L1 CAPITAL

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L1 Capital appreciates the opportunity to make this submission following the release of the *Chorus initial price-quality regulatory asset base as at 1 January 2022*, and ahead a draft decision on the value of the initial PQ RAB in the third quarter of 2021.

L1 manages money for a range of clients including large superannuation funds, global endowment funds, high net worth individuals and retail investors. L1 invests globally with North America, Europe, UK, Australia and NZ being key focus areas and has made significant investments in New Zealand over the last 10 years.

The Commerce Commission Consultation document appears to continue a pattern of policy decisions that have led to an under-recovery by Chorus of its cost of capital on the significant investment it has made, and continues to make, in critical national infrastructure.

1. **WACC Final Determination has shocked equity markets:**

   The Commerce Commission's WACC determination underestimated the required rate of return to well below Chorus's actual cost of capital and in some cases to below the cost of Chorus debt. **The market has recognised the heightened regulatory risk and punitive treatment of Chorus investors**. The cost of capital for Chorus has gone up significantly since the WACC determination was made.

2. **Commerce Commission's consultation document looks set to further undermine returns by challenging Chorus's RAB inputs which have already been very conservatively calculated.**

   The RAB calculations set forward by Chorus already reflect a conservative treatment under the price-quality framework with many assets contributed at historic depreciated cost far below their market value and several mechanisms to guard against over-recovery.

   The RAB as proposed by Chorus today already reflects a significantly lower cost to build than many countries in the world including Australia, UK and large parts of Europe. Despite this, the Commission's questioning of allocation choices, appears to be focused on reviewing Chorus's business through a retrospective economic efficiency lens and ignoring the public-private partnership at embedded in the UFB contract which has delivered real savings for NZ households.

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3. **L1 does not believe that there are incentives today for Chorus to invest in the fibre network and private investors are being taken advantage of through a punitive regulatory regime. The UFB is the largest PPP project NZ has attempted and its failure will be noted by international infrastructure investors in any future project NZ government seeks funding for.**

   Equity investors made a 10+ year investment in building the UFB during which time returns promised to private investors shifted from allowed return of 9%+ to 4.25% today – **one of the lowest returns for a regulated fibre network anywhere in the world.**

   If the Commission's process produces a RAB below original market expectations and the resulting MAR is near or below Chorus' business plan, we there is no reason for Chorus and its shareholders to contribute any further investment to the regulated fibre services.

   <u>We do not see how this outcome fits with the Commission's suggestion it is producing outcomes that incentivise regulated providers to deliver good outcomes for consumers, or indeed the broader national interest given the accepted social benefits of increased high-speed broadband penetration.</u>

4. **It is extremely concerning that the Commission now appears to be suggesting that its two-year process is in effect becoming a 2.5 year process, perhaps longer if the final MAR necessitates a revenue wash-up after 2024.**

   It is particularly unfair and inconsistent to finalise WACC outcomes in May 2021 but not finalise RAB the middle of 2022. The IM's for WACC should be reopened to align WACC and RAB determinations.

5. **Fixed Wireless Access products have evolved, and this should be incorporated into initial WACC outcomes**

   If the RAB regime is delayed then there is no reason not to reopen the WACC IM to account for very real risk of stranding from FWA. Fixed wireless services has massively stepped up competition since Commission closed the WACC review, with FWA pricing now lower and capacity higher since that review. This is before a broader introduction of 5G FWA services.

We provide more colour on these observations below.

Issue 1: WACC Final Determination has shocked equity markets:

The WACC consideration last year underestimated the required rate of return to well below Chorus's actual cost of capital. In a prior submission, L1 has highlighted several issues with the approach to estimating WACC, including:

- The calculation of the loss asset does not include an allowance for stranding risk during the build period. Stranding risk is borne by investors from the start of the project build until all efficient costs are recovered. Applying it only for some of the period is not a logical application of project finance and leads to an under recovery of efficient costs.

- The calculation of the loss asset fails to consider the additional risk born by investors during the build period. These include the costs and conditions imposed on Chorus by the CFH contract. These risks are also different to the risks faced by the comparator companies used to calculate asset beta and should be compensated through a higher WACC.

- The Commission's calculation of stranding risk ignores real world experience where 15% of users have already transitioned to FWA. FWA adoption has only grown since the WACC determination. L1 estimated stranding impact >10x higher than the Commission estimates and received no real feedback on our calculations.

