

Vodafone Cross-Submission



New regulatory framework for fibre:

Cross-Submission on Fibre Regulation Emerging Views
– Cost of Capital

9 August 2019



Contents

Executive Summary.....	3
Competitive pressure requires no uplift	5
A lower cost of capital during the losses period	10
Risk faced by investors during the pre-implementation period.....	10
Estimating the impact on the WACC	11
Crown financing reduced risk for private investors	14
On balance the requirements and concessions from the Crown reduced risk for private investors.....	14
Incenta have incorrectly estimated a cost of Crown funding	15
There is no case for a percentile uplift to the WACC	21
The role of a percentile uplift.....	21
No evidence has been provided that a percentile uplift is needed	22
Comparator firms must reflect actual risk born by LFCs	24



Executive Summary

Thank you for the opportunity to provide a cross-submission on cost of capital issues relating to the new fibre regulatory regime. We appreciate the additional time given as there was significant weight of submissions from the LFCs and their investors on this topic.

Cost of capital is a complex topic for us to provide views on. We are not experts on this matter and are not blessed with a regulatory pass-through allowing us to spend hundreds of thousands of dollars on experts. By and large, end-users must rely on the Commission to critically examine the proposals put forward by the LFCs and their investors.

That said, we have provided brief comments in this cross-submission on some of the more material cost of capital issues. We have focussed on areas we are able to provide insight based on years of engagement on telecommunications regulation, our experience as an investor and an RSP, and our relationship with the LFCs.

- **Effect of competition** – Submissions that propose an uplift to the WACC to account for a potential increase in competition do not adequately consider the relationship with the wash-up mechanism. The wash-up will compound the uplift between periods, and result in Chorus earning above FCM. We consider that FCM neutral smoothing mechanisms are better suited to account for this risk.
- **The cost of capital during the pre-implementation period** – We disagree with submissions that suggest that the cost of capital should be higher at the beginning of the UFB initiative, i.e. during the pre-implementation period. In contrast, the losses calculation acts as a form of insurance absorbing all systematic risk during the pre-implementation period, significantly reducing the cost of capital.
- **The cost of Crown financing** – Some submitters that argue that the requirements of the UFB initiative mean that the interest free Crown financing actually had a cost for investors. This is only telling half the story. There were also a number of concessions granted by the Crown that significantly reduced risk for private investors. We also find that Incenta's estimation of the cost of Crown financing makes a significant error by comparing the post-tax WACCs. When this is corrected for their estimated cost of Crown financing is de-minimis.



- **Uplift to the WACC percentile** – Submissions from the LFCs and their investors misunderstand the role of a percentile uplift. A percentile uplift is a very costly measure for end-users because it applies to all sunk investments as well as new capex. It must therefore only be considered if no other incentive mechanism are available to ensure the right level of investment is undertaken. No submitter has been able to make this case. We favour applying more effective incentives, like competition deep into the network, effective quality regulations, and ensuring the natural efficiency incentives of the regime are well implemented.
- **Comparator firms** – By and large we support the comparator firms proposed by CEPA. However, including more public private partnerships would better reflect the impact of having the Crown as a partner in the UFB initiative. We do not support suggestions from the LFCs and their investors to remove all firms from the sample that have a lower risk profile than the LFCs. This would bias the sample upwards, unless firms with higher risk are also removed. Doing this would likely result in a very small comparator sample that would not be fit for purpose.



Competitive pressure requires no uplift

The LFCs, their investors, and their experts all point towards a significant risk of asset stranding as a result of competitive pressure, and request an uplift to the WACC to account for this.

In our submission we recommended that an uplift would be the best way to deal with this risk. Although, we expressed a different view on the magnitude of the risk.

However, we note the comment from Trustpower that:

The competitive environment for high speed broadband is evolving and will continue to evolve. For example, the future environment will likely comprise of both fixed line and wireless or other technologies. For periods of time wireless technologies may be in the ascendant, only to be overtaken by fixed line technologies. It will be difficult for the Commission to accurately determine whether and when assets may be stranded, and when a future upgrade may completely change the situation.¹

This is a critical insight. Most other submitters (ourselves included) seemed to assume that we are approaching the end of history, with one more technology evolution which will describe the competitive state forever.

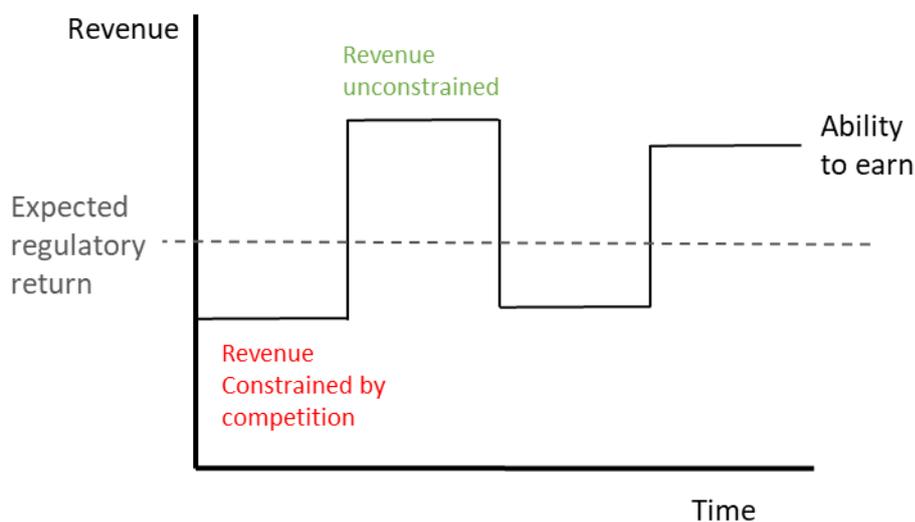
The reality, as captured by Trustpower, is that both technology and consumer demands will continue to evolve. The demand for fibre services really kicked off on the back of the 'Netflix effect'. Wireless technologies' capacity has now caught up to meet this demand, with further investment and the impending roll-out of 5G. However, newer services may appear in the future that require capability only achievable on fixed networks, meaning that fixed networks will gain a stronger market power.

