L1 CAPITAL

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ATT: Keston Ruxton
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L1 Capital is an independent Australian and New Zealand Equities fund manager and we currently have investments in the New Zealand media, telecommunications and retail space.

The Commission has referenced respecting investor expectations as an important input into the UCLL and UBA final pricing principle and has asked for submissions from interested parties. L1 is thankful for the opportunity to present its views as an equity investor into this process.

L1 strongly agrees with the Commission's position that regulatory predictability and respect for investor expectations supports investment and therefore promotes competition for the benefit of end users. This position is consistent with our experience of Australian and UK regulation which recognizes that investors expect a fair return on investment with predictable and fair processes. L1 has held the strong view that Section 18 (2A) gives effect to similar requirements in the NZ market and we believe this is reflected in the Commerce Commission's current thinking. As noted by the commission "a common theme internationally and in commission's previous approaches to TSLRIC is the ability of a TSLRIC price to incentivise efficient build or buy choices." A predictable regulatory regime will allow business to confidently make build or buy decisions which will have the effect of promoting competition long term and driving down costs.

We also agree with the Commission that regulatory predictability ensures a lower cost of capital for regulated assets and therefore delivers lower costs to end users. As noted by the Commission, regulatory certainty is especially important given the long term nature of the assets and where modelling is complicated by technology, obsolescence and significant civil engineering/construction risk. The Commission has noted that a key requirement for an efficient TSLRIC price is that "for an incumbent considering further incremental investment in its network, this should remain profitable in so far as the incumbent is efficient." We believe that without a focus on regulatory predictability and respect for investor expectations, the risk premia for a new regulated efficient operator would be so high as to drive up the cost of network investment. The extreme spikes in risk premia in regulated assets around the world when confronted by an unexpected change in regulatory regime is testament to the real need to ensure regulatory stability to maximize efficiency.

Several submitters have put forward positions as to what the Commission should consider as reasonable investor expectations. As substantial shareholders in Chorus we have had an opportunity to engage broadly with Chorus, Australian and New Zealand investment analysts, industry experts, representatives of NBN Co and New Zealand LFC's as well as hear from Crown Fibre Holdings and the Commerce Commission in various public forums. L1 Capital has also studied much of the Commerce Commission's previous announcements on the UCLL and UBA final pricing principle process. We therefore believe that we can meaningfully add to the discussion on investor expectations and present our views below.

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TSLRIC and MEA: Our modelling of the MEA has relied on the definition under the act, international comparators and the Commerce Commission's own guidance in previous correspondence. In particular we have relied on the following:

(a) The definition under the Act which states that Commission should model the forward-looking costs over the long run of the total quantity of the facilities and functions that are directly attributable to, or reasonably identifiable as incremental to, the service, taking into account the service provider's provision of other telecommunications services and includes a reasonable allocation of forward-looking common costs.
(b) The Commission's past guidance in its 2002 and 2004 consultation papers which found that the "MEA is the lowest cost asset, providing at least equivalent functionality and output as the asset being valued" and "will generally incorporate the latest available and proven technology, and will therefore be the asset that a new entrant might be expected to employ"
(c) The Commission's past guidance in the 2004 consultation papers which stated "that Optimised Replacement Cost is the appropriate asset valuation methodology for the purposes of any determination that applies TSLRIC as the final pricing principle... and that even if the assets were to be replaced by the same asset, historical costs will not capture the current and future cost of purchasing and installing that equipment"
(d) The 2013 UCLL Commerce Commission consultation paper which stated that "Forward-looking costs reflect the costs that a network operator would incur if it built a new network today using assets collectively referred to as the modern equivalent asset...the costs of these assets are the costs of currently available equipment as opposed to the costs of older equipment that may actually still be in use"
(e) Ofcom definition which highlighted "forward looking costs requires that assets are valued using the cost of replacement with the modern equivalent asset (MEA). The MEA is the lowest cost asset which serves the same function as the asset being valued. It will generally incorporate the latest available and proven technology and is the asset which a new entrant might be expected to employ."
(f) The MEA definition used by European BEREC Commission which states that the "Gross MEA value is what it would cost to replace an old asset with a technically up to date new one with the same service capability"
(g) Other countries which have used TSLRIC and have come of up with essentially simular definitions of MEA including Sweden, Denmark, Ireland, Luxemburg and others.