Outcomes reached by the Commerce Commission's input methodologies review do not allow Chorus to generate a rate of return consistent with the risks that investors have taken on building the project. The following is how we have described those outcomes to our fundholders in a public update on the ASX:

> **Chorus (Long -14%)** shares declined in March. The stock has been impacted by a punitive determination by the New Zealand Commerce Commission on the allowed rate of return for Chorus's fibre assets. The very low allowed rate of return severely underestimates the real risks investors have taken on in building and operating the fibre network. We are hopeful this will be corrected through a much more commercial approach to the assumptions underlying the asset base and a re-examination of other assumptions through the rest of this year. Failure to do so would send a strong signal that there is huge risk in entering into long term public private partnerships with the New Zealand government and that New Zealand is not a reliable destination for investing in regulated assets. In terms of company fundamentals, Chorus's fibre build has been consuming the majority of cashflow for many years, preventing the company from paying out its true underlying earnings in dividends. With the peak capex period now past, we are hopeful that shareholders will finally begin to see the returns on this 10-year investment program.

As a result of the lower WACC outcome, private investment in the UFB project is at greater risk of being stranded. The market has recognised this and cost of capital for Chorus has gone up significantly since WACC determination was made. A higher cost of capital raises the cost of future NZ fibre investment to the detriment of NZ users.

Issue 2: Commerce Commission's consultation document looks set to further undermine returns by challenging Chorus's RAB inputs which have already been very conservatively calculated.

A further area of concern is that the Commission's approach to date, and seemingly reflected again in the way it is questioning allocation choices, appears to be focused on reviewing Chorus's business through a retrospective economic efficiency lens. Such an approach continues to overlook the public-private partnership context within which the company was created.

This is highlighted in several places in the Commission's consultation document:

- **Para 4.22** – this section questions whether total exchange space is a more appropriate basis over which a proportionate cost would be allocated to UFB FFLAS, as opposed Chorus's proposed allocator which is across a proportion of the total equipment footprint. This line of argument is even though using exchanges at historic depreciated cost has helped greatly reduce the cost of the UFB rollout.

- **Para 4.34** – this section seems to suggest that the management focus created by the Commission's copper pricing review during 2013 to 2015 could indicate that corporate personnel costs should be weighted to copper services rather than fibre.

  This is a logical fallacy. As investors through this period we are acutely aware of the consequences of the copper pricing review on the company. While it is easy to say Chorus was focused on copper pricing, the fact is the company was dealing with the consequential threat to its business because of its UFB commitments. Chorus was required to have an investment grade rating under its UFB contract with the Crown.

  This is evident from the statement credit ratings agency Moody's made, when putting Chorus on negative watch immediately following the copper price cut:

  > *"Chorus' existing Baa2 rating takes into account Moody's current expectation for gradually increasing debt and negative free cash flow until around 2019, due to the company's substantial capex programme. The NZCC determination will exacerbate Chorus' negative free cashflow position and lead to materially elevated leverage, putting significant pressure on the company's key financial metrics," says O'Connell.*
  >
  > *The review will focus on 1) the impact of NZCC's decision on Chorus' financial profile, and the company's ultra fast broadband rollout, and ii) couter-measures that Chorus would be implementing to mitigate the negative impact of the decision.*

- **Para 4.29** – this section suggests that fibre connections, as a proportion of Chorus' total connections could be a proxy for operating costs. Again, this ignores that Chorus' very reason for existence was to build the UFB network for the government. Totex is absolutely the clearest indicator of this focus. You have only to look at the step up in fibre capex from its demerger to grasp how the rollout was dominating the company's focus. Fibre went from being just 12% of Chorus capex in FY11 to 79% in 2012. At the same time the company's focus shifted from delivering a fibre to the cabinet rollout, which dominated pre-2012 capex, to delivering the UFB rollout. This is a company that had geared up to deliver projects – the first being the government mandated fibre to the cabinet programme in 2008 - and its operational and management intensity must logically reflect that. From FY12 onwards the company was consistently devoting ~85% of its capex to fibre because it was building the UFB network.

Chorus has noted that if the Commission's IMs adequately reflected the true scope of the UFB requirements on its business then the initial RAB value would be nearer $6 billion. This view is consistent with our own modelling and market expectations.

