other investors²⁵ have submitted on the importance of investors being fairly compensated for the risks taken, and that the Commission's proposed approach fails to do so. We agree, as set out in more detail in our previous submissions.
- 6.2 Chorus' submission at paragraphs 33 to 38 describes well how the Commission's proposed approach is a form of asymmetric regulation which, if implemented, will result in investors not being compensated for the real risks faced by them in 2011.
- 6.3 It is easy in 2020 to assume these risks away because the UFB Initiative has been a success, but that could not be predicted in 2011. Indeed, in late 2015, when the network build was 56% complete but uptake was at 16%, the UFB Initiative was being criticised as not going according to plan because "*people don't seem to want superfast broadband*".²⁶ The failure of the UFB Initiative, it was said, "*should be a clear warning sign for policy makers proposing subsidised fibre as a panacea for rural US locations*."²⁷
- 6.4 Investors in 2011 relied heavily²⁸ on the commitment given by the Government in its October 2011 UFB Economic Policy Statement²⁹ that any future price regulation would:
- (a) recognise that revenues, over the life of the assets, are sufficient to cover efficient operating costs and a normal return on, and recovery of, capital invested; and

²⁴ Vector FLA Submission 10 September 2020 [16]

²⁵ Chorus [10-12]; Investors Mutual FLA Submission 10 September 2020 [p4] (IML); L1 Capital FLA Submission 10 September 2020 [p2] (L1 Capital)

²⁶ Bronwyn Howell *Government-funded fibre broadband – not as straightforward as it sounds*, January 2016

²⁷ Bronwyn Howell *Government-funded fibre broadband – not as straightforward as it sounds*, January 2016

²⁸ See IML p1, L1 Capital p2

²⁹ *Statement to the Commerce Commission Concerning Incentives for Businesses to Invest in Ultra-fast Broadband Infrastructure*, New Zealand Gazette No 155, 13 October 2011, 4440 (2011 GPS)

- (b) take into account the start-up risks associated with the introduction of new technology.
- 6.5 The Commission is on record that it does not regard these commitments as being “*relevant to our decisions under Part 6*”³⁰. The Government chose to withdraw its Policy Statement on 5 October 2019 for reasons it has never explained. However, these events do not change the fact that the policy statement was issued to give investors comfort about future regulatory settings, was relied on by investors, and the Commission’s decision to treat that commitment as irrelevant results, as L1 Capital submits, in “*a partial seizure of the UFB asset*”.³¹
- 6.6 The viability of future Public Private Partnership (PPP) investment programmes depends crucially on the perception of a symmetric regulatory framework that offers investors the expectation of fair compensation for risk. The Commission must bear this in mind as it finalises its cost of capital parameters. We endorse the submission of Investors Mutual Limited:

*“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”.*³²

³⁰ NZCC *Fibre regulation emerging views: Technical Paper* dated 21 May 2019 [93] (EVP).

³¹ L1 Capital p1

³² IML, p4.