Figure 1 below is a stylistic representation of this effect. It shows the ability for the LFCs to charge for fibre services in the absence of any regulation.

¹ Para 3.7.5



Figure 1: Fibre will have periods where it is constrained by competition, and periods where it is not



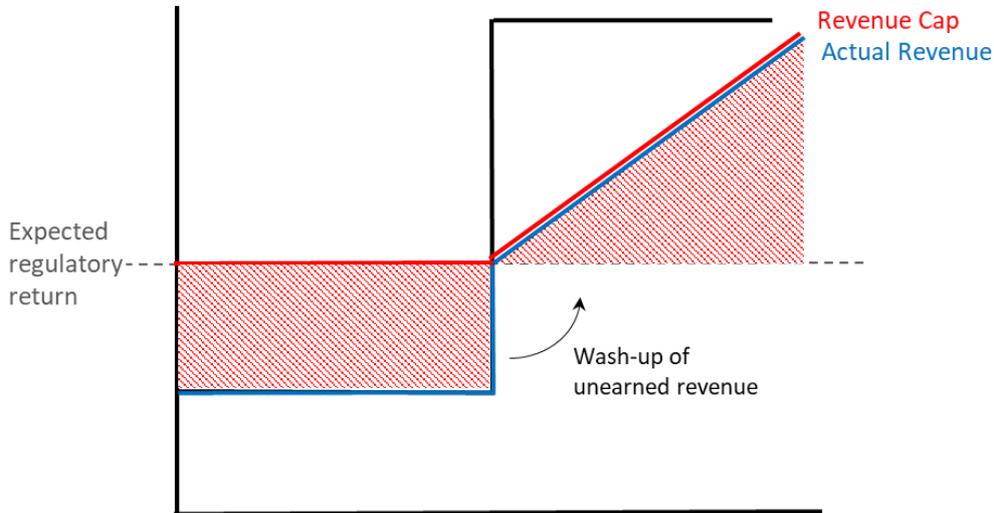
In this context, the regulatory response to competition should be focussed on spreading recovery to the times when end-users are willing to pay for it. This is largely already accounted for in the regime specified in the Act.

- Section 196 sets up a 'wash-up' mechanism. If a price-regulated LFC cannot fully recover revenues in one period, the under-recovery will be recorded in a wash-up account which can be drawn down in the future when end-users are more willing to pay.
- Section 197 requires the Commission to smooth revenues and prices over multiple periods to minimise undue financial hardship for LFCs, or minimise price shocks for end-users.

Together these clauses give the Commission considerable flexibility to smooth revenues to suit the level of competition in the market. Figure 2 below shows a simplified stylistic representation of how the wash-up mechanism will work over two periods.

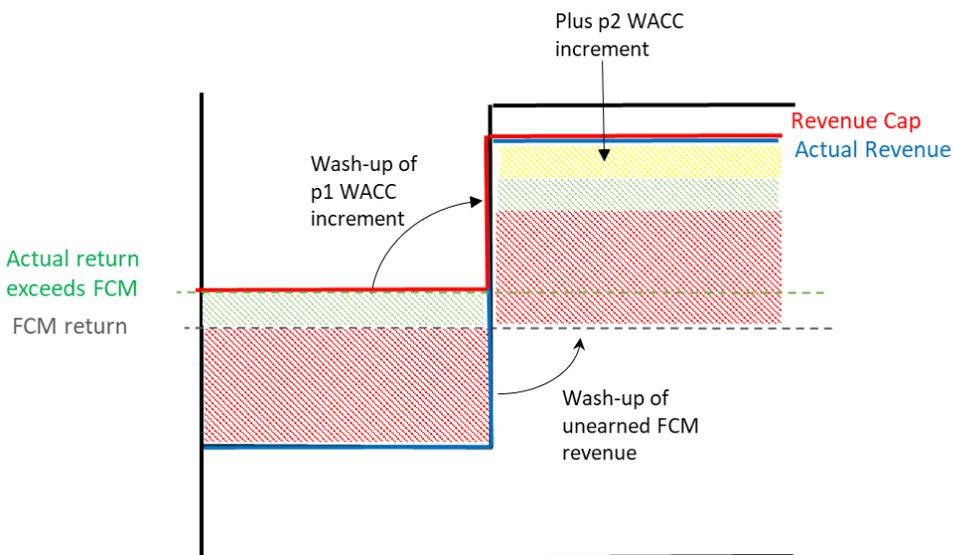


Figure 2: Wash-up between two periods with smoothing



The wash-up mechanism conflicts with the use of a WACC uplift or fair bet principle, as proposed by Oxera. This is because in times of under-recovery the WACC uplift will be added to the wash-up. This will then be compounded by the WACC uplift in the future period. As shown in figure 3 below (where the effect of smoothing has been removed for simplicity). The end result is that the LFCs will achieve a return above FCM.