The Government, via Crown Fibre Holdings, had substantial governance and reporting requirements that drove considerable activity within the company. It is highly unlikely that the IM approach accurately reflects this. The Telecom demerger Scheme Book is also instructive on this point:

2.3.6 Additional corporate operating and other costs

As separate companies, collectively New Telecom and New Chorus are likely to incur higher corporate operating costs than Telecom incurs in its present form as each will need to establish and perform a number of separate corporate functions. In addition, as they migrate from shared assets and services, New Telecom and New Chorus are expected to incur additional costs associated with the establishment of systems and network equipment on a standalone basis. The quantum and timing of these costs are uncertain.

Issue 3: L1 does not believe that there are incentives today for Chorus to invest in the fibre network and private investors are being taken advantage of through a punitive regulatory regime. The UFB is the largest PPP project NZ has attempted and its failure will be noted by international infrastructure investors in any future project NZ government seeks funding for.

The Commission's draft determination is significantly below the 8% to 9% WACC originally envisaged by CFH when the project was announced. On this topic, we note the following:

1. Chorus made commitments to invest in 2011 on a long-term basis under the conditions and commitments of the time. Equity investors like L1 have been invested in the fibre rollout for majority of that period with the expectations that once the fibre network in complete those are the returns to be expected. Chorus investors have taken significant risk in bringing this PPP project on time and on budget and vended in significant pit and duct assets at below market value only to see return expectation conveniently changed when private capital has taken on majority of the risk and the network has been largely completed.

2. An estimated WACC of 4.25% is so radically different from original indications that it sets a difficult precedent for future capital providers looking for certainty. **In addition, it also sets a rate of the return that is one of the lowest returns for a regulated fibre network anywhere in the world.**

3. The revenue cap means there is no incentive to invest further in fibre take up or penetration – our recommendation in the absence of a better regulatory regime would be to minimise future investment while it earns a returns well below cost of capital.

4. It is also difficult to also not reflect on the wide gap between PQ and ID regulation and wonder whether public capital is being prioritised in setting returns which goes to the basic question of fairness.

5. The UFB is the largest PPP project NZ has attempted – this is a massive failing of PPP programs in NZ and will be noted by international infrastructure investors in any future project NZ government seeks funding for

Issue 4: If there must be a delay to outcome of regulatory process it is essential there is an alignment of WACC and RAB processes to ensure consistent and fair outcomes.

The initial delay of the implementation of the regulatory framework, from the original January 2020 start date, means key WACC settings are being locked in at a time when the coronavirus pandemic has distorted risk-free and inflation rates to even lower levels.

It is extremely concerning that the Commission now appears to be suggesting that its two-year process is in effect becoming a 2.5 years process, perhaps longer if the final MAR necessitates a revenue wash-up after 2024. This looks very much like a last minute shifting of the goalposts. We do not understand how:

(a) The Commission can seemingly grant itself an extension of the Minister's initial two-year extension
(b) The Commission considers it acceptable that a commercial business can be expected to operate under such uncertainty.

Chorus investors are in effect being asked to continue to fund significant ongoing investment in fibre without knowing how much the company is worth and what it can earn from its investment. This kind of delay and uncertainty has a real cost to investors that is being ignored.

In the event that the RAB and MAR process is to be delayed as proposed, the Commission must surely also reconsider the use of May 2021 risk-free rate settings for RP1.

It is inconceivable that that risk-free rate can be set now on the basis that the regime will apply in six months, when the key components of the regime may not be finalised for another 12 months.

Under the Commission's timeline, rates should actually be set, or reset, in December. The Commission has said it will amend the IMs to enable the delay in process, so this implies the IMs can also be revisited to remedy this potential issue.

Issue 5: Fixed Wireless Access products have evolved, and this should be incorporated into RP1 WACC outcomes

If the RAB regime is delayed then there is no reason not to re-open the WACC IM to account for very real risk of stranding from Fixed Wireless Access.

Fixed wireless services have materially increased since the Commission closed the WACC review, with FWA pricing now lower and capacity higher since that review.

Interest in wireless broadband products has increased by 70% as at May 2021 according to a survey by UBS, compared with the same survey conducted in 2020 (source: UBS Evidence Lab, 3 May 2021). This is before a broader introduction of 5G FWA services over the next few years.

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L1 would like to again thank the Commission for its time and looks forward to their views on our submission.

Signed:

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