L1 Capital has therefore modelled the MEA and TSLRIC FPP price based on what it would cost an efficient new commercial operator to build a new service today which replicated the functionality of the existing service. As equity investors in several telecommunications companies which have rolled out fibre and network infrastructure we have seen first-hand the business planning and build decisions that an operator such as the one contemplated by the Commission would make and have modelled with these precedents in mind to form our expectation of ultimate FPP UCLL and UBA price.

L1 Capital believes that a new efficient operator would work within the following constraints:
(a) **Optimised Replacement Costs**: A new operator would not have access to an incumbent's network and would have to make build decisions regarding the construction of pits, ducts, and tranches and cabinets using a conservative estimate of civil engineering and raw material costs. Such an operator would rely on current commercial realities in its planning, factoring in the commercial cost of access to poles and other infrastructure that was capable of being shared, and not relying on mandatory consents or changes in regulation.

(b) **Demand Profile**: A new operator would be forced to make conservative assumptions on demand ramp up from the new network and just as importantly assume obsolescence and completion risks as competing networks erode demand. Alternatively where the operator made more aggressive demand assumptions the project would allow for this through a higher discount rate and IRR requirement.

(c) **Choice of Technology**: A new operator would make conservative technology choices which reflect the best in use and proven technologies to service the forecast demand. In particular, the operator would not rely on unproven wireless technologies which has not been widely adopted by other operators, given the risk of rapid obsolescence, non-performance or high maintenance costs. Alternatively, in the rare event that an operator went with a new unproven technology he would not rely on listed costs but build escalators into the model to provision for significant performance and efficiency challenges in deploying the new technology and the additional cost of building in redundancies in case of failure if the service was subject to TSO obligations like those of Chorus.

(d) **Period in which to recoup returns.** A new operator would be aware that there is significant technology, obsolescence and demand risks affecting the demand profile of the assets and depreciate the assets accordingly. In particular the depreciation policy would depreciate the assets at a faster rate than the useful asset lives of the civil engineering components of the network to reflect the fact that those assets will face obsolescence before they end their functional lives.

(e) **Risk Premia:** A new operator would recognise that building a telecommunications network carries risks including estimating demand, opex, and capex spend over an extended period, technology and competitive risks as well as regulatory risk, and in funding such a project investors will demand a higher return on their debt and equity capital than other regulated assets such as energy transmission or distribution. Examples of telecommunication network build in the Australian context include Amcomm, TPG Internet, Vocus and AAPT(fibre) and Vodafone Australia(mobile and wireless) . In all these instances these operators had demonstrably high risk premium attaches to both their debt and equity during the ramp and build phase.

(f) **Costs:** A new operator would build a bottom up operating cost model for its new service to ensure efficiency but it would benchmark closely to existing competitors and give heavy weight in its estimate to these benchmarks. That would especially be the case where the competitor is carrying out an identical service and has undergone a recent efficiency review such as the one conducted by Ernst & Young with Chorus in 2013 which identified a high level of efficiency. It would be very aggressive for a new operator to model significantly lower costs for its network than does an existing operator which is under cost pressure and has the benefits of operating scale.

The Commission has established a robust modelling framework and has formed preliminary views about some of the modelling choices discussed above in its July consultation paper. In a number of areas such as the use of ORC, re use of assets and a performance adjustment for fibre the commission has formed a view that we support and we set out our reasoning. In other cases such as aerial deployment, use of FWA, WACC and operating expenditures the Commission has not yet expressed a strong view and we present our thinking below. Our rationale for all of these are anchored on how a reasonable investor would model a new efficient entrant when replicating the Chorus network in line with the TSLRIC model.

ORC: The Commission has supported the view that optimised replacement cost (ORC) is the correct approach for a forward-looking TSLRIC review. This contrasts with the minority opinion put forward by some respondents which contends that depreciated assets of the existing operator should be used. We feel that this position is at odds with definition of TSLRIC widely adopted by other jurisdictions in Europe using ORC approach (Sweden, Denmark, Ireland, Luxembourg), the commission's past guidance and investor expectations about the network that was being modelled. It would also detract from transparency and predictability of the model since instead of forward costs which are observable and subject to wide review

one would have to make a subjective judgement about depreciated asset base of the incumbent. It would also make stability of a TSLRIC pricing regime between regulatory resets very difficult to achieve. A use of depreciated assets would mean that investors and the regulated entity would have to guess at each reset period which assets will be assessed on a depreciated or new build basis and what the depreciation in the last period has been, given changes in demand and other conditions. This will mean a high level of variability at each reset. We believe this goes against the regulatory stability goals the Commission is trying to achieve.

