Submission from Enable Services Limited on the Commerce Commission's "Determining the cost of capital for the UCLL and UBA price reviews"

28 March 2014

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1 Introduction

1.1 Enable Services Limited (**ESL**) is pleased to submit on the Commerce Commission's (the **Commission**) "Determining the cost of capital for the UCLL and UBA price reviews" (the **Capital Cost Review**).

1.2 ESL has partnered the Crown (through Crown Fibre Holdings Limited) to build a UFB fibre network in the greater Christchurch urban areas. ESL is owned by Christchurch City Holdings Limited, the commercial arm of the Christchurch City Council.

1.3 As a long term investor in telecommunications infrastructure, ESL has a strong interest in the pricing of UCLL and UBA services, and more particularly in the principles that are being established for long term regulated pricing in the industry. Regulated pricing within the telecommunications industry must allow for an appropriate margin between wholesale and retail providers, appropriate end user pricing and must encourage ongoing investment in telecommunications infrastructure, all for the long term benefit of end users of telecommunications services in New Zealand.

2 Key Issues

2.1 Cost of Capital IMs

a) As a general principle, ESL supports the use of Cost of Capital IMs as the initial basis for the UCLL/UBA Cost of Capital.

b) ESL submits that while the methodology is appropriate, the Commission should recognise that both parameter and model error may exist. In particular, the cost of capital determined under the IMs is likely to be susceptible to inaccuracies arising from industry and technology risk factors in the telecommunications industry of New Zealand. ESL submits that technology changes in the telecommunications industry are greater than changes in the electricity, gas and airports sectors that are presently covered by the Commission's cost of capital IMs.

c) ESL strongly submits that the unique risks facing the telecommunications industry, and in particular the industry's transition to UFB fibre should be reflected in the risk components used to arrive at an appropriate cost of capital unique to UCCL and UBA pricing. More specifically, the telecommunications industry faces Type II asymmetric risks, such as the threat of competitive entry or asset stranding from technical innovations. In ESL's view, an uplift to the cost of capital is necessary to the extent any asymmetric risks are not fully recognised in any cash flow expectations under a pricing model (for example, by way of an accelerated depreciation charge). We comment further on this point later in our submission.

2.2 WACC 75th Percentile

a) The Commission has an obligation to take into account the impact its price setting outcomes have on incentives to innovate that exist for, and the risks faced by, investors in new telecommunications services that involve significant capital investment.

b) The Commission has the unenviable task of creating a properly risk adjusted cost of capital calculation that provides an appropriate return for investors which take into account the long term nature of infrastructure, enables appropriate margin contributions to both wholesale and retail players and incentivises investment, all for the long term benefit of end users of telecommunications services in New Zealand.

c) Cost of Capital calculations are complex, based largely on international benchmarks and historical foundations that do not accurately reflect the current transitionary nature of the telecommunications industry in New Zealand.

d) The impact of incorrect pricing, particularly any pricing regime that reduces investment incentives, would have undesirable long term impacts on telecommunications services end users in New Zealand and New Zealand's advantage from early investment in telecommunications improvements.

e) ESL submits that these complexities in the telecommunications industry create additional risk that means any benchmark based cost of capital, such as determined under the current cost of capital IMs, is likely to be lower than an open market investor would accept. Acknowledging these risks, ESL strongly supports the use of the 75% WACC percentile to provide appropriate investment incentives and to promote future pricing efficiency for the long term benefit of end users of telecommunications services in New Zealand.

2.3 Risk Free Rate timeframe

a) ESL notes that the Commission intends to establish a risk free rate with reference to the regulatory period.

b) ESL notes that long term risk free debt rates can be volatile, which leads to a risk that establishing such rates at a time of historical lows may under-compensate investors when compared with appropriate long term returns.

2.4 Tax-adjusted market risk premium (TAMRP)

a) ESL notes that the Commission has yet to form a view on the appropriate length of the regulatory period for the UCLL and UBA FPPs.

b) ESL submits that the term of the risk free rate in the first term of the capital asset pricing model should be consistent with the term of the risk free rate in the TAMRP. This means the estimate of the TAMRP should be consistent with the regulatory term of the risk free rate.

