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Dear Dr Gale

Fibre input methodologies – input on draft decision

ATLAS Infrastructure is grateful to the Commerce Commission of New Zealand for the opportunity to provide a submission regarding the draft decision released in November 2019

Background to ATLAS Infrastructure

ATLAS Infrastructure is a global fund manager dedicated to managing portfolios of listed infrastructure companies. We have offices in London and Sydney, and we are part of the Global Infrastructure Partners group which manages USD70bn+ of infrastructure investments across unlisted equity, listed equity and debt. ATLAS Infrastructure currently manages a portfolio of 18 securities across Asia Pacific, Europe and North America. Chorus is currently one of our portfolio investments.

ATLAS input on the draft decision

We have reviewed the draft decision and have three areas of material concerns:

1. Asymmetry of risk and return represented by the selection of the asset beta – The proposed asset beta does not seem consistent with the risk & return profile of Chorus when we compare it to global regulated assets where investor returns are often higher than allowed thanks to well established incentive and outperformance schemes. ATLAS believes that, since the Chorus shareholders are exposed to roll-out, demand, price and market structure risks to the downside whilst being limited by the revenue cap on the upside, there needs to be recognition of this asymmetry in the asset beta. We note that Ofcom has recognised this in allocating a higher asset beta for the proposed BT fibre access services (0.65) where the company faces similar risks during the construction and early growth phase of fibre access investment. We further note that regulated assets that face similar downside risks (large capital programs with uncertain demand and revenues) such as airports, have asset betas in the range of 0.55 to 0.6.

2. No allowance for embedded cost of debt leading to almost guaranteed poor equity returns – the draft decision WACC example includes a notional cost of debt of 2.92% derived from the current low interest rates. That compares with actual cost of debt for Chorus of 5.75%, which reflects the historic contractual and regulatory status of Chorus. We would note that even the best run company would be unable to move its cost of debt down to the levels proposed within five years let alone the period to 2022. Therefore, as shareholders we are faced with the near certainty of having to fund the shortfall in the debt cost allowance through sacrificing equity returns. We note that regulated companies that have full visibility of their forward regulatory arrangements can be expected to synchronise their embedded cost of debt alongside a known regulatory cycle. However, absent a known regulatory cycle, these arrangements carry material cost and risk and we believe it is entirely appropriate that, for the initial regulatory period, the commission incorporates the embedded cost of debt in the calculation of allowed returns.

3. **Calculation of historic losses using a retrospective regulatory approach –** We note that the indicative approach to the calculation of historic losses proposes using a year by year cost of capital. Whilst we see some argument in a changing equity risk profile as the build out progressed, we would again expect to see a treatment of the actual embedded cost of debt as opposed to a year by year notional calculation. In our view it would be unreasonable to assume that a company such as Chorus, faced with such a large capital program with fixed service pricing, would not be forced to fix a large portion of debt costs for the period. Any other option would have been considered exceptionally risky at the time. In 2011 there was no guarantee that a building block methodology was to be adopted (or that year by year cost of debt would be remunerated) and we believe that the Chorus cost of capital for 2011 to 2022 should reflect the information that Chorus and shareholders had at the time rather than the information that we have now (as of 2020).

Conclusions and recommendations

ATLAS Infrastructure is strongly supportive of the development of the New Zealand Fibre build out so far and we believe that many aspects of the New Zealand approach can and will serve as a template for many other countries around the world that are facing similar challenges. We are also firm believers in the need for a robust regulatory model for essential, natural monopoly assets, such as Chorus that reflects the long term 'social contract' between that company and the people that they serve.

The most important role of a successful regulatory framework is not that it is necessarily theoretically perfect in all regards, but that it should reinforce the alignment of interests between the company's management, shareholders and stakeholders (customers and government). Frameworks that are asymmetric in risk and reward and that penalise management and shareholders for items outside their control can have the unintended consequence of encouraging management to take short term decisions, such as curtailing investment or roll out, in order to mitigate losses incurred elsewhere. On the other hand, frameworks that do not penalise shareholders for uncontrollable events but do provide material upside or downside depending on delivery of target outcomes, help align shareholder interests with other stakeholders and will therefore support sound, long term, management decision making.