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Commerce Commission New Zealand

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To whom it may concern;

Having reviewed the Fibre Regulation Emerging Views Paper released in May 2019, Ubique Asset Management Pty Ltd (Ubique or we) would like to put forward the following submission.

Ubique is an institutional equity investor based in Sydney and we are a shareholder in Chorus Limited (CNU), a company that will be directly impacted by the new regulatory framework for fibre.

Ubique invests in infrastructure companies such as CNU with the expectation that regulated assets will generate fair and reasonable returns on the real capital that has been employed, and that appropriate frameworks exist to allow the same fair outcomes on future investment.

Ubique are encouraged that the Commerce Commission has suggested that Real Financial Capital Maintenance (FCM) will be one of three key principles to be considered when applying the new regulatory framework. We view this economic principle in relation to a regulated supplier having the opportunity to earn a "normal return on capital" as being essential to encourage future network investment.

The WACC calculation is clearly an important element under a RAB model and the initial view concerns us. The WACC to be applied to CNU under the Emerging Views Paper would be circa 5% on a post-tax basis. Despite the current record low yields on Risk Free Rate proxies, we do not believe that this level of return is a sufficient 'through the cycle return' to encourage new capital investment to the sector and it does not take into account the business risks faced by CNU.

Section 162(a) of the Telecommunications Act 2001 is referenced as follows in the Emerging Views Paper:

..suppliers having incentives to innovate and invest – our intention is to set a return high enough for a supplier to attract sufficient capital to undertake efficient investment.

Ubique feel that a WACC of 5% is not high enough to attract sufficient capital to undertake efficient investment. The New Zealand Government has also explicitly acknowledged the high-risk nature of the fibre rollout in New Zealand. A Government Policy Statement in 2011 specifically said any price regulation should *"...take[s] into account the start-up risks associated with introduction of new technology."* Prior to the start of the UFB rollout, Crown Fibre Holdings provided its views on local fibre company WACCs to the New Zealand Parliament. They calculated a WACC range of 8-10% and used a midpoint of 9% in their modelling. Crown Fibre Holdings explicitly stated: *"In layman's terms, the business risk of an LFC is less than an incumbent telco but greater than a utility (such as power, gas, and water), due to technology and future uptake / revenue risk".*

In terms of looking outside of New Zealand, we would also highlight the following:

- A 2016 European Commission report recommended higher WACCs be applied to Next Generation Access networks to reflect different characteristics from legacy networks, including systematic demand risks, intensive capital leverage and long-term pay-offs;

- Many European regulators are adopting an approach of using a WACC premium uplift to acknowledge that fibre is a higher risk investment proposition when compared to copper. Examples of the premiums applied to the historical copper access WACC include:
  - Slovenia & Luxembourg - 2.50% premium;
  - Denmark – 2.00%;
  - Czech Republic – 1.405%;
  - Belgium – 1.23%; and
  - UK – 1.00% premium.

  We note that the Commerce Commission did not apply a WACC uplift as part of the copper pricing (FPP) review in 2015, however we feel that the reliance on broadband/data networks has increased significantly since 2015 and this trend is likely to increase going forward;

- The UK regulator Ofcom adopted the 'fair bet' principle where they gave BT/Openreach a higher WACC for their fibre to the cabinet investment and have now said they will apply this principle to their 'full fibre' (i.e. FTTP) investment. In a July 2018 report titled "Regulatory certainty to support investment in full-fibre broadband" they noted (p10):

We recognise that Openreach needs the opportunity to make higher returns when a risky investment is successful in order to compensate it for the chance a risky investment may fail (the 'fair bet' principle)… We applied this principle to superfast broadband investment.

We note the Commerce Commission's experts, Cambridge Economic Policy Advisors (CEPA) paper that considers the comparator companies to be used to derive the asset beta for CNU. The result of this analysis is a suggested asset beta range of 0.42 to 0.51, with 0.46 as the average. This asset beta is below what we would expect for a company like CNU. In its response to questions from the NZ Parliament, Crown Fibre Holdings said they had calculated an asset beta range of 0.5 to 0.8 for local fibre companies (LFC). They referenced NBN Co [0.5 to 0.65 per McKinsey Report 2010] and OpenReach [0.52 to 0.65 per Ofcom 2009] as supporting this. Crown Fibre Holdings noted (p5):

CFH believes that the business risk of an LFC is less than a normal Telco but greater than a utility such as an Electricity lines company. This is the same philosophy Ofcom has used in the UK where it deconstructs the equity and asset betas of British Telecom between OpenReach (LFC equivalent) and the rest of the BT Group.

There are some significant factors affecting the asset beta range derived by CEPA:

- The Commerce Commission's comparator set for the CNU copper pricing review in 2015 had 18 vertically integrated telcos whereas CEPA's comparator set comprises 59 companies;

- A key feature of CEPA's analysis is the inclusion of tower and satellite companies in the comparator set. CEPA suggests their inclusion is to reflect the wholesale only nature of CNU. We would highlight that these sectors do not operate fixed line access services and unlike CNU they tend to have long-dated contracts with customers. CEPA suggest at p20-21 that these long-dated contracts *"…could be viewed as providing a similar degree of long-term revenue stability and resilience to systematic demand fluctuations as Chorus' revenue cap. Overall, this means that investors may consider Chorus' fibre services as closer in nature to those of the tower companies and satellite operators, rather than the integrated telecommunication companies included in our comparator set.";*

- CEPA also include mobile only telcos in their comparator set (e.g. US Cellular, Trilogy International, T-Mobile). These companies were not included in the Commerce Commission's copper pricing review analysis in 2015. The chart and table from the CEPA report (p40-41) show that when telcos with less than 50% of revenues derived from fixed line services are excluded, the asset beta range would increase to 0.51 to 0.63;

Ubique feel that the comparator set should be aligned to calculating the asset beta of fixed line access services. Regulators such as Ofcom specifically refine comparator sets to reflect the type of service being considered and this approach should be adopted by the Commerce Commission. Companies that derive the majority of their revenues from towers, satellites, mobile and backhaul services do not meet this hurdle and should be excluded. Unlike tower/satellite companies CNU's revenue cap is not a guarantee of a return as CNU does not have long term access service contracts with retail service providers and is further limited by anchor product and unbundling requirements under the new framework. It is also worth noting that both Spark NZ and Vodafone NZ are actively promoting fixed wireless thereby seeking to circumvent the CNU fibre network.

The Emerging Views Paper also proposes that there will be no adjustment from the 50th percentile for CNU's WACC. All other regulated utilities (electricity distribution networks, gas networks, airports) in New Zealand have their WACC set at the 67th percentile to avoid the risk of under investment and we feel that this uplift would be appropriate for CNU as well. CNU is continuing to invest in fibre assets because it has contractual commitments to do so through to FY22. Post the rollout, CNU will have commercial decisions to make about ongoing investment and WACC returns will play a large part in any final decision making. It is likely that these future capex decisions could include enhancements to network capacity, resiliency and innovation, all of which have obvious consumer benefits. In addition, businesses are increasingly dependent on CNU's network for cloud-based services and the rollout of 5G will increase mobile networks' reliance on fibre networks for connectivity.

In summary, we need to remind ourselves that long-term assets require long-term funding and we encourage the Commerce Commission to recognise that providers of capital (both debt and equity) have choices as to where they allocate that capital globally. We look forward to a fair and reasonable outcome for all industry participants and thank the Commerce Commission for the opportunity to make a submission.

Yours sincerely;

John Harbot
Director

Martin Kleindyk
Director