2.5 TCSD allowance

a) In principle, ESL supports the TCSD allowance. This recognises in practice that prudent treasury management policy is not to have all debt maturing and interest rate risk concentrated on any regulatory price review date.

b) As already noted the Commission has not yet decided on the appropriate length of the regulatory period. Infrastructure companies, however, usually seek to borrow at least a portion of their term debt with a maturity greater than a typical regulatory review period.

c) We note that the High Court concluded, on the basis of material provided to the court, that a TCSD may not be needed. In our view, the TCSD is still required to compensate the supplier for higher actual debt costs, where the supplier borrows for a term greater than the regulatory review period. This is because the debt margin over the risk free rate that corresponds to the regulatory review period may not reflect an appropriate debt margin for debt with a longer term to maturity. Thus, providing no allowance by way of the TCSD or an alternative form of compensation may understate the supplier's actual cost of debt.

2.6 Industry Transition

a) The UFB Government Policy Statement notes that Government intention was for UFB infrastructure investment to make appropriate returns taking into account the start-up nature of the UFB industry.

b) Copper telecommunications technology clearly has a major competitor in UFB fibre technology.

c) In an environment of dramatically increasing data usage, copper is likely to become uneconomic to operate and maintain in the medium term. This asymmetric risk factor should be recognised in any cost of capital estimate and/or by way of an accelerated depreciation charge (return of capital). Moreover, where demand shocks for copper are systematic, some technology risk or risk of obsolete assets may have a systematic component.

d) In addition, the industry is currently facing a very significant transition of telecommunications infrastructure that will not be accurately reflected in traditional risk and cost benchmarks founded on more stable infrastructure environments.

2.7 Investment Environment Stability and Long Term Implications

a) The investment community as a whole has been largely silent in submitting to the Commission on the regulated telecommunications price points. This general lack of engagement should not be interpreted as dis-interest. The investment community has spoken loudly through the dramatic value reduction that the Commission's determinations caused for listed telecommunications providers in New Zealand.

Appendix 1 shows Chorus' share price following recent determinations by the Commission and sets out various examples of market commentary.

b) International institutional investors have generally responded by selling out of the perceived risk/return inequality that the determined price points are creating.

c) There is a very real risk that capital availability for New Zealand regulated infrastructure will become scarce or higher returns will be required to take into account the pricing instability created by a volatile regulatory regime. ESL reiterates its concern that the Commission's draft and final decisions for the UCLL and UBA FPPs could have long term implications on the willingness of investors to commit to new long term telecommunications infrastructure in New Zealand.

2.8 Further Cost of Capital Analysis

a) Given the short time frame available for submission on the Capital Cost Review ESL has only submitted on key points of principle.

b) We note the Commission states in paragraph 7 of the Capital Cost Review that there will be a further opportunity to submit on WACC, including the specific pricing parameter values the Commission adopts in response to the draft UCLL and UBA price review determinations.

c) ESL welcomes the opportunity to submit in more detail on all aspects relating to the WACC for the UCLL and UBA FPPs and the telecommunications sector in any future submissions on the WACC consultation paper and/or in response to the Commission's draft determinations.

