



**ENABLE NETWORKS LIMITED AND ULTRAFast FIBRE LIMITED**

**SUBMISSION ON DR MARTIN LALLY EXPERT REPORT – FURTHER  
ISSUES CONCERNING THE COST OF CAPITAL FOR FIBRE INPUT  
METHODOLOGIES**

**20 AUGUST 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 Dr Martin Lally's expert report: *Further issues concerning the cost of capital for fibre input methodologies* dated 25 May 2020 (**expert report**).
- 1.2 We have focussed our attention on Dr Lally's responses to key issues raised in previous submissions and cross-submissions and Dr Lally's responses to questions raised by the Commission.
- 1.3 In general, we note that there is some ambiguity in Dr Lally's paper in places, both in relation to questions raised by the Commission and the reasoning provided, and conclusions reached, by Dr Lally.

## 2. Cost of capital in the pre-implementation period

- 2.1 We disagree with Dr Lally's rebuttal to submissions and cross-submissions which argued in favour of treating the pre-implementation period as a normal regulatory period.<sup>1</sup> Lally asserts that the pre-implementation period is different from a normal regulatory period because it is concerned with compounding forward losses to the implementation date, rather than the normal regulatory price-setting process. He argues that risk-free rates and DRPs in force at the beginning of the pre-implementation period are irrelevant and that submitters have not presented evidence to the contrary.
- 2.2 We disagree with this assessment. Extensive evidence has previously been submitted that the pre-implementation period is economically equivalent to a regulatory period. For example, as submitted by Sapere, the framework of undertakings and agreements between the Crown and fibre providers from 2011 placed constraints on price, quality and service provision, making it comparable to a regulatory period.<sup>2</sup>
- 2.3 Importantly, from the perspective of an investor, the relevant risk and return expectations had to be formed at the beginning of the pre-implementation period. Estimates of WACC parameters need to reflect this and should be estimated as at May 2011, the time of the UFB tender. This is consistent with our previous submission, as well as other submitters including Chorus.<sup>3</sup>
- 2.4 Dr Lally bases his views on his interpretation of s177 of the Act. He states that
  - (a) "it seems clear from section 177 of the Telecommunications Act that losses are defined as the ex-post difference between revenues and costs rather than the difference between expected and actual cash flows"; and
  - (b) "regardless of how losses are defined, section 177 of the Act clearly indicates that the ex-post compensation involves compounding the losses forward to the end of the pre-implementation period, this compounding exercise requires risk-free rates, and the relevant risk-free for the losses incurred in (say) 2015 is the risk-free rate in 2015, with a

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<sup>1</sup> Including those made by Chorus, Enable Networks Ltd & Ultrafast Fibre Ltd, Sapere and Northpower Fibre Ltd & Northpower LFC2 Ltd.

<sup>2</sup> Sapere, *The Cost of Capital Input Methodologies for Fibre (Prepared for Chorus)*, 27 January 2020.

<sup>3</sup> Enable Networks Ltd and Ultrafast Fibre Ltd, *Cross Submission on NZCC Fibre Input Methodologies: Draft Decision - Reasons Paper and Draft Fibre Input Methodologies Determination*, 17 February 2020.; Chorus, *Submission on Fibre Input Methodologies: Draft Decision – Reasons Paper dated 19 November 2019 and Draft Fibre Input Methodologies Determination 2020 dated 11 December 2019*, 28 January 2020.

term equal to the remainder of the pre-implementation period, and applicable to each year from 2015 till the end of the pre-implementation period”.<sup>4</sup>

- 2.5 Significantly, Dr Lally does not refer to the wording of s177, nor explain how his views quoted above are “clearly indicated” by s177. In fact, the wording of s177 clearly indicates that Dr Lally’s views are incorrect.
- 2.6 Section 177 provides (relevantly) that
- (a) Each regulated fibre service provider is treated, as at the implementation date, as owning a fibre asset with an initial value equal to the financial losses, as determined by the Commission, incurred by the provider in providing fibre fixed line access services under the UFB Initiative for the period starting on 1 December 2011 and ending on the close of the date immediately before the implementation date;<sup>5</sup>
  - (b) In determining the financial losses ...the Commission must take account any accumulated unrecovered returns on investment made by the provider under the UFB initiative<sup>6</sup>; and
- 2.7 Accumulated unrecovered returns means the sum (adjusted to reflect the present value, as calculated in the manner the Commission thinks fit, at the implementation date) of the unrecovered returns on investment for each financial year...<sup>7</sup>
- 2.8 The UFB contracts committed the fibre provider to a 10 year+ capital expenditure programme. The provider entered into that commitment on the basis of a target return on investment on that capital expenditure. The “unrecovered returns on investment made by the provider under the UFB initiative” can only be calculated by deducting the actual return on investment achieved in any year from the initial target return on investment.
- 2.9 For the purposes of section 177(3) the Commission is required to use the target return on investment figure in its determination. This necessitates that the pre-implementation period be treated as a single regulatory period. If the Commission were to adopt the approach advocated by Dr Lally, the financial loss asset would not include the provider’s full unrecovered returns on investment, in breach of s177(3)(a).

### 3. Rounding in respect of the TAMRP

- 3.1 We support Dr Lally’s view that the Commission’s practice of rounding the TAMRP estimate to the nearest 0.5% is appropriate, which is consistent with our previous submission.<sup>8</sup> We agree with Dr Lally’s points that:
- (a) the notion that over and under estimations net out over time is unaffected by potential changes in methodology;
  - (b) other WACC parameters are also rounded and the degree of rounding depends on the way the parameters are presented and the degree of precision with which the parameters can be estimated; and
  - (c) the advantages of rounding the TAMRP (including reduced costs and lobbying over small changes) outweigh the small increase in the mean squared error of estimation errors.

