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The Commerce Commission has asked for cross submissions on the New Regulatory Framework for fibre from interested parties. As an independent fund manager with investments in New Zealand media, telecommunications and retail companies and as a substantial shareholder in Chorus since 2014, L1 Capital has followed the new telecommunications legislation closely and is thankful for the opportunity to present our views.

We believe the UFB NZ fibre network build has been a fantastic success for the people of NZ Zealand. By the time the communal build is complete in 2023, the UFB project will have connected more homes at far faster speeds than the equivalent Australian NBN network. This will be achieved at a cost that is 20-25% cheaper per premise to install, with internet prices 19% lower than the equivalent service in Australia. It is also significantly cheaper than other OECD countries. New Zealand's approach is being keenly followed by governments and regulators throughout the world, with this legislation being one of first real tests of structural separation.

The support of shareholders and debt markets has been essential for Chorus in building the UFB network given that returns have been negative during the 10-year construction period (we set this out in further detail below), with cashflows back-ended to 2023 and beyond when largest component of capital expenditure ends. This is significantly longer than the construction period for other infrastructure assets including electricity and gas networks, for example.

The back-ended nature of returns makes it particularly crucial for investors that, at the completion of the network, the regulatory regime is not distorted through further constraints on Chorus that make it impossible to achieve regulated returns.

Although it is early in the process and many of the details have yet to be debated, we are troubled by several of the submissions that in our opinion either (1)set out to collectively undermine the intent of the legislation for a fair and predictable regulatory regime and (2)jeopardise the ability of Chorus to earn the regulated revenue base.

In the sections below, we set out our views on some of the submissions.

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**1. Despite Vodafone's claims, Chorus's UFB investment has seen a period of heavy investment and negative returns, with the ultimate profitability of the fibre project contingent on the regulatory regime rewarding long dated investment appropriately.**

Vodafone has claimed that Chorus does not need to recover costs in the fibre business given its "excessive profit, resulting in an average return on equity of 24.4% means its fibre costs" "could easily be recovered from existing sources of revenue". It has also claimed that the recent "surge in uptake would have substantially improved the expected returns". We would make the following points:

A. **Chorus's returns are enhanced through commercial services and not comparable to fully regulated utilities**: Chorus has a mix of regulated (copper TSLRIC regime), contracted (subsidised fibre prices agreed with Crown Fibre Holdings) and unregulated (fibre backhaul, business fibre lines, services) revenues. Therefore, comparing Chorus's return to a regulated ROE is not a meaningful comparison, as Vodafone would be keenly aware.

B. **Our previous analysis of Chorus profitability in the 2013-2018 period clearly shows Chorus is not earning a return on its investment today:** Despite investing $3,245m in fibre capital expenditures since 2013, profit before tax for Chorus has declined by $114m during this period. This is driven by large increases in expenses related to the roll out of the fibre network. This is unusual for any company investing large sums of money and particularly for infrastructure companies, which typically grow profits in line with invested capital, and highlights that at the net income line Chorus is earning a negative return on its fibre investment currently.

| Chorus<br>Summary Profits and Cashflow<br>2013-2018 | 2013<br>12 Months<br>Actual | 2014<br>12 Months<br>Actual | 2015<br>12 Months<br>Actual | 2016<br>12 Months<br>Actual | 2017<br>12 Months<br>Actual | 2018<br>12 Months<br>Actual | Annual growth rate<br>2013-2018 |
|---|---|---|---|---|---|---|---|
| | | | | | | | |
| Revenue | 1,057 | 1,058 | 1,006 | 1,008 | 1,040 | 990 | -1.3% |
| Expenses | 394 | 409 | 404 | 414 | 388 | 337 | -3.1% |
| Profit before Tax(PBT) | 236 | 206 | 127 | 127 | 159 | 122 | -12.4% |
| NPAT | 171 | 148 | 91 | 91 | 113 | 85 | -13.0% |
| Fibre Growth Capex | 579 | 566 | 504 | 486 | 503 | 607 | |
| Other Capex | 102 | 113 | 93 | 107 | 131 | 143 | |
| Total Capex | 681 | 679 | 597 | 593 | 634 | 750 | |
| | | | | | | | |
| Cash Dividends Paid | 83 | 42 | 0 | 15 | 45 | 57 | |
| | | | | | | | |
| Total Fibre Investment (2012-2018) | 3245 | | | | | | |
| Total change in PBT (2013-2018) | -114 | | | | | | |

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**2. Chorus is exposed to some unique technology and regulatory risks not borne by other regulated utilities. L1 believes this may make it very difficult for efficient costs to be recovered through the revenue cap in an ex post sense and strongly argues for a WACC uplift or thorough conservatism in estimating other parameters such as end demand.**

Although not every technology risk Chorus investors face should be compensated for ex ante, there are a significant number of risks, which are a construct of the UFB process and government policy. These process and policy factors impact Chorus's ability to manage risk and thus must be compensated for either through WACC or other building blocks. We highlight some examples below.

