



Expert reports on the cost of capital for UCLL and UBA price review

- Review of submissions on the cost of debt and the TAMRP for UCLL and UBA services – Dr Martin Lally
- Review of the beta and gearing for UCLL and UBA services – Oxera Consulting

Cross-submission | Commerce Commission

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Introduction

1. Thank you for the opportunity to provide comments on the submissions provided by other stakeholders on 21 July as part of the Commission's consultation process on the weighted average cost of capital (WACC) for the UCLL and UBA price review. The two reports on which the Commission consulted and which were responded to in the 21 July submissions are:
 - *Review of submissions on the cost of debt and the TAMRP for UCLL and UBA services* – Dr Martin Lally, Capital Financial Consultants Ltd, ("**Lally Paper**"); and
 - *Review of the beta and gearing for UCLL and UBA services* – Oxera Consulting, ("**Oxera Paper**").
2. We have asked PricewaterhouseCoopers to provide us with further advice ("**PWC Advice**"). in response to specific matters raised in submissions from Chorus, and their expert advisors, CEG, ("**CEG Submission**"), and Dr Bruce Grundy ("**Grundy Submission**"). PricewaterhouseCoopers' advice to us is appended to this submission.
3. Telecom's cross-submission addresses a range of other WACC related issues raised in submissions by Chorus, CEG, Dr Grundy, and by Vodafone and on their behalf by Network Strategies. These include comments on debt management strategies, the costs of financial distress, the tax adjusted market risk premium, and issues relating to estimation of WACC for TSLRIC modelling.
4. There is no confidential version of this submission.

PricewaterhouseCoopers' advice

5. The PWC Advice considers a range of issues raised by Chorus, CEG and Dr Bruce Grundy relating to the estimates of the company-specific cost of capital elements set out in submissions on this specific consultation process, earlier submissions on the subject of WACC in the context of the FPP processes, and on the Oxera paper. It identifies particularly and in relation to the issues raised in relation to asset betas, debt beta, leverage and credit rating:
 - the areas in, and extent to, which PricewaterhouseCoopers agree with the views put forward by CEG;
 - the areas in which they consider the approach adopted by Oxera is to be preferred to the approach suggested by CEG; and
 - those areas where they consider further adjustments may be required to one or the other approach to improve the quality of the parameter or WACC estimate.
6. We trust that this assists the Commission in its decision process on the approach to these matters.

Comments on the Chorus Submission

7. Chorus' 21 July submission emphasises the importance of making the best possible estimate of WACC for use in the FPP process. We agree that it is extremely important to make the most accurate possible estimate of WACC. Chorus asserts in paragraphs 2 to 4 that the estimate of WACC –

“for Chorus, for the first time, enables investor returns to be set at the level which properly reflects the risk profile of Chorus’ business.”

8. We disagree with Chorus' characterisation of the task the Commission is required to carry out. The Commission is seeking to estimate the WACC of a hypothetical efficient provider of the regulated services.
9. In respect of the UCLL and UBA services, the WACC estimate sets the returns from that part of Chorus' business at the level which properly reflects the forward looking risk profile of that part of the returns to investors from those services. The Oxera Report clearly considers this issue in section 6.
10. As set out more fully in our previous submissions, TSLRIC forward looking costs seek to provide efficient signals to providers, access seekers and consumers - encouraging and rewarding efficient investment, use of the infrastructure by access seekers, and ultimately to provide consumers services at lowest cost.
11. The efficient cost signals that interest consumers are not Chorus' or a hypothetical new entrant, but those of an efficient provider unencumbered by Chorus' past inefficiencies and technologies, deploying the lowest cost technology available to it. This is consistent with the proposed general approach set out in the Commission's framework paper.
 - We believe the efficient provider approach should be applied consistently to the FPP process. Accordingly, the Commission should build a TSLRIC model, (as that term is defined in the legislation), using its best estimate of WACC based on the risk profile of the hypothetical efficient provider (rather than Chorus which reflect past and current efficiencies).
12. This provides Chorus and its investors with the correct economic incentives to manage the provision of UCLL and UBA services as a part of Chorus' overall business activities based on the appropriate return on those services given the level of long run risk they face, and the level of long run return which could be expected in workably competitive markets for those services.
13. The balance of Chorus' submission largely sets out key findings of the CEG and Grundy Submissions and we provide comment on those matters below and in the appended PWC Advice.

Comments on the CEG and Grundy Submissions

14. The PWC Advice provides detailed comments on the aspects of the CEG Submission and the Oxera Report in relation to asset betas, debt beta, leverage and credit rating. We support those comments.
15. In section 3.1 of the CEG Submission, the argument is made that the choice of benchmark gearing should be on Chorus' actual gearing level. For the reasons set out above, we think that it is more correct for the purposes of TSLRIC modelling to use the notional gearing appropriate to a hypothetical operator using the most efficient means presently commercially available to provide the services required in each of the FPP processes.
16. CEG also suggest that the Commission currently does not take into account compensation for the expected costs of financial distress. Dr Grundy makes a similar suggestion in section 5 of the Grundy Submission. In our view, the Commission does implicitly take account of compensation for the expected costs of financial distress
17. We think that the cost of debt estimation process followed by the Commission incorporates expected default losses, (in the sense of the costs of financial distress borne by debt holders), into the promised return on debt. The actual effects of default on equity holders or on firm value are not explicitly allowed for by regulators, but the regulator does implicitly provide a return on equity based on expected (rather than promised) returns on equity (since expected returns on equity are arguably captured in the TAMRP).

Comments on the Network Strategies Submission

18. We agree with Network Strategies comment that the use of curve fitting can be complex and somewhat subjective and requires sufficient suitable data in order to provide a robust and reliable result.
19. We also agree with their comments in relation to the TAMRP estimation processes used in the Lally Report, and particularly in respect of the effective double-weighting of the Siegel methodology.