Figure 3: over recovery of a WACC increment when combined with a wash-up (no smoothing)

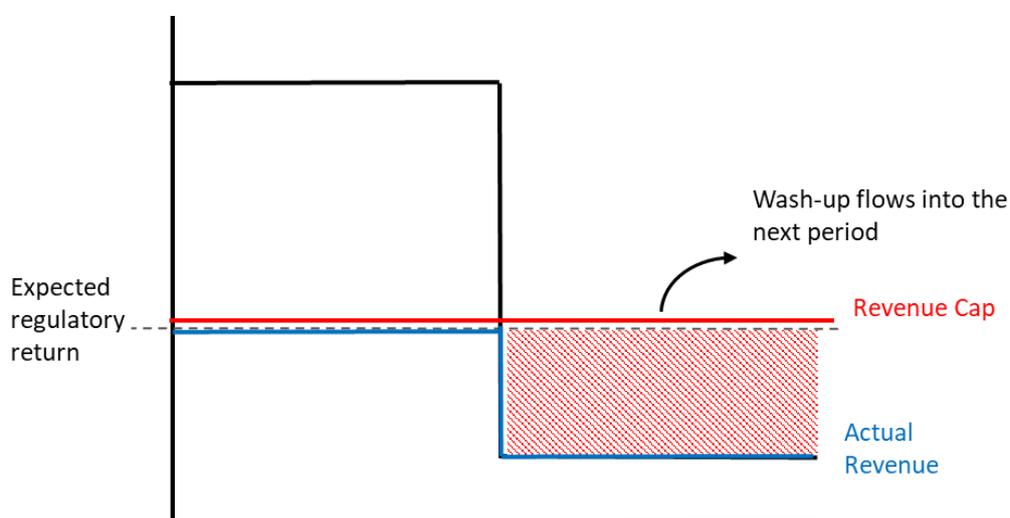




Oxera have proposed a complex regime that may help mitigate this risk by continually monitoring whether NPV=0 has been achieved and adjusting accordingly. This is unnecessary as under the currently proposed regime the wash-up account already tracks FCM over time, and continually adjusting a WACC uplift to ensure FCM isn't exceeded may prove unworkable.

The only potential gap in the current regime is that the wash-up account is only backwards looking, and cannot account for an anticipated increase in competition in the future. The simplest example of this is if revenue is unconstrained in the first period, but then competition creates a constraint after that. This is represented in figure 4 below.

Figure 4: Wash-up cannot account for expected future increases in competition



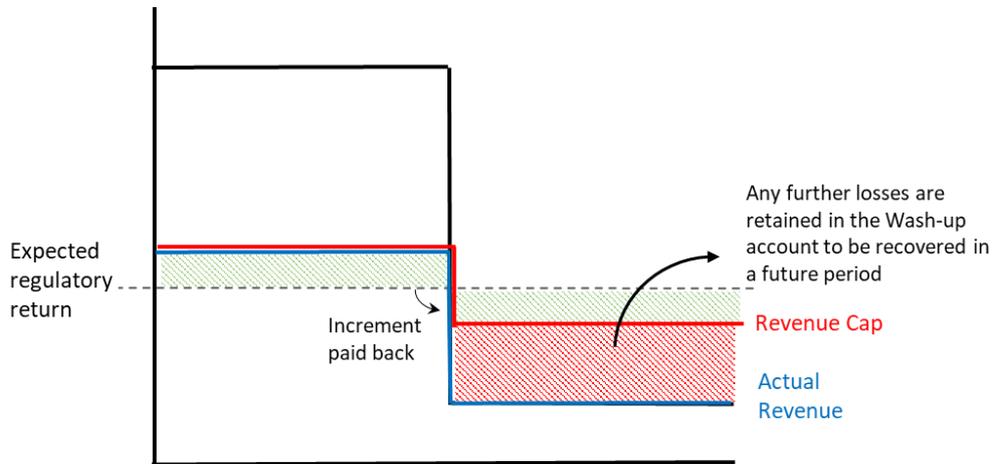
This situation is unlikely in the medium term. 5G will be full swing by 2022, fibre unbundling will be rolled-out, and the anchor product prices will be in place. It is unlikely that the overall revenue of Chorus or any other LFC would be unconstrained without a revenue cap.

However, if it provides comfort to the LFCs then it may be appropriate to allow recovery to be brought forward from future periods under certain circumstances. The most obvious way to do this is an adjustment to the depreciation profile. Another approach may be to allow the LFCs to run the wash-up account down below zero, on the expectation that it will be repaid by future under-recovery.² This is represented in figure 5 below.

² Section 197 may already allow for this by smoothing revenues between periods to minimise 'undue financial hardship'.



Figure 5: Allowing draw forward of revenue to be paid back in the future



The size of any draw-forward should be based on the risk adjusted expectation of future under-recovery. It must also be done in an FCM neutral way, and undone in the future if the perceived risks do not eventuate.



A lower cost of capital during the losses period

We strongly disagree with the suggestion from Chorus, Oxera and Chorus' investors that the cost of capital during the pre-implementation period was higher than it will be going forward. In fact, there is compelling evidence that the opposite is true.

Risk faced by investors during the pre-implementation period

Oxera on behalf of Chorus argue that a higher asset beta is justified for fibre services because they have a high demand risk, operational leverage and longer term cash-flows. They suggest that this is particularly true in the early stages of the project, but decreases as the network matures.³

However, because of the capitalisation of the losses it is end-users, not Chorus' investors that have born all systematic risks. Submissions demonstrate that investors expected that they were not facing any systematic risk during the pre-implementation period.

