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Ms Tricia Jennings
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Submission on UCLL and UBA pricing reviews

Dear Ms Jennings,

Please find below our submission in relation to the UCLL and UBA pricing reviews currently being undertaken by the New Zealand Commerce Commission ("NZCC").

The NZCC regulatory process in relation to Chorus has significantly damaged the reputation of NZ as a destination for investment in regulated businesses. The damage extends beyond telecommunications to other forms of infrastructure and more broadly to NZ's reputation in the financial markets. To treat existing investors as 'trapped' and historical investment as 'sunk' is short sighted as it will increase the cost of capital for future infrastructure investment and result in under-investment in the telecommunications network. The recent decisions and statements made by the NZCC gravely concern us as they indicate that the NZCC does not respect the rights of investors nor understand the substantial effect of regulatory decisions on the cost and availability of capital for New Zealand infrastructure.

The decision not to back date the FPP prices is a prime example of this. From an investors perspective, there cannot be any rationale for lack of backdating. Investors must be confident that they will earn a fair return on their investment. There is no escaping this fundamental principle when seeking private investment in infrastructure. The fact that back dating may cause problems for consumers and/or retailers does not detract from this. Telecommunications retailing is a highly competitive business with significant uncertainty and is funded by investors with much higher return requirements than investors in regulated monopoly infrastructure assets. Whilst it's unfortunate that the IPP process led to an erroneous result, the fair response cannot be to penalise Chorus investors. If the Government or the NZCC wishes to compensate retailers or consumers, then they should fund that themselves. We note that many of the RSPs have already partially passed on the potential price increase to consumers and hence the decision not to back date is an unexpected windfall for RSPs and possibly consumers, if they are compensated.

There is a logical disconnect between applying a WACC appropriate for regulated monopoly infrastructure assets to Chorus where substantial regulatory uncertainty exists due to the TSLRIC approach. In our estimation, Chorus currently trades on an effective EV/EBITDA multiple of around 7 times (after taking into account future capital investment in the UFB network). Typically, monopoly regulated infrastructure assets trade on EV/EBITDA multiples of 10-12 times. For example, this is the historical average for the NZ electricity network companies. This discount is clear evidence of the effect of the current regulatory uncertainty on Chorus's cost of capital. It's almost twice as high as it could be.

The effect of regulatory uncertainty on the cost of capital has a much larger effect than the various assumptions about the cost of the hypothetical network that are being endlessly debated in the current process. The most effective way for the NZCC to reduce the cost of infrastructure for NZ in the long run is to provide greater predictability in regulatory decisions.

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Whilst pricing certainty is needed, there must be certainty at the right price. There are two key reasons for this. Firstly, if prices are set at levels which do not reflect an appropriate return on the sunk cost of investment in the network, then a discount will be observed in the trading price of Chorus shares, serving as a warning to future investors in NZ infrastructure. Stock market investors are already speculating, based on the Chorus experience, that other NZ listed infrastructure companies may experience similar treatment.

Secondly, prices also need to be set at the right level to enable continuing investment in the network. If Chorus is unable to earn a fair return on its historically invested capital, then it will not be able to convince its shareholders that it can earn an adequate return on future capital investment. In other words, shareholders will assume that the NZCC will continue to regulate value away from Chorus to retailers and/or consumers. Chorus shareholders will then require Chorus to minimise capital expenditure in order to increase distributions to them so that they may then re-invest that capital in more favourable places. This will result in under investment in the network to the disadvantage of consumers, retailers and the country as a whole. We highlight that Chorus in it's latest half year report indicated that the constraint on cash resources imposed by the IPP decision has already had an effect on its ability to invest in the network.

From the above discussion, it's clear why the TSLRIC process is problematic for regulating NZ telecommunications. It takes too long to reach decisions and is unpredictable. The fairest method is one based on actual costs rather than hypothetical costs. This is the most effective way to ensure that investors are fairly compensated and to limit uncertainty. This in turn will minimise the cost of private capital for New Zealand infrastructure.

In summary, the current NZCC regulatory process of Chorus has severely damaged NZ's credibility with infrastructure investors and damaged its reputation with the financial markets generally. We believe that the NZCC should set connection prices to levels that reflect the actual cost of investment. Anything short of this is, in effect, a partial nationalisation of private assets. Whilst this may sound alarmist, it logically follows and is a view held by many investors and financial analysts. If the status quo persists, then we expect a significant increase in the cost of capital for listed NZ businesses that have regulatory exposure. The current NZCC decisions on Chorus will not be viewed in isolation by investors.

Black Crane Capital invests money on behalf of pensions funds and other investors. We write this letter in an attempt to protect their interests.

Yours sincerely

Peter Kennan