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<sup>4</sup> Martin Lally, Further issues concerning the cost of capital for fibre input methodologies, 25 May 2020, p3

<sup>5</sup> s177(2) Telecommunications Act 20001

<sup>6</sup> s177(3)(a)

<sup>7</sup> s177(6)

<sup>8</sup> Enable Networks Ltd and Ultrafast Fibre Ltd, *Cross Submission on NZCC Fibre Input Methodologies: Draft Decision - Reasons Paper and Draft Fibre Input Methodologies Determination*, 17 February 2020.

#### 4. Credit rating and leverage

4.1 Dr Lally acknowledges that there is some inconsistency between the comparator sample that the Commission used to set its benchmark leverage (31%) and the sample it used to set its benchmark credit rating (BBB+). The comparator sample used to set the benchmark leverage suggests a credit rating below BBB+. Dr Lally proposes two alternative approaches to address the inconsistency:

- (a) lower the benchmark leverage to a level that would be consistent with the higher benchmark credit rating of BBB+; or
- (b) determine the benchmark leverage from a comparator sample of firms with a BBB+ credit rating, which would result in a leverage of 34%.

4.2 In our view, the Commission should pursue Option (b) above. This option follows the principles of using an evidence-based approach to setting parameters, using empirical data and ensuring internal consistency. As Dr Lally notes, Option (a) is not consistent with the empirical data, which suggests that the average leverage for 2014-2019 for BBB+ firms was 34%.

#### 5. Pre-implementation period beta

5.1 We welcome Dr Lally's clarification of his previous advice to the Commission in relation to the appropriate value for beta in the pre-implementation period. Dr Lally clarifies that his advice did not set an upper bound on beta. Rather, the only suitable comparator for systematic risk in the pre-implementation period was the beta applicable in the regulatory situation. However, this could be too high or too low.

5.2 Dr Lally's advice supports the position that the appropriate asset beta in the pre-implementation period should be at least equal to the beta in the post-implementation period. We reiterate the position expressed in our previous submission (as well as by other submitters) that there is compelling evidence that systematic risk is in fact higher in the pre-implementation period.<sup>9</sup> This would support a higher asset beta relative to the post-implementation period. Dr Lally's response above acknowledges that this is possible and clarifies that interpreting the regulatory period beta as an upper bound is incorrect.

#### 6. Risk-free rate for cost of debt and equity

6.1 Dr Lally was asked by the Commission to clarify whether the same risk-free rate should be used for both the cost of debt and the cost of equity for compounding losses forward to 2021. In our view, Dr Lally's response demonstrates the difficulties that arise when applying annual resets of the risk-free rate during the pre-implementation period, a method which deviates from usual regulatory practice.

6.2 In the context of compounding losses forward, for a loss incurred in a given year, this would involve using a risk-free rate from that year to the end of the compounding period (2021). This implies that risk free rates are required for terms of between 1 and 10 years (for losses occurring between 2011 to 2021). This approach is possible for estimating the cost of debt. Dr Lally notes that a complication arises when calculating the cost of equity, because estimates of the TAMRP would be required for the same terms (1 to 10 years). However, such estimates are only available for terms up to 5 years. To resolve this, Lally suggests an approach whereby:

- (a) The risk-free rate within the cost of debt has a term equal to the entire period from the year in which the loss occurs to 2021; and

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<sup>9</sup> Enable Networks Ltd and Ultrafast Fibre Ltd, *Cross Submission on NZCC Fibre Input Methodologies: Draft Decision - Reasons Paper and Draft Fibre Input Methodologies Determination*, 17 February 2020; Chorus, *Submission on Fibre Input Methodologies: Draft Decision – Reasons Paper dated 19 November 2019 and Draft Fibre Input Methodologies Determination 2020 dated 11 December 2019*, 28 January 2020.; Sapere, *The Cost of Capital Input Methodologies for Fibre (Prepared for Chorus)*, 27 January 2020.

- (b) The risk-free rate within the cost of equity has a term equal to the entire period from the year in which the loss occurs to 2021, if that period is five years or less. If the period is greater than five years, then a five-year risk-free rate is used for the first part of the period, followed by a risk-free rate that corresponds to the residual part of the period up to 2021.
- 6.3 Dr Lally notes that a shortfall of this approach is that it requires a number of assumptions, including about the way firms acted in relation to borrowing.
- 6.4 In our view, no clear answer is provided to the question raised by the Commission. We reiterate the position from our previous submission that a more appropriate approach would treat the pre-implementation period as a single regulatory period.<sup>10</sup> The risk-free rate should then be based on data from a short period preceding May 2011, with a term matching the expected term of the pre-implementation period.<sup>11</sup>
- 6.5 This is consistent with the Commission's usual approach and reflects the notion that the pre-implementation period is economically equivalent to a normal regulatory period. Further, it acknowledges that from the perspective of an investor, the relevant risk and return expectations were formed at the beginning of the pre-implementation period, at the time the investment decisions were made.

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<sup>10</sup> Enable Networks Ltd and Ultrafast Fibre Ltd, *Cross Submission on NZCC Fibre Input Methodologies: Draft Decision - Reasons Paper and Draft Fibre Input Methodologies Determination*, 17 February 2020.

<sup>11</sup> This is consistent with prior evidence presented by Sapere and HoustonKemp: Sapere, *The Cost of Capital Input Methodologies for Fibre (Prepared for Chorus)*, 27 January 2020.; HoustonKemp, *Risk free rate, debt premium and TAMRP (A report for Chorus)*, 9 July 2019.