- Chorus highlighted that the UFB Government Policy Statement promised that any future regulation *“recognises that revenues over the life of the assets, are sufficient”* to cover all costs.
- Many of the submissions from Chorus' investors demonstrate that they were keenly aware of the promise in the Government Policy Statement
- Oxera's other expert report shows that advice provided to Chorus' board suggested that they will be compensated for any under-recovery during the pre-implementation period.⁴

This is also supported by the frequent assertion from the LFCs that the prices set in the contracts with the Crown were below costs. It would have been financially

³ Oxera “Compensation for Systematic Risks: Prepared for Chorus” 15 July 2019.

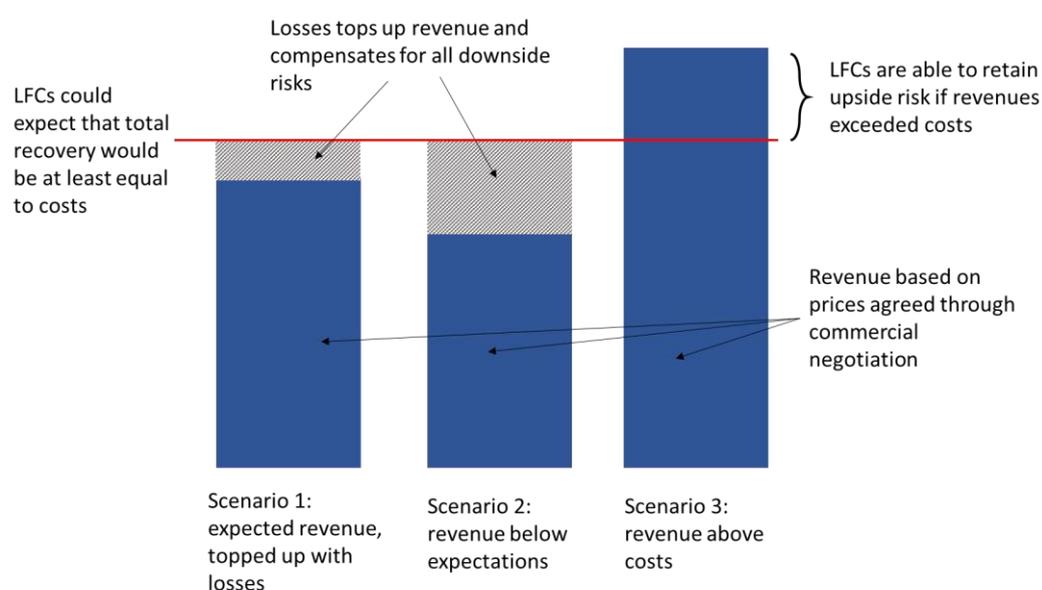
⁴ Oxera “Compensation for asymmetric type 2 risks: Prepared for Chorus”, 15 July 2019, section 3A.1



irresponsible to accept a contract that did not allow cost recovery, unless there was also an expectation of foregone revenues being topped up in future regulations.

The impact on LFCs' risk profile is demonstrated in Figure 6 below.

Figure 6: All systematic risk during the losses period is absorbed by the losses asset



The losses asset therefore functions as a type of insurance, or off-book capital contribution that absorbed all systematic risk. The cash-flow risk at the centre of the debt premium appears unaffected by the losses calculation and should be retained in the calculation of the WACC.

The Commission typically defines the threshold for applying an adjustment to the WACC as requiring two criteria:

1. The risk (mitigation) must be a consequence of the regulatory settings
2. The risk (mitigation) must be asymmetric

The losses calculation meets both of these criteria. It is clearly an artefact of the regulatory settings, and because it will absorb downside risk, but allow upside risk if revenue exceeds costs, then it is clearly asymmetric. Therefore the equity component of the WACC must be adjusted downwards.

Estimating the impact on the WACC

The reduced risk faced by equity holders in the pre-implementation period was noted by Dr Lally in his paper accompanying the emerging views consultation. Lally noted



that under the assumption that revenue cap is set correctly, the appropriate rate of return during the pre-implementation period “would be risk-free” and would result in “a beta of zero”.⁵

However, Lally goes on to state that while there was no systematic risk in the accumulation of the losses asset, there may be systematic risk in its recovery. His argument focusses on the difficulty of assessing the market risk premium (MRP), and therefore the likelihood that the Commission has it wrong in any given period. This implies an asset beta higher than zero, but lower than the forward looking beta. However, given no intermediate option exists, he recommends simply using the forward looking beta estimate as he considers it the lesser of two evils.

While we appreciate Dr Lally’s approach, when some of his simplifying assumptions are relaxed, a very different conclusion is reached. We make the following observations.

- The Commission’s estimate of MRP will not be biased. This means that while it may be incorrect in any given period, over the long run it will be accurate. Lally’s calculation doesn’t account for this as he assumes the losses is recovered over a single period
- The Commission will re-estimate the MRP prior to the regulations commencing, drastically reducing the chance that it is misspecified in the first period.
- In practice the MRP has been very stable over time. This was observed by the Commission in the review of the input methodologies for Part 4, where it confirmed the estimate of 7%. Even when MRP does change, it changes by small amounts. During the global financial crisis, the Commission estimated a 0.5 percentage point increase.
- The Commission can and has adjusted MRP to account for significant events. The Commission increased the MRP to 7.5% during the global financial crisis, bringing it back down to 7% again after June 2011.⁶
- The estimate of beta after the implementation date will already account for this risk. This is because many of the comparator businesses used to estimate the beta face similar regulatory risks.

⁵ Dr Lally, M. ‘The Cost of Capital for Fibre Network Losses’ 30 April 2019, p7.

⁶ Commerce Commission, ‘Input Methodologies (Electricity Distribution and Gas Pipeline Services) Reasons Paper’, December 2010, para 6.5.16.



