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Dear Keston

Consultation on the cost of capital for the UCLL and UBA price reviews

Thank you for the opportunity to comment on the Commerce Commission's technical consultation paper "Determining the cost of capital for the UCLL and UBA price reviews" (7 March 2014) (the Consultation Paper).

This is a very significant consultation for the telecommunications industry: the Commission is considering the appropriate weighted average cost of capital (WACC) to apply under TSLRIC processes for services set out in Commission standard terms determinations (STDs) for the first time in this industry. We do not consider that the Commission should bind itself to accepting the approach to the discount rate that has been adopted in the past in respect of other industries.

Chorus has asked Dr Tom Hird of Competition Economists Group and Professor Bruce Grundy to advise Chorus on the elements of the risk adjusted WACC faced by a fixed line provider of broadband services in the New Zealand market, including the questions raised in the Consultation Paper. The expert advice of Dr Hird and Professor Grundy is attached.

When engaging Dr Hird and Professor Grundy we have been careful to ensure they are clear on the New Zealand context, in particular:

- The background of the Commission's development of the cost of capital Input Methodology and the subsequent High Court litigation. Where Dr Hird proposes a departure from the cost of capital Input Methodology (IM) it is as a result of analysis that was not considered by the Commission and was not considered in the High Court litigation; and

- The Commission's task under the Act to apply the prescribed final pricing principle (FPP) to find a forward-looking TSLRIC cost for services set out in STDs.

In our view, consistent with the advice of Dr Hird, it would not be appropriate for the approach to the WACC taken in the IMs for Electricity Distribution Businesses (EDBs), Gas Pipeline Businesses (GPBs) and airports to be adopted unchanged for the FPP process, because:

- Provision of the STD services would be expected to have different risks compared to those regulated under the IMs; and

- Regulatory precedent should be capable of changing over time in response to new data, advances in theory and improvements in analytical techniques.

Chorus' position is that certain WACC parameters should be revised to ensure that they are consistent with the risks experienced by a business providing services as set out in the STDs in New Zealand. In particular, the Commission should follow the advice of Dr Hird in setting the following parameters:

- asset/equity beta (a comparator sample for use in determining an appropriate beta is provided. Dr Hird notes that the best comparator to Chorus in the sample is BT Group and that the average asset beta of BT Group is 0.76);

- gearing (Dr Hird finds that a 40%-60% gearing is appropriate for calculating WACC for the provision of UCLL and UBA, based on a benchmark gearing); and

- credit rating (Dr Hird finds that a credit rating of BBB- is appropriate to use in calculating WACC for the provision of UCLL and UBA in New Zealand, drawing on an estimated benchmark gearing).

Further, the Commission should consider a number of methodological departures from the approach to WACC adopted in the IMs on the basis that new analysis and reasoning are available that were not before the Commission in the IMs process or before the High Court. In our view the Commission should adopt the recommendations of Dr Hird in respect of the following aspects of the WACC:

- the estimation of the debt risk premium (DRP) at a point in time (better information and improved techniques should be used in the calculation of the DRP);

- the basis for estimating the cost of debt (Dr Hird recommends the Commission should estimate a cost of debt consistent with efficient debt raising practice);

- the need for consistency between the tax-adjusted market risk premium (TAMRP) and the risk free rate (Dr Hird advises that the estimate of the TAMRP at a point in time should be consistent with the estimate of the risk free rate that is used); and

- accounting for asymmetric risk (Dr Hird recommends that the Commission begin a separate process to quantify these risks and consults on a proposed policy for how it will respond to future events that are relevant to a quantification of asymmetric risk).

Turning to the 75th percentile issue, the Commission should consider the expert report of Professor Grundy. He explains that, with regard to uncertainty in WACC parameters, even if there is no asymmetric risk, setting the regulatory WACC at the midpoint estimate will only result in positive incentives for investment around half of the time. Dr Hird states his view on the matter as follows:

> *It is my view that setting the cost of capital above the midpoint WACC estimate is required in order to ensure an efficiently managed regulatory regime [...] The Commission's use of the 75th percentile is a reasonable response to the problem it faces.*

We consider that the Commission should retain the 75th percentile adjustment.

Yours faithfully,

Vanessa Oakley
General Counsel and Company Secretary