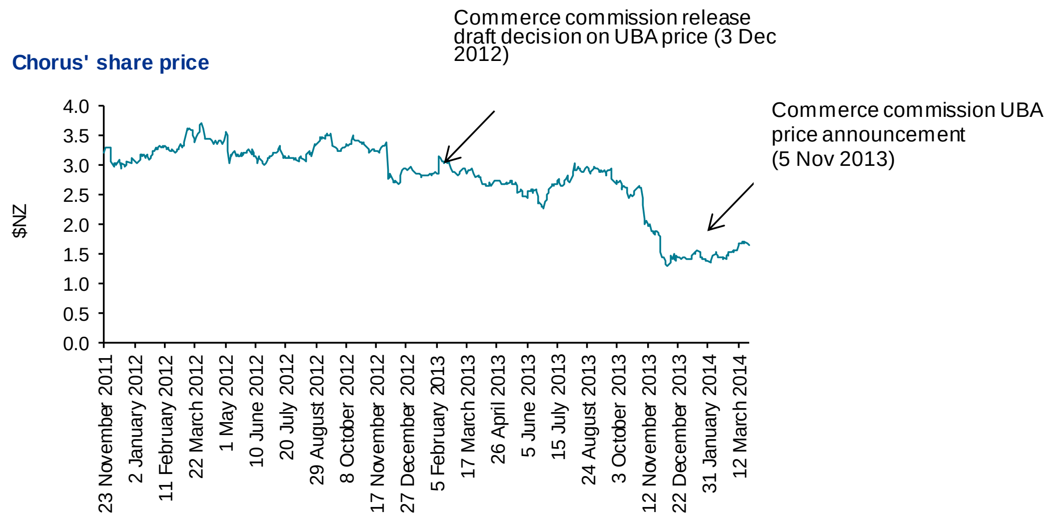
d) In this respect ESL recognises that the Commission will be seeking more specific evidence and independent views on the approach to the WACC, including the parameter inputs into WACC model, the standard errors of the parameter estimates, the appropriate WACC percentile range and other specific industry risk factors in reaching any final decision on the cost of capital for the UCLL and UBA FPPs.

e) ESL is currently looking to engage with its consultants and other UFB participants on a more detailed assessment of Cost of Capital for UCLL and UBA and the implications for New Zealand telecommunications in particular.

f) The company intends to make these available through the continuing consultation process.

Steve Fuller
Chief Executive
Enable Services Limited

Appendix 1: Chorus Share Price Performance around the Commission's regulatory announcement



Share price reaction		
	Following announcement shares fell by	Five days after announcement shares fell by
First announcement (Dec 2012)	14%	18%
Second announcement (Nov 2013)	7%	22%

Market commentary

- Paul Harrison at BT Funds Management said "Offshore investors don't like regulatory risk and particularly if you are trying to convince them to go buy some [shares] of Mighty River Power, they don't want to see regulatory risk being a feature of our market. " *NZ Herald, 20 April 2012*
- Regarding Chorus' falling share price – "The company's plunge started last week when it said earnings would be slashed if a draft determination on pricing from the regulator was enforced." *Business Desk, 10 Dec 2012*
- "Chorus said the Commission's decision today means it won't be able to borrow what it needs to invest $3 billion in building the ultra-fast broadband network – unless the Government intervenes... If the price drop did come into effect, the company said its lenders would be entitled to trigger an event of default." *NZ Herald, 5 Nov 2013*
- "Prime Minister John Key is refusing to rule out dramatic intervention such as injecting taxpayer cash into...Chorus and even partially nationalising it to keep his Government's flagship ultrafast broadband rollout on track." *NZ Herald, 6 Nov 2013*

- “The copper and fibre lines company's share price has slumped since September after Prime Minister John Key said Chorus could "go broke" if price cuts imposed by the Commerce Commission were allowed to stand.” *Taranaki Daily News, 6 Dec 2013*
- “London-based fund manager Jason Pidcock, who manages a fund worth more than $8.5 billion, claimed investing in New Zealand was as risky as investing in Pakistan. His fund owns shares in Chorus, Meridian and Mighty River. [Bill] English dismissed the claims, but admitted New Zealand might have taken its reputation for granted and had to "relentlessly" communicate with the world to prevent the complaints from becoming the prevailing view” *Stuff, 9 Dec 13*
- “Moody’s Investors Service has cut Chorus’s credit rating to Baa3 from Baa2 - a notch to the bottom of its investment grade band over the prospect of enforced price cuts to its copper line service.” *Scoop 21, Jan 2014.*
- “Chorus, whose shares have tumbled 53 per cent in the past two years because of price cuts imposed by the regulator.” *NZ Herald, 19 March 2014*