Taken together this means that if the losses is subject to any systematic risk, it would be vanishingly small. The most accurate estimate of beta during the pre-implementation period is zero rather than the full beta estimate. Any residual risk is best considered as part of the decision on whether or not to apply a WACC uplift, as this is the mechanism the Commission has applied to account for forecasting error. We consider this in more detail in the section below.

It may also be argued that there is a risk that the losses asset is not recovered due to increasing competitive pressure. This risk is better managed in the post-implementation period as described in the section above.



Crown financing reduced risk for private investors

Chorus and many of its investors have argued that the interest-free Crown funding incurred a cost. This is most forcefully raised by the expert report from Incenta and from L1 Capital.

We disagree. On balance, the Crown intervention in the UFB initiative reduced risk for private investors. On that basis it is better to consider the Crown funding to have a negative cost. Below we first consider the broader impact of the Crown's involvement on the risk absorbed by LFC investors. We then show that Incenta's estimate of the cost of Crown financing is almost entirely based on a number of errors.

On balance the requirements and concessions from the Crown reduced risk for private investors

L1 Capital suggest that the requirements placed on the LFCs through the contracts with the Crown meant that the cost of capital during the pre-implementation period was higher than it will be going forward.

We strongly disagree. The size of the risk from the Crown requirements are exaggerated, and the countervailing concessions from the Crown are ignored. L1 Capital point to three key requirements placed on the LFCs

- **Chorus issuance of warrants to CFH.** The price of these warrants was based on a total shareholder return of 16% per annum. L1 Capital claim that this would cap the upside risk of equity investments. However, they only kick in at an extraordinarily high return, and as such Incenta estimated that their impact would be 'immaterial'.⁷
- **Financial penalties and step-in rights for failure to achieve delivery plans.** This is common practice for all infrastructure development, both those funded publically and privately. There is no evidence to suggest that the LFCs faced particularly large risks compared to the comparator firms.

⁷ Incenta, 'Chorus's actual financing cost for Crown-financed investment' Report prepared for Chorus Ltd, July 2019, para 90.



- **Requirement to maintain investment-grade credit metrics.** It would have taken spectacular mismanagement for an LFC to drop below an investment grade given the Crown's involvement. This risk must be considered as near to zero.

Any minor additional risk that these requirements placed on the LFCs was more than compensated for by the significant concessions afforded to them by the Crown.

These include:

- Contractual arrangements that would compensate investors if the Commerce Commission regulated prices lower than those contracted.⁸
- Allowing the UBA prices to remain at the retail-minus level during a three year transition period. These prices were subsequently found to be excessive when compared to the prices set under the FPP process.
- The price for the unbundled copper local loop was averaged across urban and rural areas. This substantially increased the price in urban areas and stopped any further copper unbundling.
- Delaying fibre unbundling until 2020.

Furthermore, the involvement of the Crown would have substantially reduced the risk to private investors. If the Crown is an investor, it typically shields private investors from the most extreme downside risks. This is evident in past bail-outs of companies like BNZ and Air New Zealand.

The best way to account for the impact of Crown investment would be to include more public private partnerships, in the comparator groups to estimate the debt premium and asset beta.

Incenta have incorrectly estimated a cost of Crown funding

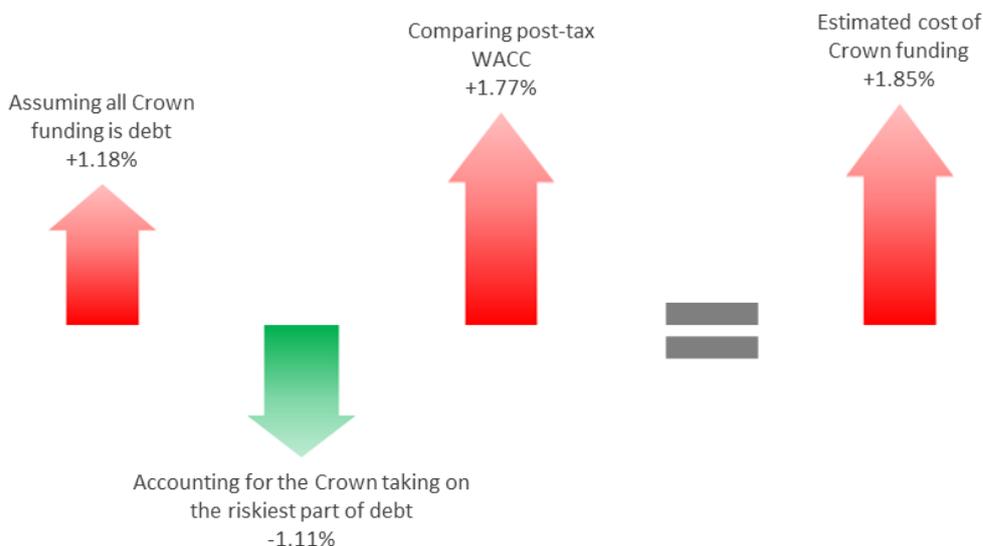
Incenta argue that the Crown did not take on a proportionate amount of project risk, leaving a residual cost of 1.85% to be applied to the Crown funding. However, their report includes a number of critical errors that drive the result.

⁸ Hon Joyce, S, Media Statement: 'Regulatory forbearance to be replaced' 18 May 2011
<https://www.crowninfrastructure.govt.nz/2011/05/18/regulatory-forbearance-to-be-replaced/>



The three key effects implicit in Incenta's analysis are shown in figure 7 below with their respective impact on the cost of the Crown financing. Each of these effects are considered in more detail in the following sub-sections.