Reuse of Assets: The Commission has also supported the view that reuse of assets is not consistent with a TSLRIC based on forward costs for a new operator. We strongly agree for all the reasons related to the ORC modelling mentioned above. Reuse of assets does not reflect the idea of an efficient new build operator that is central to a TSLRIC model and produces high variability should assumptions around reuse of assets change between periods.

Performance Adjustment: The Commission has also judged that should a fibre network be the MEA choice, there should be no performance adjustments for copper MEA network. We agree with this on the basis that the modelling is extremely problematic given the effect that the market does not send a strong price signal to indicate the degree of preference of fibre over copper and the advantages of a fibre network for an end user (speed) has to be balanced against loss of functionality (no independent power supply, loss of support for legacy fax, alarm and other services). Without a price signal any performance adjustment would be arbitrary and increase uncertainty in the modelling.

Aerial Deployment: The Commission has also sought consultation about the amount of aerial deployment to model for an efficient new operator. We have modelled a deployment level in line with Chorus 20% aerial target for UFB. We believe that this is the upper bound of a new build efficient operator could achieve given that Chorus which has a huge incentive to deliver UFB at the lowest cost and all the advantages of incumbency with access to existing ducts, trenches and poles not available to a new operator is only aiming for 20%. Our understanding is that other operators such as TelstraClear and Saturn in NZ have had significant difficulty in getting consents for pole access which severely limited the program. The Australian experience for NBN Co is also instructive with NBN Co currently able to get only 30% of the aerial consents it was seeking in the early areas of the roll out. Sweden took an ORC approach in its modelling and the aerial target was set at 16%. We believe that a target that no realistic efficient operator could achieve will simply penalise the incumbent and lead to a less predictable TSLRIC model and under recovery in costs, without achieving any of the Commission's objectives.

WACC Approach: The Commission is also consulting on WACC approaches and cost of capital to use in modelling the new efficient operator. As we discussed above a new telecommunications build has a range of demand, opex, capex, technology and regulatory risks which raise the risk premium relative to other regulated industries. This has been acknowledged in Australia with higher regulated asset betas for telco networks relative to electricity and gas operators. The ACCC also explicitly considered the need to allow NBN to earn a return on its investment as part of its special access undertakings process. Again we believe a WACC approach which is set artificially low does not reflect the true intent of the TSLRIC model. It decreases the predictability of TSLRIC to investors and ultimately causes an under recovery of costs, which leads to an inability for the incumbent to make new build investment decisions, impacting end users. We believe the Commission should continue to consult widely and use real life examples of risk premia from telecoms, including Chorus and Australian telecommunications companies where practical, to form its views.

Fixed Wireless Access: The preliminary views of the Commission suggested that fixed wireless technology should be used in rural/costly areas. We totally agree with the commission that the most effective technology solution would be deployed by a new build efficient operator. However, as we highlighted earlier we believe a prudent plan for a new incumbent would involve the use of a proven technology solution which has been widely deployed and is capable of large scale roll out. Roll out of an unproven technology would generally be avoided given the risk of non–performance, concerns on cost escalation on wide scale rollout, limited

operating knowledge, level of redundancy/maintenance required and the compatibility risks with other network infrastructure. These operating risks would be compounded if the new build operator was subject to TSO obligations like the incumbent. In this context we would argue that fixed wireless is not a proven technology that an efficient operator would adopt(except in fringe areas). The TERA document talks about only 15 customers being able to use the Vodafone wireless system being rolled out in rural areas. In Australia, NBN Co is using fixed wireless as a limited solution in some areas but are already experiencing delivery issues and the prospect of having to build considerably more towers than they expected to meet their initial coverage requirements. The use of wireless is also not consistent with other regulators position on wireless deployment in the MEA. TERA's recent TSLRIC modelling work for Denmark found no reference to wireless technology as the MEA and our understanding of Swedish TSLRIC modelling is that wireless was only considered at the fringes. Our summary view is that wide scale adoption of FWA would reduce the regulatory certainty of the TSLRIC model given that investors and the regulator would have to consider a wide range of emerging, unproven technologies as possible MEA solutions which would dwarf other aspects of the model in materiality and greatly increase modelling risk. It would also not be consistent with other ORC implementations. Lastly it is likely to lead to an under recovery of costs for the incumbent with the effect of not sending efficient build signals and chilling future investment. If unproven technology is to be used for the hypothetical build operator then one approach the Commission could factor into its model the high likelihood of cost overruns and the potential for capex blowouts associated with deploying unproven technology and increase the WACC to account for the significant additional business risk involved

