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Tricia Jennings
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Dear Ms Jennings

Submission to UCLL and UBA FPP further draft determination

We appreciate the opportunity to make a submission to the consultation process on the Commerce Commission's final pricing principle further draft determination. 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. The currently proposed prices fail to meet that standard as it has changed little since the last iteration.

While the further determination attempted to address some of our points, we believe there are bigger-picture issues that have not been tackled. As outside observers of this process, we see that every assumption used in the model can be justified as being within a wide range of possibilities, while the outcome ends up having little basis in (hypothetical) reality. The most telling example is what we see as the implied pre-tax return on and of capital based on **actual** costs, which we have outlined in our previous submissions as being 6.8% at best. Even if we assume the assets all have 50-year lives, the return on capital is at best 4.8%. If we then use the Commission's leverage assumptions (37%) and the cost of debt assumption (5.34%), the implied pre-tax return for equity holders is **at best** 4.5%. This is below the level required by any reasonable investor, which is probably why we have not seen any retail service providers in New Zealand plan their own rollouts based on similar pricing. We hope that this issue is addressed in future determinations, in a manner that is consistent with Section 18.2(A) of the Telecommunications Act 2001.

The Commission further argues in its Cost of Capital decision that the asset value of $6.6b compares favourably to a market-determined enterprise value of Chorus of $3.3b (paragraph 313.2, page 78). We have grave concerns about making such a comparison. In fact, if anything, this demonstrates exactly the point we have made above. Because these assets are not fungible, investors seek to value the cash flows. Investors have decided that the current price settings do not deliver a return that is sufficient to justify a $6.6b asset valuation. Just because a factory might cost a company $1m to build, if the cash flows from the factory are zero or otherwise sub-economic, a rational market would not ascribe a $1m valuation to the factory.

We also urge that the following inconsistencies are resolved:

- *Backdating*. The current proposal is glaringly inconsistent with previous Commission submissions. In 2006, the Commission argued convincingly for the ability to backdate and noted that all providers knew they operated in a regulated environment where backdating was a distinct possibility. We see no reason to diverge from this view, especially when retail service providers reportedly approached Chorus for a commercial agreement that was much higher than the initial pricing level (and so can hardly claim the more recent pricing determination was unexpected)[1]. In fact, we further believe backdating should correct the wrong prices set by benchmarking. The current proposal on backdating will inevitably produce the wrong incentives. It will always be to one party's advantage to delay the process as long as possible knowing that the final decision will not be backdated and the windfall profits along the way can be pocketed. Such a decision could make future regulatory processes unworkable and inefficient.

- *Capital costs.* Large parts of the actual network seem to have been excluded, much more of the network is now assumed to be aerial, and underground trenching costs for lead-ins have also been excluded (even though the costs are not fully reimbursable in the real world). In fact, the Commission's model suggests a total cost of $3.2b in urban MDFs, covering a total of 1.35m lines or approximately $2,380/line. Chorus' current rollout of fibre, which involves extensive reuse of existing assets including ducts, has a total cost of $3.1b across 1.1m lines, equating to $2,740/line. While the Commission asserts it has been generous in its capital cost assumptions, a comparison with actual expenses being incurred suggests otherwise.
- *Operating costs*. We note that the efficiencies the Commission had previously assumed have been moderated, but we still see issues in the assumed operating costs. The Commissioner has noted that New Zealand is different and yet the process still uses benchmarks based on a very small number of overseas countries to model operating costs. Grounding these assumptions in a New Zealand context is something most investors would expect.
- *WACC*. By setting a WACC even lower than the last draft, we worry that the Commission penalises equity investors who would fund any 50-year asset. To invest in such long-life assets, equity investors need more consistency in the WACC-setting process. The resulting low WACC also ignores the very real stranded asset risk and the regulatory risk that this delayed process and draft determinations around backdating have only further highlighted.
- *Pricing*. We note that the implied urban cost estimate of $18.72 for UCLL (paragraph 1838 of the UCLL further draft determination) is below the costs obtained by benchmarking. This seems very inconsistent with remarks about costs in New Zealand being higher. The resulting UCLL+UBA price of $29.56 is also well below the entry-level UFB price, which some LFCs have declared as inadequate for their return on investment[2]. This is concerning given the Commission is modelling a modern FTTP network.

This process has simply taken far too long. It has undermined investor confidence as delays only serve to prolong a period of uncertainty, for which the investor, based on the Commission's latest draft view, will not be compensated either through a WACC uplift or backdating.

We reiterate that we understand the difficulties the Commerce Commission faces in trying to determine prices. We also reiterate, however, that current settings make investors question whether the hypothetical efficient operator could ever exist in practice. That operator would not be able to build the network as cheaply as is suggested by the Commission and it would never be funded. This should be of particular concern to the New Zealand Government, which seeks further investment in rural broadband and UFB. Without adequate returns to investors, those investments may become more difficult, which would be to the long-term detriment of New Zealand citizens.

[1] Described in http://www.stuff.co.nz/business/68686473/spark-staff-outnumber-its-protesters

[2] *Submission from Enable Networks Limited to the Ministry of Business, Innovation & Employment – Review of the Telecommunications Act 2001 Discussion Document*, Enable Networks, September 2013

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We therefore still hope that the Commerce Commission considers the true price level required to justify investment in important, nation-building infrastructure. We also hope that the Commission can bring this process to a conclusion quickly.

Yours sincerely

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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.

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