L1 CAPITAL

20th August 2020

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L1 Capital appreciates the opportunity to make this submission regarding the analysis of cost of capital issues set out in Martin Lally's paper, "*Further Issues Concerning the Cost of Capital for Fibre Input Methodologies*" ("the Issues paper").

The Issues paper is organised around four headings:

a. Systematic Risk in the Pre-Implementation Period
b. Implications of Crown Financing
c. The Choice of Credit Rating

Our central submission is that the cost of capital parameters that are the subject of the Issues paper must be based on an accurate analysis of the provisions of the UFB contract which was the basis of a 10 year, multibillion dollar investment by Chorus and other LFC's.

L1 believes the current parameters used to calculate the loss asset simply do not recognise the terms of the UFB contract and are internally inconsistent. This will result in private capital being unable to recover efficiently incurred costs and strand private investment in the UFB project right at the point when all capital has been invested. It is also contradictory to what the NZ government promised investors at the beginning of the project and amounts to a partial seizure of the UFB asset.

The NZ government set out its objectives for the UFB project very clearly. We quote from the UFB Interim Period Agreement between Crown Fibre Holdings and Telecom Corporation of New Zealand dated 24 May 2011.

"The Government expects to achieve significant productivity benefits from the UFB network. ***However, these benefits would only be realised if wholesale and retail prices were low enough to encourage service providers and end users to migrate to the UFB network from the existing copper network****. The Government's policy objective is that its investment of $1.35 billion will attract sufficient private investment to achieve deployment of a fibre-to-the-premises broadband network to 75 percent of the population over 10 years.* ***Deploying this network successfully would require significant upfront investment from private partners in a new market, where only a small margin for return exists during the first eight-and-a-half years."***

Chorus investors and equity analysts also had a clear conception of the UFB project as a significant infrastructure investment subject to a variety of risks including those related to the obligations under the CFH contract.
We quote from the risk section of a Deutsche Bank report on Chorus published on 1st December 2011, shortly after Chorus demerger from Telecom NZ.

"The UFB rollout will be subject to the risks typically applied to large scale infrastructure project. These include (a) "Uncertain end-user demand for fibre" (b) "UFB fibre network deployment costs and construction risks (c) "Failure to meet UFB system and product plan delivery milestones" (d) "The UFB agreements require Chorus to maintain an adequate service levels relating to Chorus's operation and availability of the UFB Network and specified services. Failure to meet these service levels would result in financial penalties" (e) "**Failure to achieve and maintain an investment grade credit rating:** As a condition precedent, Chorus must obtain an investment grade credit rating (BBB- or above) within two months after the date on which the Subscription Agreement is entered into". Chorus will be prohibited from paying dividends without CFH's approval if it fails to maintain an investment grade credit rating

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The central legal effect of the UFB contracts is that Crown financing is provided to Chorus and LFCs subject to the Crown having contingent rights (including liquidated damages and other penalties) as consideration for construction of the UFB network and the supply of specific services at fixed dollar prices during the transition period. These rights and conditions were discussed in our 13th of August 2020 on the Loss Asset and were reasonably assumed by investors as representing the total obligations under the project.

In relation to beta and returns the NZ government clearly stated its intention that there would be incentives to invest in new infrastructure and regulation would take into account the unique risks of the UFB project.

"The Government's economic policy is that businesses have incentives to innovate and invest in new or upgraded ultra-fast broadband infrastructure for the long term benefit of end users "recognises that revenues, over the life of the assets, are sufficient to cover operating costs and a normal return on, and recovery of, capital invested" and "takes into account the start-up risks associated with the introduction of new technology"

The Commission has rejected outright the contention that it is valid to view the period of the UFB contract up until the Implementation date (ie the transition period) as analogous to a Part 4 regulatory period. As a result of that decision the key issue becomes what is the appropriate analogy or hypothetical financing strategy on which to base the estimation of the cost of capital parameters.
The Issues paper proposes an idiosyncratic set of considerations and analogies be used to decide the parameter values for the estimation of the discount rate which is required for either a BBM or DCF analysis of the value of the financial loss asset (FLA):

1. As regards the term of the risk-free rate (in both the equity and the debt cost of capital), the Issues paper recommends it be assumed that the UFB providers' financing strategy is based on an interest rate reset at the Implementation date with rates fixed until that date.

