Devon
FUNDS MANAGEMENT

**UBA DRAFT DETERMINATION SUBMISSION**

**31 January 2013**

## SUBMISSION FROM DEVON FUNDS MANAGEMENT ON THE DRAFT DETERMINATION FROM 3 DECEMBER 2012 TITLED: "UNBUNDLED BITSTREAM ACCESS SERVICE PRICE REVIEW"

*Devon Funds Management is an institutional investor with circa $1 billion of funds under management on behalf of a range of New Zealand clients including the NZ Super Fund, Kiwisaver schemes, charitable trusts and retail investors. Devon has significant investments in infrastructure companies and has spent considerable time analysing the regulatory environment in New Zealand, Australia and further abroad. On behalf of clients, Devon holds significant stakes in Chorus, Telecom and Telstra.*

### REGULATORY REGIME

We contend that a stable and predictable regulatory regime lowers the cost of capital for infrastructure projects and is ultimately beneficial for consumers. Capital costs are a major factor determining the economic viability of infrastructure and the prices paid by consumers for the services provided. Low capital costs are in the best long run interests of consumers and this is driven by confidence in the regulatory regime. The draft UBA decision was a significant surprise to infrastructure investors. As evidence of this, $270m was wiped off the market value of Chorus as the stock fell 21% in the weeks following the decision. This was a very large move for an infrastructure stock. Shock decisions such as this raise the perceived regulatory risk of New Zealand as an investment destination and ultimately increase the price consumers pay for services.

### UBA DRAFT PRICING DETERMINATION

The transition from a retail minus to a cost based pricing regime for UBA was well understood by investors. It was widely anticipated that this would lead to a lower UBA price, however the quantum of the proposed cut was not expected. The unique network architecture in New Zealand and the degree to which the Commerce Commission might adjust international TSLRIC prices for cabnetisation, backhaul, urban/rural mix, unbundling penetration, and other factors affecting the network owner's ability to recover costs were uncertain. During the consultation process Vodafone and Telecom suggested prices for UBA in the range of $7.65-16.55 and $17.00-20.00 respectively. Such variability in the price estimates highlight the uncertainty and the impact the Commission's interpretation could have on the process. We believe the draft determination is not representative of forward looking costs in New Zealand and lacks regard for the public private partnerships established to build the UFB network. In our view increased weight needs to be placed on the following factors:

1. **UFB prices provide a recent test of forward looking broadband costs**. The government ran a competitive process in awarding contracts for the UFB rollout. The initial UFB wholesale prices of $37.50-42.50 are representative of the forward looking average costs for a national broadband network. Adding back the substantial subsidy provided via interest free financing would raise this range further. Fibre is the shape an efficient forward looking broadband network currently takes. With a substantial portion of the UFB build costs related to civil works the forward looking costs for a copper network are unlikely to be substantially different. Given the initial pricing principle (IPP) is intended as a proxy for forward looking costs, and the subsidies inherent in the UFB prices, the IPP was expected to arrive at a price above UFB parity.

2. **Unbundling costs are high for the average copper line**. An alternative approach to assessing the cost base of UBA is to look at unbundling economics. It is clear the cost of unbundling in concentrated urban areas is low, with costs for DSLAM depreciation, co-location and other operating expenses consistent with the draft determination. However adjusting this for backhaul over cabnetised lines (which has previously been the subject of a Commerce Commission determination) and higher costs in regional/rural areas moves the average price of unbundling back above UFB parity. The low cost of unbundling implied by the draft determination is not consistent with the relatively low level of access lines (<10%) that have been unbundled in New Zealand. Given the IPP is intended to be representative of cost recovery of the whole network, again investors had an expectation this analysis would lead the Commission to an average price above UFB parity.

3. **Public private partnerships and Section 18.2A.** Under Section 18.2A the Commission is required to give consideration to the risks faced by investors in new telecommunication services that involve significant capital investment. The greater than $2 billion that Chorus and Local Fibre Companies (LFCs) are investing to build the UFB network is orders of magnitude larger than other current investments impacted by this determination. The clause was inserted at the time of the UFB deals and it is hard to imagine it wasn't intended to apply to them. From analysing the economics of Chorus and the LFCs' business models, which are enshrined in the UFB deals with the government, it is clear the implied UBA price that make them viable is above UFB parity. For a regulatory decision to undermine the viability of a public private partnership so soon after the deals were signed indicates inconsistent policy and regulatory frameworks, or at least a divergence from the intended interpretation of the regulatory legislation.

## CONCLUSION

We believe the proposed UBA price in the draft determination is too low. The proposed price doesn't reconcile with market evidence of the forward looking costs of providing a nationwide broadband service in New Zealand. The UFB deal and unbundling economics both suggest the cost base for the UBA service (including the UCLL component) is above $37.50-42.50 per month. This would also be consistent with government UFB policy, Section 18.2A, and the public private partnerships with the UFB builders.

TSLRIC is the backstop to this process and will address the issue of forward looking costs directly. The time, cost and uncertainty that a TSLIRC review will introduce should be avoided if possible. The Commission has significant discretion on how it applies the initial pricing principle and this should be used to make it more representative of forward looking costs in New Zealand.

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