Figure 7: the individual effects of Incenta's estimate of the cost of Crown financing



Structure of the Crown funding

One of the key issues in estimating the cost of the Crown financing is how to reconcile the difference between the leverage of the notional WACC and the structure of the Crown financing.

There are two key questions that need to be answered:

1. Should the notional leverage of the WACC be adjusted due to the structure of the Crown funding?
2. What should be the assumed structure of the Crown funding?

Should the notional leverage be adjusted?

L1 Capital propose that the Commission adjust leverage (and by consequence the equity Beta) to reflect the introduction of the Crown funding.⁹ We understand that this would including the following steps (represented in the figure 8¹⁰):

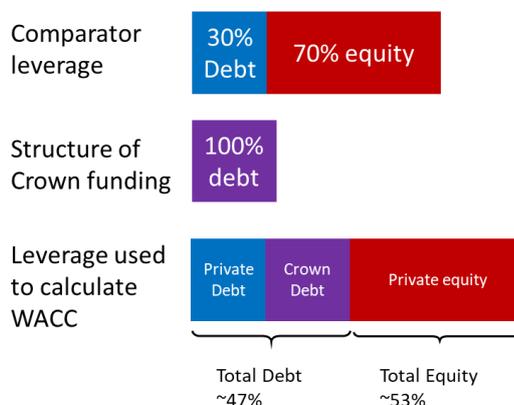
⁹ L1 Capital, 'Fibre emerging views submission' 16 July 2019, p16.

¹⁰ Figure 8 uses a Crown to private funding ratio of 1:3. This is simply for demonstration purposes, and does not reflect our view of the size of the starting RAB.



- Estimate the leverage of private investment, based on comparator firms, (or as L1 Capital have argued, based on Chorus' actual leverage).
- Then estimate the structure of the Crown financing. L1 Capital argue that this should be 100% debt (we consider this assumption in more detail below).
- Combine the two based on the size of the respective funding pools and adjust the leverage accordingly.
- Calculate the equity beta on this adjusted leverage.

Figure 8: Adjusting leverage as a result of Crown funding



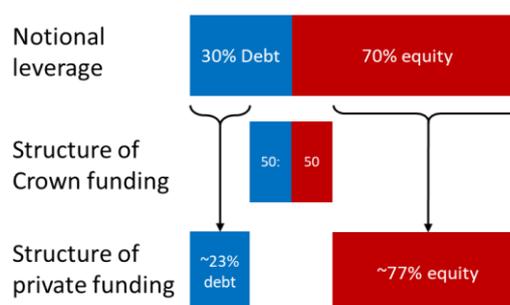
We disagree with this approach. We see no principled reason to assume that the Crown funding should sit outside the leverage determined by the comparator analysis. This also brings the leverage anomaly to the fore. An increased leverage would increase the WACC, causing a perverse outcome.

Instead the Crown funding must be considered as a part of the leverage determined by the comparator analysis.

Figure 9¹¹ to the right represents this using the assumption that the Crown funding is 50:50 debt / equity.

The equity beta should be determined on the notional leverage as this best represents the average risk of equity holders.

Figure 9: Crown funding as part of the total funding pool



What should be the notional structure of the Crown debt

Both Incenta and L1 Capital assume that the Crown funding should be treated as 100% debt. This assumption on its own would result in a cost of Crown financing of 1.18% using Incenta's input values.¹²

¹¹ Figure 9 again uses the simplifying assumption of a 1:3 ratio of Crown to private funding.

¹² Calculated as the pre-tax WACC (8.65%) less the cost of debt (7.47%).



We disagree with this assumption. As noted by Incenta, Chorus could convert the Crown equity funding into shares. This means that the Crown's risk more closely resembles equity. If it were cheaper (or they simply did not have the free cash flow) they could convert to shares rather than pay the debt amount, insulating them from the debt repayment risk.

There are two other options for the assumption of the structures for the Crown funding that are more aligned with the actual terms and the regulatory model:

- Adopt the actual 50:50 structure that the Crown funding was issued at. Because this structure is still more heavily weighted to debt than the notional leverage it still infers a cost of Crown financing. Under Incenta's assumptions this cost is 0.34%.¹³ However, as shown below this is largely mitigated by the additional risk that Incenta calculated that the Crown absorbed.
- Assume that the notional Crown funding is structured the same as the notional leverage. This is the assumption currently taken by the Commission. It is also our preference because of its simplicity, and that it results in largely the same result as the 50:50 option. This approach would mean that there is no cost of Crown financing.

How much additional risk is absorbed by the Crown

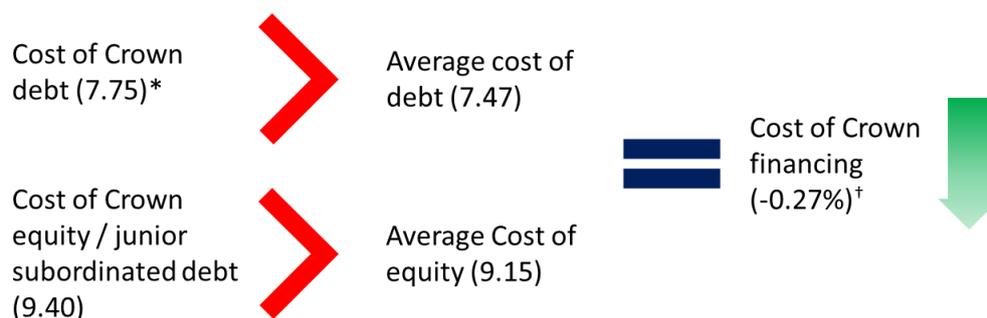
We agree with Incenta that the Crown took on more risk for its respective debt and equity funding than private investors. This helps to mitigate the impact of the structure of the Crown financing.