**Nationally geographic pricing exposes Chorus to under-recovery:** Nationally geographic pricing means that Chorus will be structurally disadvantaged as it competes with wireless competition in high density urban area who do not have universal service obligations or a requirement to offer the same price nationally and can cherry pick areas. On the other hand, Chorus cannot charge higher costs in less dense areas where its fibre costs were higher. This means that Chorus may need to lower fibre prices in high density areas **and** undercharge for fibre in other areas. There is a high likelihood that this requirement will lead Chorus to under-recover under a revenue cap and is a risk Chorus cannot mitigate against.

Spark acknowledges this as a restraint in its own submission - "115. The Act contains a scheme for determining prices for anchor products, and section 201 requires Chorus to set geographically consistent prices. The non-discrimination provisions in the Fibre Deeds will also continue to apply."

**The risk of under-recovery is significantly higher if wireless competition is prioritised over other requirements of the Act and Chorus is forced to subsidise fibre inputs into wireless services at below fair value. This risk cannot be mitigated by Chorus and is a function of the legislation, which must be compensated through WACC uplift.**

AXIOM, as a submitter for Spark highlights that exact scenario below and how it will lead to under recovery of costs for Chorus. We reproduce their submission below.

"However, even applying a revenue cap with a wash-up cannot necessarily guarantee that enough demand will ultimately materialise to enable Chorus to cover all the costs it incurs providing FFLAS. For example, if the FFLAS IMs are designed to prevent Chorus from foreclosing potential competition and effective rivalry ultimately emerges in some circumstances over the longer-term (e.g., in certain geographic locations), it is theoretically possible that it may never fully recoup its past costs. 27 The 'mature' networks (i.e., with established assets and more predictable demand) regulated under Part 4 did not face these challenges to the same extent (although the 'stranding risks' were non-zero)"

**Government policy for the upcoming 5G spectrum auction may focus on subsidising 5G entry and jeopardise returns on fibre investment. Again this is a risk not borne by other regulated utilities and cannot be mitigated against.**

Pat Duignan in his submission noted this exact issue and how it was dealt with in the case of other regulated utilities, which we reproduce below.

"The way competition between 5G FWAS and FFLAS plays out will be significantly influenced by the form and results of the Government's tendering of spectrum. The tendering process will affect the potential for and intensity of competition between competing FWAS providers which in turn will condition their competition with FFLAS.

"Under a BBM regulatory approach an increase in the probability of economic stranding of some of the assets of a regulated supplier requires the Commission to consider allowing that supplier to accelerate the depreciation of their assets. The Commission has agreed to do exactly this in the case of electricity distribution businesses. The input methodologies for EDBs have been amended to allow the Commission on application to agree to shorten the remaining lives of EDB assets by up to 15%, with a consequent increase in the depreciation charge for such assets of 17.7%."

**As the Commission has noted, if suppliers are not compensated for risks outside their control, this may have a detrimental impact on investment incentives in New Zealand.**

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**3. Equal regulatory treatment should apply to all investment in the UFB regardless of whether ownership is public or private. Furthermore, regulated fibre businesses must be assessed on a standalone basis in line with the intent of the Act. Any other treatment would undermine the whole integrity of the regulatory process, raises sovereign risks and greatly deters further investment in regulated assets.**

There have been several troubling submissions from Vodafone and Spark which basically appear to make two claims (a) Past losses from the fibre network should not be factored in, even if they were incurred, since Chorus can do little about it now that investment has been made and (b) Chorus had other revenue while building the fibre network and therefore does not need to be compensated for start-up losses. We reproduce some of these quotes below.

**Spark** - "Boosting the RAB through the identification of past losses which are, by their nature and in this instance sunk, has little or no impact on beneficial end user outcomes".

**Vodafone** - "Awarding any losses would be a huge mistake, potentially burdening end-users with significant unwarranted costs for years to come. We know that Chorus has earned an excessive profit ever since the UFB build began. Common costs should not be allocated to fibre if it causes losses to occur".

As an international fund manager, we have seen examples of infrastructure projects that have been left stranded without adequate returns after the build period has concluded. In almost all those instances, what has followed has been a long-term strike of private capital which has raised the cost of future infrastructure projects for years to come. We believe the UFB project represents one of the largest PPP projects attempted in NZ with a large group of international debt and equity investors. L1 believes a strong signal that private investment in long term projects will be respected will greatly lower the cost of future PPP projects and the cost of sovereign debt to the betterment of NZ.

