

30 March 2021

THE IMPACT OF THE COVID-19 PANDEMIC ON COST OF CAPITAL INPUT METHODOLOGY FOR FIBRE

In July 2020, in our further consultation paper for the fibre input methodologies (IMs) made under Part 6 of the Telecommunications Act (**Act**)¹, we committed to examine by April 2021 whether or not we should re-open the Cost of Capital IM to take account of any significant effects on financial markets of the Covid-19 pandemic and policy responses to it. This commitment reflected the fact that, at that time, there was considerable uncertainty about the future path of the pandemic and its impact on the New Zealand and global economies and financial markets.

At the time our commitment was given, the economic impact of Covid-19 appeared more severe than we now know to be the case. The most recent Reserve Bank of New Zealand quarterly report has noted that the New Zealand economy is in a stronger position than anticipated at the outset of the Covid-19 pandemic, although significant uncertainty for the economic outlook remains.² We have also recently seen long-term bond yields increase which may be associated with expectations for economic growth and inflation.³

For the reasons set out below, we are of the view that re-opening the fibre Cost of Capital IM to take account of the impact of the Covid-19 pandemic would not be consistent with our framework for considering IM amendments, and so have decided not to consult on any amendments in this regard under s 181 of the Act.

Our framework

We outlined in our final decision reasons paper for the fibre IMs⁴ our framework for amendments to IMs. Input methodologies are a key tool within Part 6 for helping to promote regulatory certainty. Unduly ready recourse to IM amendments as part of the s 181 process may have a detrimental effect on the role that predictability plays in providing suppliers with incentives to invest in accordance with s 162(a), and the role that the IMs play in promoting certainty for suppliers and consumers in relation to the rules, requirements, and processes in advance of them being applied by us and suppliers (for example, in setting the PQ path).

¹ Commerce Commission “Fibre input methodologies: Further consultation draft – reasons paper” (23 July 2020), paragraph 4.3.

² Reserve Bank of New Zealand, “Monetary Policy Statement” (February 2021)

³ We understand this has occurred in markets around the world and some central banks have responded to push yields down.

⁴ Commerce Commission, “Fibre input methodologies: Main final decisions – reasons paper” (13 October 2020), paragraphs 2.344-2.353

For that reason, we stated our expectation that significant changes to the “foundational building block” IMs, such as the Cost of Capital, outside the statutory review cycle would usually only be considered in exceptional circumstances. By contrast, we expect that the s 181 amendment process might be used to consult on proposed changes:

- a. to support implementation of incremental improvements to the way the PQ path is set;
or
- b. to enhance certainty about the rules, or correct errors, ahead of a PQ path reset.

The reasons for our decision

We have decided against re-opening the Cost of Capital IM for fibre, based on the following considerations:

1. The NZX has recovered from the initial impact of the pandemic

Share markets around the world, including the NZX, have recovered from the substantial falls incurred in early 2020. Some academic observation has examined the causation behind the share market reactions and has associated some of these movements with a sharp increase and then relatively quick correction of the Market Risk Premium to normal levels.⁵ We do not see this as conclusive evidence, but it is not supportive of the need for any urgent adjustments.

2. The Fibre sector has not been unduly negatively impacted by the pandemic

A characteristic of the economic impact of Covid-19 is its uneven impact across sectors. Telecommunication services is not one of the sectors severely negatively impacted by the pandemic.

3. A negative OCR is not imminent

In July 2020, we noted that a negative OCR may (or may not) raise practical issues for corporate debt. The most recent decision by the Reserve Bank has been to hold the OCR at 0.25 percent. We recognise that a move to a negative rate is still a possibility, although it appears considerably less likely than was the case in mid-2020 (when some commentators expected a negative OCR decision to occur by April 2021.⁶)

4. To the extent that market conditions produce impacts on the risk-free rate, this will be fed into cost of capital through via our WACC determinations

The most notable ongoing impact on financing conditions for regulated suppliers, the risk-free rate and debt premium, will be captured in the WACC determinations, which are based on updated data at the time of the determinations.

Conclusion

We will continue to monitor developments in financial markets. We will also, in any case, be reviewing the Cost of Capital IM for Part 4 of the Commerce Act prior to 2023, as part of the IM

⁵ For example, see Damodaran, “A Viral Market Update XIV: A Wrap on the COVID market, premature or not!” (5 November 2020)

⁶ For example, see ANZ Research, “Into the twilight zone” (18 August 2020).

review mandated by s 52Y of that Act. We will consider closer to that point whether or not one or more of the fibre IMs should also be subject to the statutory review at the same time, in order to create a cross-sectoral approach to the IMs.

Finally, I note that whilst we have decided against re-opening the Cost of Capital IM, this does not prevent us from reconsidering the position if conditions change or substantive new information comes to light subsequent to setting the first price-quality path.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Tristan Gilbertson', followed by a period.

Tristan Gilbertson

Telecommunications Commissioner