This is shown in figure 10 below. Incenta have estimated that when the structure of Crown financing is controlled for, then the Crown took on more risk than the average debt and equity components across the entire WACC. This means that the risk to private investors is reduced, resulting in a reduction in the cost of Crown financing of -0.27% (assuming a Crown funding structure of 50:50 debt/equity).

¹³ Calculated as the pre-tax WACC (8.65%) less cost of debt (7.47) X 0.5 less Cost of equity (9.15) X 0.5



Figure 10: The impact of Incenta's estimations on the cost of Crown financing (when the effect of the structure of financing is controlled for)¹⁴



* Calculated as $\frac{\text{Senior debt (7.47\%)} \times 0.2 + \text{subordinate debt (7.94\%)} \times 0.3}{0.5}$

[†] If all Crown funding is assigned to debt, then the cost of Crown financing is -1.11% all else equal
= Cost of debt (7.47%) – cost of Crown debt (7.75%) × 0.5 – cost of Crown junior subordinated debt (9.40%) × 0.5

However, there are also a number of risks that the Crown has absorbed that Incenta do not take account of. This is particularly true of the equity component of the Crown funding. As noted by Incenta themselves, the way this funding was structured meant that Chorus would be partially insulated from catastrophic market events (such as the global financial crisis).¹⁵ Considering these risks would further reduce the cost of Crown financing.

The comparison must be made on a pre-tax WACC basis

Incenta have made a serious error by comparing the post-tax WACCs. This shows a fundamental misunderstanding of the regime, and is quite disappointing for a typically well regarded organisation (especially one who produced an entire report on the impact of applying a post-tax WACC). This error results in an over-estimation of the cost of Crown financing of 1.77%.

The Commission's proposal to use a post-tax WACC for price setting purposes is entirely cosmetic. In Part 4 a pre-tax WACC is used to calculate prices. When a post-tax WACC is used, the tax allowance compensates for the difference, resulting in the exact same revenue allowance under either approach.

For this analysis, it is easier to compare using the pre-tax WACC. If the post-tax WACC is used then consideration should also be given to the effect on the tax allowance.

¹⁴ Figure 10 does not cover the option of assuming that the Crown funding was structured equal to the notional leverage. This is because it is unclear what risk the notional Crown funding would have taken on in this option. The simplest assumption is that the level of risk was the same as other notional investors.

¹⁵ Incenta, 'Chorus's actual financing cost for Crown-financed investment' Report prepared for Chorus Ltd, July 2019, para 71.

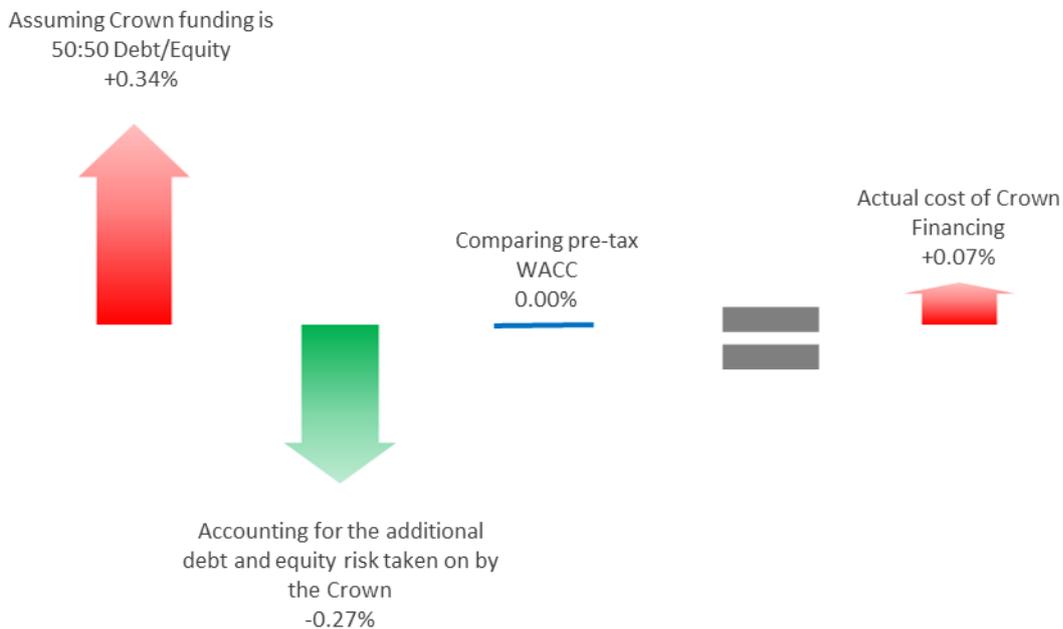


Since both approaches produce the same result, it is simpler to just use the pre-tax WACC.

Revised conclusions from Incenta's analysis

Putting the above comments together we can re-cast Incenta's analysis as per figure 11 below. This shows that the cost of Crown financing is 0.07%. We get the same result whether we assume the Crown funding was financed as 100% debt or 50:50 debt/equity.

Figure 11: Cost of Crown financing estimated by Incenta with errors removed



This result is de minimis and can therefore be ignored by the Commission. However, as covered above further analysis should be undertaken to assess how much more risk the Crown truly took off investors (such as minimising the risk of major financial downturns, and the reduced risk as part of a public private partnership). When these are taken into account it is likely that the cost of Crown financing will be shown to be a negative number offsetting the cost of private funding.



