

Dr Stephen Gale  
Telecommunications Commissioner  
New Zealand Commerce Commission

By email: @comcom.govt.nz

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**Submission on Fibre Input Methodologies: Draft Decision Paper**

Dear Dr Gale,

Please see below our response to the Draft Decisions Paper (“DDP”) of the Fibre Input Methodologies consultation currently being undertaken by the New Zealand Commerce Commission (“NZCC”).

This is our second submission to the Fibre Input Methodologies consultation, following our earlier response to the Emerging Views Paper (“EVP”) in mid-2019. Our earlier response focused on the cost of capital discussion in the EVP, and we are pleased to see that the draft decisions reached by the DDP in this area contain significant improvement on the views expressed on the EVP. In particular, we note that the NZCC’s position with respect to the asset beta estimate, the risk of asset stranding and the treatment of Crown Financing have all evolved in a more favourable direction in line with your three stated economic principles, in particular Real Capital Financial Maintenance (“FCM”).

That said, we still have material concerns regarding some of the draft decisions reached in the DDP relating to the cost of capital. A number of our concerns are the same as those expressed in our earlier response to the EVP, while others are new. In particular we would highlight:

- The calculation of the asset beta
- The WACC applied for the 2011-21 period in calculating the financial loss asset at the end of 2021
- Leverage and long-term credit rating assumptions in calculating the cost of debt

**Asset beta**

With respect to the calculation of the asset beta, the main thrust of our EVP submission on this topic was that the demand systemic risk profile of Chorus and the LFCs was more similar to the integrated service provider peer group and less similar to the wholesale service provider peer group than the EVP allowed for. Unfortunately, based on how the asset beta is derived in the DDP, it seems that the concerns we expressed were only partially addressed.

We do not propose to restate our perspective on the demand systemic risk profile issue as we have little further comment to add on this. Instead, in this submission our focus is on how market participants perceive the asset beta of Chorus and the LFCs and similar assets, as per the “asset beta reasonableness check” in the DDP (figure 3.8). Looking at figure 3.8, I would put particular emphasis on the survey of market analyst reports from 2019 (clause 3.390) where the entire range of estimates is above the 0.49 figure the DDP has landed on. Given that this survey had seven different data points which we would regard as reasonably comprehensive, it seems clear that the DDP’s 0.49 figure is quite clearly below what the market thinks the asset beta should be

(including ourselves of course). We would also add that we have a more comprehensive and up to date survey of market analyst reports than was available to the NZCC at the time of producing the DDP, and the resulting average asset beta of our own survey is 0.57.

Meanwhile, one very relevant datapoint figure 3.8 is missing is OFCOM's Wholesale Fixed Telecoms Market Review 2021-26 ("WFTMR"), which was only published on 8 January 2020 subsequent to the date the DDP came out. The WFTMR landed on an asset beta of 0.57 for Openreach, which we see as a reasonable figure and halfway within the 0.51-0.63 range we referenced in our EVP submission. It is also identical to the average of our survey described above.

#### **WACC used in derivation of financial loss asset**

The financial loss asset will be calculated using the conventional regulatory WACC for each year of the pre-implementation period. We have four major areas of concern with respect to how the DDP has proposed to do this:

- Risk free rate used: the DDP proposes to use a risk-free rate that varies each year, with the term of the risk-free rate based on the number of years remaining until the implementation date. However, using this approach does not reflect the actual cost of capital faced and incurred by Chorus and the LFCs when the investments were made during the pre-implementation period. The risk free rate has fallen significantly over time during the pre-implementation period, but Chorus and the LFCs did not experience anywhere close to the full effect of this because in order to secure certainty of funding and reducing volatility of cashflows they would have locked into long term fixed rate funding. This needs to be captured in the calculation of the risk-free rate used
- TARMP used pre-2020: the DDP proposes for the TARMP to be 7.0% before 2020 and 7.5% thereafter, with the adjustment to 7.5% reflecting the discovery and correction of a calculation error. The DDP justifies its intention to keep the erroneously calculated 7.0% figure for the pre-2020 period because that was the NZCC's estimate during that time. This logic seems misguided to us – taking a step back, what the TARMP is being used for is to estimate an appropriate return to compensate investors for taking equity market risk. The fact that the historic TARMP calculation had an error and came out with a lower figure than it should have in no way changes the actual equity market risk taken in the past. Investors should be compensated appropriately for the equity market risk they took, and that means using the correct TARMP pre-2020 i.e. 7.5%
- Asset beta used: the DDP proposes to use the same asset beta in both the pre- and post-implementation periods. This is a methodology which we feel does not reflect the reality of the higher risks faced by Chorus and the LFCs during the pre-implementation period, a point in time when the regulatory environment was most uncertain, and also when the investment is further from the point of being completed and revenue able to be generated. As such, we believe the asset beta used to calculate the WACC in the pre-implementation period should be higher than that in the post-implementation period. This approach would be consistent with, for instance, how OFCOM have addressed the issue in the WFTMR, which had an asset beta separate from Openreach for what it called "Other UK Telecoms". This separate asset beta was 0.65 i.e. higher than the 0.57 for Openreach. In comparing the various assets within each area, the Openreach assets are somewhat analogous to Chorus' and LFCs' assets during the post-implementation period, and the "Other UK Telecoms" assets to the pre-implementation period
- Asset stranding risk: while we are pleased to see that the DDP is proposing to make an adjustment to allowable return to reflect asset stranding risk, we are surprised that this would only be the case for the post-implementation period. We outlined in our submission to the EVP that we saw the higher asset stranding risk that Chorus and the LFCs face as compared to the asset beta benchmark peer group as coming from differences in underlying business structure and also technology, and are not regulatory in

