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Keston Ruxton
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Dear Ms Ruxton

Submission to UCLL and UBA FPP draft determination

We appreciate the opportunity to make a submission to the consultation process on the Commerce Commission's final pricing principle draft determination. We note that the Commerce Commission has now decided not to use 'reasonable investor expectations' as a test in its determinations. As we outlined in our last submission, however, we still believe regulated prices need to be at a level that makes an adequate return on invested capital in order to attract long term capital.

We are long-term investors on behalf of pension funds. While the draft determination goes part of the way towards addressing the shortcomings of the initial pricing review, we believe the Commission should reconsider some of the inputs it has chosen. The price settings in the draft determination do not result in an adequate return on capital, which would be detrimental to long-term investment in critical infrastructure in New Zealand.

Consider an operator that is looking to pass 831,000 premises in New Zealand. It estimates that it will cost $2.7b to complete the roll-out, including connections. The table below summarises the economics of this investment.

Table 1. A hypothetical efficient operator's economics under the draft determination

	Value	**Explanation**
Cost to roll out to 831,000 premises	$2,700m	
Maximum revenue allowable under current draft FPP pricing	$383m	$38.39/month price, assuming **full take-up** of UCLL and UBA services
Operating costs to provide these services	$199m	Chorus' FY14 operating costs before depreciation and amortisation, adjusted down for number of premises. It assumes the costs are completely variable, which is optimistic, and excludes any return of capital considerations
Operating profit before tax	$184m	
Pre-tax return on investment	**6.8%**	

The resulting pre-tax maximum return of 6.8% is far below adequate given the risks involved, noting in particular the finite lives of the assets and the requirement to get investors' capital back over that finite life. Given the perceived risks and estimated return, no private investor would invest in a project like this in today's environment. In this example, the capital expenditure figures are Chorus' own estimates for their new fibre network. A full replacement cost of the network would be significantly higher because Chorus is reusing assets in their build. The draft determination implies

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the Commerce Commission believes that Chorus is building its new fibre network extremely inefficiently relative to a hypothetical efficient operator or that Chorus has extremely inefficient operating costs.

As investors, we have concerns over inconsistencies in this draft determination, particularly in relation to the following parameters:

- *Post-tax WACC*. The post-tax WACC of 6.47% is too low and the lowest we have seen in determinations across a variety of companies and industries, especially given this is a nominal figure. It is also below the WACCs used by New Zealand's other fibre rollout companies. This value underestimates the very real risks facing any investor in a hypothetical efficient operator. These include the risks of stranded assets and technological change, which are high for a telecommunications provider, and regulatory risk, which is demonstrably higher. In our view, the current WACC does not meet the reasonableness test.
- *Capital costs.* Several categories of costs should be based on the reality faced by an operator in New Zealand. Trenching costs assumed in the draft determination deserve a comparison with Chorus' actual costs.
- *Operating costs*. The operating costs used in the draft determination have been assumed to be 50% of copper opex, which seems to be already lowered from Chorus' actual accounts by 22% (based on the incomplete information in Figure 2 of the UCLL draft determination documentation released on 2 December, 2014). The overall impact of a 61% reduction is inconsistent with TERA's previous modelling in Denmark which only showed a reduction of up to 17% in opex.

We also have concerns over the current proposal for backdating. In the draft determination, it appears that any final decision may only be backdated to December 2014. This only decreases investor confidence in the regulatory process. It should not be Chorus' investors who endure two years of a benchmark price that more rigorous work concludes is too low, or pay for the imprudence of retail service providers who banked the windfall profits from that previous decision. Chorus' investors should certainly not wear that pain without a commensurate increase in WACC to compensate for this type of regulatory risk.

We understand the difficulties the Commerce Commission faces in trying to determine prices. The current settings, however, make investors question whether the hypothetical efficient operator could ever exist in practice because it would never be funded. For the sake of future investments in regulated industries, we would hope that the Commerce Commission considers the true price level required to justify investment in important, nation-building infrastructure.

Yours sincerely

Suhas Nayak

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Who is Allan Gray?

Allan Gray is an Australian based investment manager. We manage money for retail and institutional clients. A large proportion of our institutional clients are pension funds.