There is no case for a percentile uplift to the WACC

No new evidence of substance has been provided to justify a percentile uplift to the cost of capital. The expert report from Houston Kemp largely recycles well-trodden ground that has been insufficient in the past and continues to be insufficient today.

The role of a percentile uplift

Houston Kemp state that Vodafone has misunderstood the role of a percentile uplift. In doing so they have revealed a deep error in their approach to this analysis.

We agree that the core role of a percentile uplift is to mitigate the risk of under-investment that may result from an under-estimation of the WACC. This risk arises because the WACC is not observable, so it must be estimated by the Commission, and is therefore subject to estimation error.

However, we strongly disagree that the absence of an uplift would result in a 'persistent inability to recover costs', and that this will send a signal to investors that 'the Commission will not reward innovation and investment'.¹⁶

A WACC percentile uplift is a very expensive and imprecise way to incentivise investment. This is because it is applied to all sunk assets, as well as the investments it is intended to incentivise.

For this reason, a percentile adjustment must always be considered as a last stop measure when nothing else is sufficient. This is in stark contrast to Houston Kemp's scattergun approach of arguing the only way to ensure a whole range of investments is through a percentile uplift. This will only result in a significant over-payment by end-users.

In the case of fibre services, there are many other mechanisms to encourage investment that must be fully exhausted before even considering a percentile uplift. These include promoting competition across the entire network, quality measures, and the natural incentives of the regime.

¹⁶ Houston Kemp 'WACC uplift – asymmetric consequences of under-investment: A report for Chorus' 15 July 2019, p25.



Relying on other incentives before a percentile uplift will not leave Chorus out of pocket. As stated by the Commission many times, if the WACC is specified correctly, there is no reason to suggest that the mid-point estimate will be biased downwards.¹⁷

Houston Kemp are mistaken to assume that applying the mid-point WACC estimate will result in a 'persistent inability to recover cost'. Because the mid-point estimate of the WACC is unbiased that means it is just as likely to be over-estimated in any given period as it is likely to be under-estimated. Over the long term the mid-point WACC estimate will be accurate and is therefore sufficient to maintain FCM.

No evidence has been provided that a percentile uplift is needed

The justifications provided for an uplift by Houston Kemp largely stem from misunderstanding the proposed regime, and the various incentives at play. There are three broad areas they suggest justify a percentile uplift:

- to encourage efficiency saving investments;
- to encourage investment to support 'hidden' quality metrics; and
- to encourage new innovations.

Houston Kemp argue that without an uplift Chorus may choose to not invest in timely investments to reduce the 'cost per byte', or IT capability that 'will result in lost efficiencies in operating costs'.

This is hard to believe. The core premise of the price-quality regime is based around rewarding Chorus for making efficiency saving investments. Because allowed revenues are fixed periodically any efficiency savings are initially retained by Chorus, and only later passed on to end-users. There is no reason to suspect that any further incentive is required to promote efficiency saving investments.

Houston Kemp also argue that quality metrics may be insufficient in some areas, as under-investment may be hidden, building up a long term problem. However, none of the examples they produce support this assertion. They point to:

- **resiliency** – this is not a hidden feature, it is often discussed and negotiated between LFCs and RSPs, furthermore it can also be easily measured by the Commission through a quality metric;

¹⁷ Commerce Commission, 'Amendment to the WACC percentile for price-quality regulation for electricity lines services and gas pipeline services: Reasons Paper' 30 October 2014, Para 4.25 – 4.27.



- **congestion** – this is one of the first areas where under-investment will show up; and
- **lifecycle management of assets** – the Asset Management Plan reporting established under Part 4 was specifically designed to measure this risk. There is nothing stopping similar reporting requirements being applied to the LFCs as well.

The Commission should use this list of potential quality risks as the starting point for more detailed quality measures.

Finally, Houston Kemp also argue that an uplift is required to ensure the right level of investment in innovative new technologies is undertaken. We disagree. A percentile uplift is not precise enough for this job, and would likely result in gold-plating investments in areas that may be completely unrelated to consumer demand.

Encouraging innovation is a critical problem for the Part 6 regime. We consider that a mix of incentives are required, including, promoting competition deep into the network, targeted quality metrics tied to consumer demands, and a robust capex IM that requires effective consumer engagement.



Comparator firms must reflect actual risk born by LFCs

We broadly agree with the comparator sample chosen by CEPA for the debt premium and the asset beta. Given the unique make-up of the LFCs it is difficult to find direct comparators, so a sample of firms with similar risk profiles is the appropriate approach to take.

However, as mentioned in the section on the costs of Crown financing above, including more public private partnerships would better reflect the impact of the Crown's involvement.

Apart from this omission, we do not see any fundamental bias in the sample. Some firms clearly have a higher risk profile than the LFCs, while it is arguable that some may face less risk. But as a group they produce the right result.

We therefore strongly disagree with the suggestions from Chorus and its investors that any comparator with less risk than Chorus should be removed from the sample. This would bias the sample upwards.

L1 Capital and Oxera go into some detail to prove that the satellite and tower companies have a lower risk profile than Chorus. Even if this is true, this analysis has little value without comparing the risk profile of other firms in the sample.

For example, many 'full service telecommunications firms' are also included, such as BT Group, Go, Koninklijke KPN, Telecom Italia, Vocus, and many more. As noted by Schroders (another Chorus investor):

we would accept that risks are lower than traditional telco operations given lower competitive intensity¹⁸

If we continue to remove all firms that look different to the LFCs, we would quickly remove every firm from the comparator group.

¹⁸ Schroders Investment Management 'Submission on Commerce Commission Emerging Views Paper' 15 July 2019, p2.