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Regulation Branch
Commerce Commission
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Wellington

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UNISON SUBMISSION ON DRAFT FIBRE IMs

Opening comment

This letter constitutes Unison's submission on the Commission's consultation paper on *Fibre input methodologies: Draft decision - reasons paper, 19 November, 2019.*

Our focus has been on reviewing the Commission's cost of capital proposals and related elements (not the wider IMs). It has necessarily been limited because of the timing in relation to the DPP3 reset and the Christmas period. Due to this unfortunate confluence, the Commission needs to ensure that the decisions it makes on Fibre IMs are not simply taken as a precedent for the next Electricity IM Review. We believe that EDBs have not had appropriate ability to engage fully in the process, given competing regulatory issues. We have contributed to the ENA's submission, which has been similarly limited in scope.

Unison's submissions

Overall, Unison is strongly of the view that the draft Cost of Capital Input Methodologies for fibre fixed line access services contain several practical and theoretical errors. These errors are such that the resultant WACC estimates are below the level that appropriately reward investors for the risks of their investments in regulated infrastructure assets.[1] We also think the Commission's proposals to address asymmetric risks are not consistent with outcomes that are observed in competitive markets.

With respect to the draft decisions:

- We note that current estimates of risk-free rates for a five year term are based on yields on five year Government bonds which are providing expected negative real yields. ENA and Vector requested that the Commission consider the implication of this outcome for the cost of capital IM when resetting the DPP for EDBs. The Commission declined to urgently revisit the calculation of the risk-free rate or market risk premium. The Commission has stated that the potential for negative real risk-free rates existed

1 Unison has noted the recalculated TAMRP of 7.5%, which appears to be relevant to the cost of capital for EDBs for the DPP3 period. Even on this narrow measure it appears the cost of capital for the DPP3 reset is 0.18% too low.

when the Electricity and Gas IMs were reviewed and negative real rates were already being observed internationally at that time:

a. however, the Commission did not state whether the potential for negative real risk-free rates was in fact considered when reaching its cost of capital IM decision, or

b. how the Commission considered a negative real risk-free rate is compatible with the capital asset pricing model, or the consequences for calculation of the market risk premium.

Unison recommends:

a. the Commission review the calculation of risk free rate and market risk premium to ensure they are adequate in light of observed negative real Government bond yields; and

b. the Commission publish its views on why it considers an estimate of a negative real risk-free rate is compatible with its equity market premium - especially when a number of models it uses for establishing the equity market risk premium observe the relationship with risk-free rates.

- The Commission proposes to use the five year average of debt premiums immediately prior to the regulatory period to set the debt risk premium for the entire regulatory period. Unison submits the use of a historically calculated debt premium to establish a fixed debt risk premium for the entire regulatory period is inconsistent with businesses rolling their debt over during a regulatory period.

  In the 2016 IM review the Commission considered a rolling debt premium to be too administratively costly to implement, but it is not evident why this is the case. The Commission recalculates debt-premiums on an annual basis, and it seems relatively straight-forward to adjust for the financial implications of changing debt premia, even if the adjustment is not contemporaneous (e.g., through an end of period wash-up). The key point however, is that debt premia allowances are not reflective of regulated businesses' actual costs of debt during the regulatory period;

  Unison recommends alignment of calculation of the cost of debt to more realistic, efficient treasury policies, including reflection of businesses' actual debt financing practices during a regulatory period.

- The Commission proposes to calculate the risk-free rate based on a three month window of observed five year Government bond yields calculated immediately prior to the regulatory period. Establishing cost of debt and equity based on short-term measures of risk-free rates leads consumers being subject to significant exposures to fluctuations in interest rates. The bulk of changes in EDB's prices arising from the fall in WACC in the recent DPP reset has highlighted the significant impact of using short-term periods for measuring the risk-free rate. The cost of debt approach by the Commission relies on a very specific hedging strategy linked specifically to the regulatory control period. This approach reduces the ability of supplier Treasuries to use a variety of products of different maturities for managing their debt portfolios. Indeed, the recent EDB reset demonstrates how specific the Commission's requirements are which has resulted in a WACC below the cost of debt of suppliers which did not hedge all their capital needs to the Commission's observation window.