2. As regards beta the Issues paper states "*I concluded that suitable comparators are not likely to be available for estimating the beta in the Pre-Implementation period and the only candidate was that applicable to the regulatory situation which might be too high or too low.*" (Issues paper p18) Thus, the recommendation is that it is not feasible to analyse the effect on beta of the commitment of expenditure required by the UFB contract.

3. As regards the credit rating for the estimation of the debt risk premium the Issues paper suggests the incentivising of more efficient balance sheet management is a justification for a higher credit rating than that required by the UFB contract.

Our view is that the appropriate conceptual basis for estimation of the cost of capital parameters is to view the UFB contract as similar to a public private project financed agreement such as the Transmission Gully contract between NZTA and the Wellington Gateway Partnership. We submit that the estimation of the cost of capital parameters for the Pre-Implementation period should be based on the analogy with project financing. That would be compatible with the provisions of the UFB contract and the requirements of section 177.

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Systematic Risk in the Pre-Implementation Period

The Issues paper comments regarding beta, in the latter section, "*In respect of the upper bound, I did not present one. Instead, …, I concluded that suitable comparators are not likely to be available for estimating the beta in the Pre-Implementation period and the only candidate was that applicable to the regulatory situation which might be too high or too low.*" (Issues paper p18)

L1 would point to the highly respected corporate finance textbook by Brealey, Myers and Allen[1] as a guide to why the binding capital expenditure commitments under the UFB contract in the Pre-Implementation period result in beta being higher in that period than the value applicable to the regulatory situation. The textbook explanation discusses the effect on the beta of a utility when it commits to undertake an major capital investment and is directly applicable to the beta of the FFLAS UFB business under the UFB contract as indicated by the following extract.

"*Suppose that an electricity utility commits to build a large electricity-generating plant. The plant will take several years to build, and the cost is fixed. Our operating leverage formula still applies but with PV(future investment) included in PV(fixed costs). The commitment to invest therefore increases the plant's asset beta. Of course the PV(future investment) decreases as the plant is constructed and disappears when the plant is up and running. Therefore the plant's asset beta is only temporarily high during construction.*" (Page 227, Brealey, Myers and Allen, 11th Edition (2014))

The beta "applicable to the regulatory situation" is derived from observed betas of a sample of listed comparable telecommunications companies, few of which would have been committed in the relevant period to a network construction on a scale, relative to their asset base, as large as that to which the FFLAS UFB providers were committed during the Pre-Implementation period. Based on the Brealey, Myer and Allen analysis, the beta of the FFLAs UFB providers during the Pre-Implementation period would be higher than the beta estimate derived from the sample set of companies. The upper end of the plausible range of beta estimates derived from the sample set of comparable companies would be a valid candidate to be used as the estimate of beta for the Pre-Implementation period.

We would also note our January 2020 submission which highlights that risks were clearly higher in several areas during UFB build period.

Risk	UFB build period (2012-2022)	Regulatory period beginning 2023	L1 Comment
Construction risk -Risk of cost overruns during build phase	**High:** Very large financial obligation related to build with all risk borne by equity holders	**Low:** Communal build largely complete and large section of premises connection complete by 2023	Construction risk is higher than set of comparable companies given extreme capital intensity of rolling out UFB network and should be reflected in a higher asset beta.
Risk of insufficient demand for fibre services	**Very high**: Unclear demand for fibre services at inception of projection. Penalties from CFH for insufficient take-up of fibre services in form of accelerating CFH equity repayments	**High:** Fibre take up to 2019 is running in line with projections	Clearly higher than during first regulatory period: Demand risk has been viewed as a systematic risk by other regulators and reflected through uplift in allowable WACC.

[1] The Commission references another Brealey and Myers textbook in footnote 85 of the FLA paper

Risk of financial penalties for non-completion of build milestones	**High**: Financial penalties for non-completion and step in rights(see previous section on CFH instruments)	**Low**: Communal build should be largely complete by 2023	Clearly higher than risk in first regulatory period
Balance Sheet Risks:	**High:** Cost of not maintaining investment grade rating during build period is very high for equity holders (see section on CFH instruments)	**Medium:** End of build period should allow stronger cashflow generation, supporting credit metrics	As covered in section above this greatly increased risk to equity holders by increasing effective leverage and equity beta
Interest rate risk	High: High amount of financial leverage, higher interest rates and negative cash flow profile make Chorus sensitive to rates	Medium: Ability to match interest rate to regulatory period and cashflow generation mitigates risks	Clearly higher than during regulatory period

The Commission has previously discussed beta in the context of a WACC uplift.