nature. As such, asset stranding risk will not suddenly materialise in the post-implementation period; instead they already exist and have existed for a long time, certainly before 2011. For instance, substitution risks were explicitly noted in the documentation relating to the demerger of Chorus from Telecom New Zealand, while the potential for fixed line customers to choose to “cut the cord” for both voice and data and go mobile only was clear long before then. Hence, we believe an adjustment to account for asset stranding risk should also be made in the pre-implementation period as part of the financial loss asset calculation

### **Leverage and long-term credit rating assumptions in calculating the cost of debt**

We see a number of issues in the assumptions used with respect to leverage and credit ratings in calculating the cost of debt. These have the effect of reducing the cost of debt assumed to be paid by Chorus and the LFCs below what was or will be actually the case.

First, in our EVP submission we highlighted some inconsistencies in approach in how CEPA conducted its benchmarking exercise in calculating the debt premium and leverage ratio used in the WACC building blocks. Although the DDP has stated that they do not believe what we highlighted to be inconsistent, we remain of the view that our point is valid, in such a way that penalises Chorus and the LFCs.

Second, we would highlight a new inconsistency between the DDP’s proposal to use a BBB+ credit rating in its benchmarking for the debt premium for the purpose of the WACC building blocks, but to use a BBB credit rating for its benchmarking to estimate a cost for Crown debt financing. The DDP explains that there is a requirement to reflect the actual financing costs incurred by regulated providers when accounting for the benefits of Crown Financing. While this may be the case, it does not change the fact that the inconsistency exists, and that Chorus in particular will be penalised as a result. Furthermore, the DDP appears to be selective in its view of when actual incurred financing costs need to be used – we pointed out above for instance that the DDP does not apply this logic when it comes to calculating the WACC used to derive the financial loss asset.

### **Conclusion**

Ultimately, whilst the DDP represents a significant improvement on the EVP, we feel that the NZCC’s current position as reflected by the DDP remains neither sufficiently fair to Chorus and the LFCs with respect to the investment they has already made in fibre fixed line access services (“FFLAS”), nor realistic in terms of assessing the return that investors in Chorus and the LFCs would look for if they are to provide them with capital to invest in FFLAS in the future.

With respect to the latter point, we speak with first-hand knowledge both from the perspective of being a long term (since 2014) shareholder of Chorus, and also as an investor with significant experience of investing across a range of industries (including telecom and regulated infrastructure companies) and geographies (including New Zealand). Our experience of investing in Chorus but also of other industries and geographies both similar and quite different from Chorus and New Zealand gives us the breadth of experience to recognise situations where we feel investors are being offered insufficient reward for the risk they are taking, and we believe that is the case here were the DDP was translated into policy outcomes. For example, the midpoint post tax WACC estimate for regulated FFLAS of 4.88% in the first regulatory period does not seem sufficient in terms of risk/reward. In contrast, our previous submission referenced the example of Netlink NBN Trust in Singapore which is regulated under a regime with an allowable return reflected in a pre-tax WACC of 7%. We

also now note that OFCOM's WFTMR concluded a midpoint pre-tax WACC of 7.1% for Openreach and 7.9% for "Other UK Telecoms".

In conclusion, we would re-iterate two points we made in our submission to the EVP:

- We still feel that the cost of capital methodologies resulting from the DDP will result in allowable returns that clearly fall below the level which would achieve FCM
- We would urge the NZCC to treat the investments made by Chorus and the LFCs in the pre-implementation period fairly, because not to do so will be particularly damaging to New Zealand's reputation as a well-regulated investment destination. Some elements of the DDP do raise questions as to whether there is an intent in trying to retrospectively undercompensate historic investment – the issues we raised with respect to calculating the financial loss asset for example

We remain available to discuss further this response with you at a time of your convenience. The undersigned, Peter Kennan, may be contacted by email at [peter.kennan@black-crane.com](mailto:peter.kennan@black-crane.com), or you may contact Arthur Chow by email at [arthur.chow@black-crane.com](mailto:arthur.chow@black-crane.com).

Yours sincerely,



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