Moreover, we do not observe such sharp changes in prices in workably competitive markets, because businesses are setting more stable prices based on long- term averages. As the expectation is that over the long-term fibre will likely compete with other technologies such as 5G, 6G etc, we think the Commission needs to give much greater consideration to an appropriate method of ensuring a more stable cost-of-capital that more accurately mimic outcomes in competitive markets than adopting the five-year regulatory period paradigm as the basis for setting a cost of capital IM;

Unison recommends the Commission review the calculation of risk-free rate to reflect a more stable calculation methodology that does not unduly expose consumers and regulated businesses to short-term conditions existing immediately prior to a regulatory period.

- We are highly concerned about the proposal to remove the WACC uplift on the basis that the economic cost of under-investment in fibre services means the risk of setting a WACC too low is acceptable. This removal is especially worrying to us given the Commission has indicated that it does not see IMs as setting any kind of regulatory compact, but can be changed at a point in time that they no longer are considered to be consistent with achieving the relevant legislative Purpose. As we have articulated previously, regulatory commitment is so fundamental to achieving the purpose of regulation, it is essential that the IMs are viewed by regulated suppliers as setting out a regulatory compact.

  We are concerned that the proposal not to include a WACC uplift is time inconsistent and a different decision on the uplift would have been taken had the fibre roll-out not commenced. In the early 2010s the 75th percentile was seen as a well-entrenched part of the regulatory landscape.

  Unison recommends the Commission include a WACC uplift to ensure wider confidence that regulatory decisions are time consistent.

- We recommend the Commission consider the interaction between Type I and Type II risks. The Commission's view is that Type I risks (earthquakes etc) should be dealt with by re-openers, whereas Type II risks (asset stranding) should be dealt with via an *ex ante* allowance. The risk of asset stranding is a function of prices (e.g., relative to substitutes), service attributes (quality, reliability, performance) and the availability of substitutes. With the emergence of 5G and ongoing improvements in wireless options, asset stranding risk increases over time. When Chorus is subject to a significant earthquake event (e.g., rupture of Alpine Fault), then if potentially faces a significant jeopardy from:

a. significant repair and replacement costs,
b. recovering the costs of existing un-depreciated assets and past losses,
c. loss of custom due to competition from alternatives such as 5G which are likely to be subject to faster repair/restoration times, and
d. depopulation risks.

Accordingly, the prospect of Type II risks increases the risks associated with Type I events. In simple terms, it is not realistic to assume that the costs of adverse events could be fully recovered given the constraint of competitive offerings that are likely over the longer term. In Unison's view, the most appropriate method of compensating Chorus for Type I risks is to determine an actuarially fair self-insurance premium (for any non-insurable assets) and include that in Chorus's regulated cost base. It may be appropriate for Chorus to establish a Captive Insurer to provide a level of assurance around the establishment and management of appropriate insurance premiums.

In our view, an insurance premium-type approach for Type I risks is much more in the interests of consumers. Rather than concentrating the costs of recovery on those consumers who remain connected after an event, it more equitably recovers the costs of expected events across a more diverse population and across a longer timeframe.

An insurance premium-based approach is also consistent with outcomes observed in workably competitive markets. Following an adverse event, businesses operating in workably competitive markets cannot simply lift prices above competitive levels to recover the costs of past losses (e.g., due to fire etc), but these possibilities must be addressed through insurance or higher returns which can cover the impacts of periodic adverse events.

Unison recommends

a. The Commission include a self-insurance premium in Chorus' cost base to enable a much more efficient method of compensating Chorus for risks of Type I events.

b. The Commission's assessment of adequate compensation for Type II events considers the interaction with the likelihood of Type I events and the challenges of recovering the costs of a Type I event in the long-term presence of the potential for asset stranding.

Closing comment

In this brief submission we have raised issues with the draft cost of capital IMs and related matters. Although we recognise that the low interest rate environment is consequently flowing through into calculated WACCs, it is Unison's strong view that the regulated cost of capital in the draft fibre IMs and in the IMs for EDBs are unreasonably low, based on both theoretical and practical considerations. Furthermore, the reasonableness check on page 353 of the consultation document indicates that the Commission's WACC estimates are low compared to other regulators' decisions and brokers' estimates. We think the proper interpretation of the comparisons is that the Commission's estimate is too low.

Thank you for considering Unison's submissions. Please contact me if you have any questions on the matters raised in this submission.

Yours sincerely

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