"The risks that may be systematic include aggregate demand, operating leverage, the specification of price and potential for growth opportunities. It is possible that the aggregate demand risk and potential for growth opportunities were higher during the pre-implementation period compared to the post-implementation period. Operating leverage may also have been higher during the pre-implementation period when capital costs made up a proportionally greater share of costs, which could point to a higher asset beta for the pre-implementation period. Overall, any adjustment to the asset beta to account for differing systematic risk in the pre-implementation period and post-implementation periods would be arbitrary and difficult to quantify. ***It is reasonable to assume that the case for a higher asset beta due to aggregate demand risk, lower operating leverage and construction risk is offset by the case for a lower asset beta due to the compensation for losses."***

L1 appreciates there the calculation of a higher beta in the pre-implementation period includes many areas subject to significant judgment by the Commission (including stranding risk, the appropriate comparators for asset beta and many others) but the Commission has made choices in each of these areas because it recognised that not doing because it was difficult or imprecise would violate financial capital maintenance principal (FCM) and result in an under recovery of costs.

In the case of systematic risk there is a very reasonable argument for a higher asset beta due to higher aggregate demand risk, lower operating leverage, and construction risk as the Commission itself has acknowledged.

On the other hand, compensation for losses, presumably through the loss asset does not give a higher degree of protection that the wash up regime that applies post 2022. The loss asset is still subject to stranding risk, as we have explored in the previous section so to the extent the losses accrued and guaranteed are in a deregulated area they will not be recovered. Additionally, the loss asset still has the possibility of not being recovered if the revenue cap is not achieved, so it subject to the all the usual risks including that are present in the post 2022 regime.

There thus appears to be a strong basis for awarding an uplift to reflect the risks of a new fibre build. That would be consistent with the intention of government policy in 2011 "to take into account the start-up risks associated with the introduction of new technology" and with the approach several other regulators have taken, where construction risk, demand risk and operating leverage of a new fibre network were called out as a basis for a higher beta or WACC uplift.

Implications of Crown Financing

The main discussion on Crown financing in the Issues paper responds to the Commission raising "*the question of whether this funding should be assumed to displace conventional funding at the benchmark cost of capital*". (Issues paper p16) The discussion argues that the saving from subordinated Crown finance would be higher than the benchmark cost of debt where the later relates to senior debt.

The Issues paper does not even mention the unusually onerous conditions to which Chorus is subject by the terms of the Crown finance. These conditions include a variety of control rights over Chorus's activities that the terms and conditions of the finance awarded to the Crown agent CFH. The conditions also included liquidated damages for example. These conditions go far beyond the normal rights associated with subordinated debt. They impose a cost on Chorus which needs to be taken into account by netting this cost off in an assessment of the benefits to Chorus of Crown finance.

These costs may have been ignored in the Issues paper's discussion because it is not recognised that the provision of the Crown finance is the consideration for Chorus committing itself to the terms of the UFB contract including the penalty provisions. The Crown finance is not a separate component to be analysed independently of the onerous network delivery requirements, take up milestones, control rights and penalty provisions. The Crown financing is the compensation for Chorus agreeing to the obligations imposed by the UFB contract.

Section 177 requires the Commission in respect of any Crown finance provided in connection with [UFB] investments, "*to refer to the actual financing costs incurred by the provider (or a related party)*". L1 Capital submits that the terms and conditions are actual financing costs. The wording in section 177 is "financing costs" not "financial costs". Terms and conditions are costs which are incurred in order to obtain that is they are actual financing costs incurred by a provider. The Issues paper's reference to "zero cost" Crown financing is a misinterpretation of section 177.

In discussing the assessment of the effects of Crown financing the Commission refers to "the benefits of Crown financing". We submit that the that section 177 requires the Commission to refer to the actual financing costs incurred and the costs need to be considered in detail before any conclusion is reached that there is a net benefit. There would less risk of a misunderstanding of section 177 if any conclusions were expressed in terms of the "net benefit" as that would acknowledge there are costs.

We have covered these points in more detail in our 13th August submission on the Loss Asset.