The other crucial signal we believe international investors are looking for is a clear statement from the Commission that there will be equal regulatory treatment of public and private investment in the fibre network. That should mean that a fibre investment from a new fibre entrant such as Enable, with no other revenues, is treated identically in calculating start-up losses to Ultra-Fast Fibre, which has the benefit of other non-fibre revenues, or Chorus which has existing investment in copper networks and non-regulated fibre services. Anything else would again greatly increase sovereign risk.

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**4. Workable competition should not mean entrenching the position of the largest Retail Service Providers (RSP's) by forcing Chorus to subsidise their input costs.**

In the name of promoting workable competition both Vodafone and Spark have argued that Chorus should be forced to price certain wholesale fibre services at below economic cost.

**Vodafone Submissions**

Vodafone, for example, is focused on ensuring layer 1 fibre is sold to Vodafone below economic cost– as can be seen from below comments.

- **Vodafone arguing that it should not bear the cost of unbundling** - "40. Directly charging access seekers for the costs associated with unbundling is inconsistent with the EOI principle. It would reduce the margin between layers 1 and 2, and make competition near impossible."
- **Vodafone arguing that economic cost should not be used to calculate prices** - "36. The key exception is the Netherlands, where they have costed an unbundled fibre product based on estimated costs of the Layer 1 network. This has resulted in a very high unbundled price, resulting in less than 6% of fibre connections being unbundled by the end of 2017. This approach has not promoted the emergence of competition."
- **Vodafone arguing that its Layer 1 service should be subsidised by everyone else including Chorus and other fibre users –** "41.This was the conclusion reached by Ofcom...they concluded that the costs of unbundling couldn't be charged to one access seeker. These costs must be included in the duct and pole price and charged across all access seekers evenly, including the fibre provider itself."

**Spark Submissions**

Spark's submissions, by contrast, are focused more on forcing Chorus to uneconomically price DFAS and other fibre services. Many of these services are fibre backhaul links to Spark's mobile towers and lower prices will primarily benefit Spark. It should also be noted that many of these fibre links were built under standard commercial arrangements with Chorus post structural separation – arrangements which Spark is now seeking to overturn.

Subsiding these services will mean burdening fibre access users with the cost of upgrading some of Spark's mobile network – many of these same fibre links will entrench Spark's leadership in the mobile market at the cost of mobile competitors.

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- **Spark encouraging the Commerce Commission to price inputs below cost** "Commission to also consider how its control of the regulated service will impact on competition for the benefit of end users of other (non-FFLS) services. b. It follows that limiting prices to recover the efficient costs of providing FFLS may not be sufficient to comply with section 166(2). The Commission must also consider whether further steps are required to promote competition in other markets... this could include promoting or preventing distortion of existing and likely future competition: i. at the wholesale level (eg fixed wireless, 5G); and ii. at the retail level (eg services provided to end-users that use relevant wholesale services as inputs)".

**L1's View**

The current fixed line market in NZ is characterized by a high degree of market concentration with Spark, Vodafone and Slingshot/Orcon controlling 90% of the market. Market concentration in the mobile market is even higher with Spark and Vodafone accounting for an estimated 91% of industry profits with MVNO operators not a prominent feature of the market. The fixed line market has recently seen price rises from both Spark (Oct 2018) and Vodafone (Feb 2019).

L1 believes that both Spark and Vodafone's intent is to increase the profitability of their existing networks and entrench their competitive advantages. Vodafone is attempting to secure uneconomic Layer 1 input prices in the expectation it will be one of a handful of fixed players that have the capital to deploy into network equipment and gain an advantage over smaller RSP players. In the case of Spark, the intent is to introduce subsidised prices for fibre inputs for their mobile network, further entrenching their dominant position in the mobile phone market.

**In both cases the costs of this transfer of value to Spark and Vodafone shareholders will be borne by other fibre users, as Chorus has to charge higher prices on remaining products to earn its regulated rate of return. We strongly believe the Commission should not take any decisions that would reduce the ability of consumers to easily switch RSPs or disadvantage RSPs who do not own mobile networks.**

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**Conclusion**

The Telecommunications (New Regulatory Framework) Act is a significant step towards establishing a stable and predictable regulatory framework for investors, promoting the interests of end users and incentivising further investment.

Given the significant costs of the network there are significant incentives for Retail Service Providers (RSP's) to advocate for unorthodox interpretation of the Act to minimise their own input costs or entrench their competitive position. We believe this would result in either higher costs for other users of the fibre network or the impairment of fibre assets if efficient costs cannot be recovered leading to (a) an inability to invest in fibre services and (b) higher costs of capital for future PPP projects and other NZ regulated utilities.

We thank the Commission for the opportunity to make this submission and look forward to engaging further in the process.

Regards,

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