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Dr Stephen Gale
Telecommunications Commissioner
Commerce Commission
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Dear Dr Gale,

Investors Mutual Limited (IML) is an Australian based fund manager with over AUD 9 billion that it manages on behalf of a wide range of investors including many retail investors. IML takes a long-term approach to investing and we look to invest in companies which generate a high level of recurring income, have competent management, and that can grow their earnings and dividends over time. Since our inception in 1998, we have been a long-term shareholder in many New Zealand listed companies, including Sky City, Fletcher Building and Chorus. We are attracted to New Zealand because of its relatively stable economy and its generally predictable and transparent regulatory system.

Although the draft decision on Fibre Input Methodologies represents an improvement on the prior emerging views paper, the result still treats investors unfairly in several key areas. We ask that you consider our perspective on the key issues below because unfair treatment of investors will harm New Zealand's reputation as an investment destination.

**A fair rate of return during the build period**

The WACC for the entire construction period must be calculated on the market's forward view of interest rates at the time Chorus made the original commitment. In 2011, Chorus signed a 10 year commitment to build its share of the UFB network. The agreement included 10 years of fixed pricing, based on CFH's WACC estimates (CFH Response to Select Committee Questions, 2011), and Chorus quite sensibly aligned its debt financing to this 10 year period. Subsequent capital expenditures were contractually committed and cannot be viewed as separate investment decisions. Retrospectively calculating a year-by-year WACC during the UFB construction period is unfair on Chorus, because in practice the company had no chance to reduce its financing costs commensurately or to alter its investment decisions during this period. In fact, Chorus' cost of finance increased during the build period because of regulatory uncertainty relating to copper pricing. This situation is distinct from mature regulatory environments where regulated returns are established in advance, typically for 4 or 5 year periods, and the regulated business has the opportunity to hedge its finance costs and determine a capex program in light of this knowledge.

In addition, Ofcom (Wholesale Fixed Telecoms Market Review, January 2020) highlights that it is appropriate to use a higher asset beta for fibre networks under construction than mature copper networks. This is because:-

1. Fibre networks have higher operating leverage due to the operating and capital costs being higher relative to the immature revenue streams,
2. Fibre networks will face higher competition from copper and wireless networks than copper historically faced, and
3. High end fibre services, such as 1Gbps speeds, are viewed by consumers as luxury items which means fibre revenues will be more sensitive to economic conditions than historical copper network, or electricity utility, revenues.

**Asset Beta and WACC**

The proposed WACC of 4.88% is too low to incentivise investment in Fibre networks. Fibre networks face substantial technology risk, and competition from wireless services, meaning investors would be better off to invest in the much lower risk electricity utilities at 4.23%. In a January 2020 research note, UBS states that their valuation WACC estimate for Chorus is ~6%. On these assumptions professional investors will value fibre assets at less than 1x RAB, and the company will be forced to halt all discretionary capital expenditure.

Part of the problem is that the proposed asset beta of 0.49 is too low for a fibre asset. The asset beta should be in the range of at least 0.5 to 0.65. This is consistent with the view expressed by Crown Fibre Holdings prior to the start of UFB construction (0.5 to 0.65) and OfCom in January 2020 (0.65 for fibre). In a March 2019 research note, Forsyth Barr stated that they believed 0.55 was "toward the lower end of a reasonable expected range". Note that this statement related to fibre specific earnings, whereas other analysts WACC estimates that you have referenced are for the entire Chorus business.

The other major issue is that the WACC should be set at the 67th percentile of the commission's cost of capital estimates for 2 important reasons:

1. Incentivising fibre network owners to invest in maintenance and capacity upgrades over time will maximise the benefits, and prevent outages, of this nationally significant infrastructure; and
2. Consistency and predictability of the regulatory process is important to attract future infrastructure investment. In this regard, investors in the fibre networks reasonably expect to be treated in a like manner to other regulated assets in New Zealand.

**Service Definition**

To avoid regulatory creep, and negative competition impacts, regulation should only cover fibre access services to homes and businesses. All other commercial products, from backhaul access to subdivision network design services, should be specifically excluded from Chorus' revenue cap. Regulating these non-monopoly services reduces Chorus' incentive to compete because revenue gains in commercial products will be offset by revenue cap reductions elsewhere. The requirement for Chorus to provide services at nationally averaged pricing would also hamper its ability to compete for commercial services in low cost areas. Simply put, services such as network design, are clearly not part of the intended regulatory product set.

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The UFB network is an asset of national importance, which should provide benefits to New Zealand homes and businesses for many years to come. However, without appropriate incentives to invest in maintenance and upgrades the asset will not realise its great potential over time. Furthermore, the mistreatment of sunk capital raises the issue of sovereign risk and will make future infrastructure investment more expensive in New Zealand.

Yours sincerely,

Hugh Giddy
Senior Portfolio Manager

Nigel Hale
Equities Analyst