The Choice of Credit Rating

L1 believes the issue paper appears to quite inconsistent in its justification of the use of a BBB+ benchmark and we call out some of the inconsistencies below. We also respond to some specific comments in the paper in relation to the L1 submissions on the choice of credit rating
The Issues paper asserts "*it is fundamental to regulation that the regulator specifies a benchmark DRP, which may be derived from a benchmark credit rating and must be consistent with its benchmark leverage. This incentivises a firm to outperform the benchmark (ie attain a lower DRP) by improved operating efficiency. …".*

This comment is inconsistent with the Issues paper's response to Enable Networks Ltd's submission that the losses should be determined in in accordance with the Commission's usual approach and its approach in the post implementation period. The Issues paper responds "*this argument fails to recognise that the Commission's usual approach is concerned with setting allowed prices or revenues at the beginning of a regulatory cycle whereas the present exercise is concerned with the entirely different exercise …* ". (Issues paper p12)

Yet when responding to credit rating submissions, the Issues paper contradicts its earlier argument by asserting that the standard ex ante incentive regulation benchmark approach should be applied to incentivise a firm to outperform the benchmark. Later in discussing L1 Capital's submission the Issues paper argues that the rationale for the BBB+ credit rating is to signal that firms like Chorus need to improve their credit rating and suggests that

We respond to some of the comments regarding the choice of credit rating below

1. **L1 Comment 1:** A BBB+ regulated rating works against the Commission's goals by increasing stress on the revenues of the regulated entity and increasing regulatory risk.

   Issues Paper Response: L1 Capital (2020, page 17) also argues that a benchmark credit rating of BBB+ rather than BBB reduces the revenues of Chorus, with no compensating advantage. However the Commission (2019, para 3.848) has articulated a clear rationale for its BB+ benchmark: to signal to firms like Chorus the need to improve their credit rating so as to reduce their bankruptcy risk.

   L1 Response: As an owner of a copper, regulated fibre and unregulated fibre business, Chorus credit metrics are based on not just indebtedness but a range of risk factors including technology risk, operating risk, and regulatory risk, including the risk of a punitive regulatory regime. It simply may not be possible for Chorus to achieve a BBB+ rating because of these factors, even with a materially lower level of indebtedness.
   For example in a December 2014 Chorus credit rating note, Standard & Poors notes the following in assigning a BBB rating to Chorus

   "Tempering these strengths are regulatory risks associated with network pricing; cost escalation risks associated with the rollout of the proposed UFB fibre to the home network and network volume risk associated with fixed to mobile substitution and competition from local fibre companies"

   Additionally, setting a credit rating for a past period obviously cannot incentivise outperformance in that period. Obviously the FFLAS UFB providers cannot change their credit rating for a past period and it is unreasonable to invoke an incentive justification for the proposed approach to setting the credit rating. Furthermore *Chorus cannot "attain this by the simple expedient of reducing its leverage which has averaged 55% in the 2014-19 period*" since that period is past. The Issues paper's implication that Chorus's leverage during the period 2014-19 was inefficiently and inappropriately too high is particularly troublesome since Chorus was subjected to a highly problematic two stage process of setting copper prices which resulted in dramatic drop in its share price as a result of an initial benchmark price determination process. Investor confidence was only partly belatedly restored by the final TSLRIC based pricing outcome. The fall in Chorus share market capitalisation and revenue outlook resulted in a high debt to equity ratio in that period.

2. **L1 Comment 2:** The Commerce Commission already has strong protections built into the Fibre Act to ensure consumers are protected and penalties for non compliance. The UFB contract also had very strong performance protections built into it which dictated the capital policies of Chorus during the build period.

   Issues Paper Response: No Comment on these specific additional requirements and how they interact with "incentive" structure for credit rating.

   L1 Response: There has been no comment from the Commission as to why penalties in the CFH and SLA obligations under the new Fibre Act need to be supplemented by a credit rating that only reduces regulated returns.

3. **L1 Comment 3: Imposing a BBB+ standard on regulated provider is tantamount to unstitching the UFB contract and resetting the commercial terms retrospectively since original CFH contract called for a minimum investment grade rating BBB-.**

   Issues Paper Response: L1 Capital (2020, pp. 17-18) also argues that the BBB+ benchmark credit rating is above the earlier contractual requirement for Chorus to maintain a rating of at least BBB- during the pre-implementation phase. However, the earlier contracts provided no guarantee that pre implementation period losses would be reimbursed. L1 Capital (naturally) does not object to the November 2018 announcement concerning reimbursement of the losses. Its complaint concerning the revised credit rating standard is therefore cherry picking.