Operating Costs: The act requires the Commission to include a reasonable allocation of forward-looking common costs in setting the operating costs for the new efficient operator. The Commission has set out a range of approaches to this requirement which include a mix of bottom up modelling and use of various estimation approaches where practical. This is one of the most complicated aspects of the modelling task and we believe the Commission has applied significant intellectual rigour to the task. We would like the model to point out that Chorus as the incumbent is carrying out an identical service and has the benefit of significant operating scale. Additionally as a response to significant operating pressures Chorus has already enacted significant cost out in the previous year. Our impression is that Chorus is not inefficient and nor would we expect it to be, given that it has emerged from an operationally separate business unit where there was a distinct focus on its own operations. Our perception seems to be consistent with the view expressed in the EY report released by New Zealand's Minister for Communications late last year which said that *Chorus* has "historically shown an ability to implement cost saving initiatives" and that the *ability to implement and achieve revenue increases, cost and capital expenditure savings"* from recently announced initiatives "will clearly be challenging." Therefore we believe regulatory certainty would be enhanced if the new operating estimates also gave weight to Choruss operating costs as an existing efficient operator. It would be very aggressive to assume that a new operator would achieve significantly lower costs for its network than does an existing operator which is under cost pressure and has the benefits of operating scale. An unrealistically high expectation of operating efficiency will reduce regulatory predictability of the model and will impair the ability of Chorus to recover its efficient costs and impair future build decisions.

We would also like comment specifically on the role that the commission's IPP price decision had on setting L1 Capital's and other investor's reasonable expectations on the FPP price. Some respondents have submitted that the IPP price sent a signal to investors which should have changed their price expectation in relation to the final FPP process. We would like to categorically state that our expectation of the UBA and UCLL price was grounded in the FPP process and we have spent significant time modelling the parameters around the process as discussed in this letter. The IPP process was widely understood by investors to have a high level of estimation error. It was described as "quick and dirty" in the recent High Court Case. The commission in its

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draft benchmarking decision spoke extensively about the difficulty of benchmarking given the different topography, network deployment, population densities and definitions of regulated services between various reference countries. The Commission further acknowledged the very small comparator set of 2 countries to base a benchmarking decision on out of the hundreds of countries considered in the benchmarking and it identified this as modelling risk. The fact that the IPP process has not led to revised expectation for FPP can also be seen from the work of the investment community which continues to argue that the benchmarking process has serious limitations and has set the benchmark price too low relative to real cost of providing the service. This is reflected in the significantly higher UCLL and UBA prices being modelled by investment community today relative to the IPP price.

We believe that the commission should be commended for applying significant intellectual rigour to its modelling around the FPP process. In our opinion the Commission has set in place some draft opinions which will ensure the lowest cost to end users while also promoting regulatory predictability and enabling the operator to recover its efficient costs and make appropriate investment decisions to complete against emerging LFC networks. There are of course a wide range of very material decisions in front of the commission and we hope our feedback in this submission has been helpful. We would note that some submitters have claimed that Chorus has a minority position on its policy positions (ORC, deployment choices, WACC, Opex, etc), while the majority view (mainly the RSP's) have a different view on most of these issues. The commercial reality is that New Zealand, like Australia, has a small group of RSP's with significant market power and are in a position to secure windfall gains from a lower FPP price. Telecom NZ(Spark), Vodafone and CallPlus have 95% of the broadband retail market which suggest a very high degree of market power. The very fact that these RSP's are so actively engaged in the consultation process for FPP suggests that they believe they have a reasonable prospect of securing windfall gains as a result of this process. We believe should be aware that a lower wholesale price for UBA and UCLL may not achieve the overriding goal of delivering efficient costs to consumers while distorting build or buy signals for the incumbent, raising regulatory risk and slowing down the adoption of fibre services.

We thank the commission for the opportunity to make a submission into this important process and look forward to the Commission's views on the matters that we have canvassed.

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