   L1 Response: L1 strongly rejects the assertion that L1 is "cherry picking" and would point out the current Commission position does not at all guarantee that pre implementation losses would be reimbursed. As we have highlighted previously in this paper the government's announcement in 2011 clearly set out that investors could have reasonable expectations of recovering their efficient costs and being compensated for start up risk.

   "The Government's economic policy is that businesses have incentives to innovate and invest in new or upgraded ultra-fast broadband infrastructure for the long term benefit of end users "recognises that revenues, over the life of the assets, are sufficient to cover operating costs and a normal return on, and recovery of, capital invested" and "takes into account the start-up risks associated with the introduction of new technology"

   The recognition of start up losses for a new fibre network is entirely consistent with recovery of efficient costs. We would note that the loss asset does not reimburse costs but adds them alongside capital costs to the RAB, making them subject to all the risks of the RAB regime and entirely consistent with UFB commitment in 2011.

One could argue that if returns on the loss asset were guaranteed that would modify the terms of the UFB commitment. However, the loss asset is still subject to stranding risk, to the extent the losses accrued and guaranteed are in a deregulated area they will not be recovered. Additionally, the loss asset still has the possibility of not being recovered if the revenue cap is not achieved, so it subject to the all the usual risks RAB risks that apply post 2022. We quote the Commission below in respect of their treatment of standing risk as it applies to the loss asset.

"3.268 Our draft decision is to maintain symmetric treatment and remove the cost component relating to deregulated assets from both the main RAB and the financial loss asset. We consider that the ability to recover revenue from the financial loss asset is closely linked to the ability to recover revenue from the main RAB. ***This means that, as the size of the RAB decreases due to removing deregulated cost components, so does the ability to recover revenue from the financial loss asset."***

One could also argue that if the costs Chorus incurred in 2012-2022 were somehow not efficient and represent a windfall then reimbursement of losses amounted to a favourable change in the UFB contract. However, there is absolutely no evidence of that being presented and the project was carefully managed by CFH at a very detailed level. As equity investors during the period, we can attest that Chorus was very focused on efficient delivery of the fibre build, given the strain the project was putting on the balance sheet and the reduced revenues from copper services.

L1 believes that it is clear that it is inappropriate to unstitch the terms of the UFB contract which was the basis for Chorus and other LFC investment and set a BBB+ credit rating when another Crown agency specified what credit rating was acceptable under that contract. The Issues paper is advocating that the Commission impose an after-the-event financial penalty on Chorus because, Chorus complied with the credit rating set by the Crown agency to which it reported at the relevant time rather than - in a past period - conform to a more stringent credit rating thought appropriate by another Crown agency.

Conclusion

L1 believes that the methods the Issues paper advocates for determining the parameters for the purpose of estimating the financial losses incurred by the FFLAS UFB businesses in the Pre-Implementation period are internally inconsistent and result in a material underestimate.
The task required of the Commission under section 177 of the Act is particularly complex because the commitments required by UFB contract make invalid the standard analysis applicable to a entity which has complete discretion over its expenditure. The most appropriate analysis is one based on the analogy with a project finance funding structure.

If the Commission is not able to base its estimate on this analogy then it should at the very least recognise that its draft methodology results in a material underestimate and correct this by increasing beta for the Pre-Implementation period to the top of the plausible range, reduce to BBB- the credit rating used in assessing the debt risk premium and increase to the average observed level (ie 50% or higher) the leverage used in assessing the debt risk premium.

In regard to the leverage, the Commission should not be inhibited from adopting a 50% or higher level by the "leverage anomaly" since the analysis in this submission regarding the role of fixed rate debt locked in at the beginning of the UFB contract in a prudent risk management policy for the FFLAS UFB business indicates any increase in WACC due to the anomaly would be offset by the lack of recognition of the fixed rate debt issue.

L1 Capital thanks Dr Lally and the Commission for its open and transparent approach in formulating fibre regulation and look forward to the opportunity to engage further on the key inputs as the regulatory regime is developed.

Signed:

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