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Tricia Jennings
Project Manager, Regulation Branch
c/o telco@comcom.govt.nz

Submission on draft determinations of the UCLL and UBA access service final pricing principles

In response to the invitation from the Commerce Commission for further submissions on the draft UCLL and UBA determinations, we have detailed below our views on what we believe to be a number of the more significant issues faced in the determination. To ensure full transparency, clients of Schroder Investment Management Australia Limited, for whom we act in an investment management capacity, are significant investors in Chorus Limited.

Overall Regulatory Landscape
The pricing outcomes under the TSLRIC methodology have highlighted the significant weaknesses in the previously adopted approach and the extent to which investors were effectively forced to subsidise NZ consumers in an effort to align prices more closely with other jurisdictions. Factors raised in the FPP review, such as the markedly longer network length per customer and variations in trenching costs, highlight the importance of adopting actual costs rather than relying on benchmarking. Although believing the assumptions on modelled network value still err in favour of delivering consumers lower prices through the exclusion of some network elements and through the cumulative impact of small amounts across a range of assumptions, we understand that these assumptions are all liable to debate from both directions and we do not doubt the thoroughness of the Commission's approach in researching and validating these assumptions.

Our concern on the collective impact of these assumptions and the regulatory process overall is the lack of symmetry in potential outcomes for Chorus investors. A low cost of capital assumption, extensive delays in the regulatory process and the lack of any backdated compensation are all working to the detriment of Chorus shareholders. The Commission has been clear on its approach of considering the potential gains and losses in consumer welfare, however, we would contend that the long-term availability of capital for network investment remains the most crucial element of long-term consumer welfare. Of the end price of broadband to consumers, infrastructure charges (from Chorus or other fibre providers) typically represent around 50% of costs, whilst providing the vast majority of the industry's capital. The Chorus valuation continues to reflect a very small premium over the tangible written down asset value. Almost all other regulated assets and the vast majority of listed businesses reflect a significant premium to this figure. Valuations of retail service providers (RSP's), including the recent sale of Call Plus to M2 Telecommunications, typically reflect values well above the capital invested in the business, implying an expectation of disproportionately higher returns than their infrastructure based counterparts. These differentials, as is usual in the case of equity market valuations, reflect a combination of historic experience and future expectations.

WACC calculation

As a theoretical construct, WACC is a valuable tool in estimating discount rates of capital providers, however, we believe the underlying principles are often neglected in its application. In the case of asset beta, this input is designed to reflect the risk and volatility of ungeared cash flows. Given that the cash flows generated for capital providers in return for network investment are effectively determined through periodic regulatory review, the asset beta is inextricably linked with the frequency, consistency, timeliness and predictability of those reviews. Asset betas in jurisdictions with widely varying approaches to regulation are of limited relevance. Additionally, we believe the derivation of asset betas from share prices is fundamentally flawed, as share prices reflect short term variability in investor opinion to a greater degree than cash flow variability. Having experienced a broad range of regulatory outcomes, significant changes in approach, continual delays in decisions and meaningful changes to cash flow forecasts as a result of these decisions, we have great difficulty in according the underlying cash flows the low level of risk which the asset betas adopted by the Commission imply. Even assuming the observed range of asset betas is valid, adopting a figure closer to the lower end of the range would appear unjustifiable.

Benchmarking/Transaction charges

We concur with the views of the Commission in moving away from the benchmarking approach given the myriad of factors affecting network costs across jurisdictions. In seeking to arrive at pricing structures which provide a return for capital deployed in a particular country, it is only the costs of that country that are relevant. We believe these principles need to be applied universally, including transaction charges. If transaction charges are deemed excessive, this should be able to be demonstrated through isolation of costs against these services versus the prices charged, rather than through any reference to charges in other jurisdictions. The incorporation of benchmarks in assessing transaction charges is inconsistent with this approach. Again, we would observe that the direction of this adjustment is detrimental to Chorus investors.

Backdating

The approach of the Commission in not backdating prices appears fundamentally inconsistent with a predictable regulatory environment. If the FPP determination concludes that historic pricing has been too low, Chorus investors have clearly been detrimentally impacted. Beneficiaries must either be RSP's or consumers. Even in a situation where the Commission believes the benefit of lower than justifiable prices has been fully passed on to consumers, a fair process should require consumers to compensate Chorus investors for losses, effectively requiring RSP's to raise prices for a period to fund the reimbursement to Chorus. We cannot understand why there should be a requirement for backdating to either promote competition or stimulate additional investment, as the backdating adjustment is facilitating the provision of a fair return on historic investment. The requirement for Chorus to pay backdated connection charges to Spark in April 2014 (relating to the period back to December 2012), also seems inconsistent with this decision. In order to maintain the integrity of the regulatory process and the faith of investors in this process, we would suggest that there must be a preparedness to apportion costs to consumers or RSP's where necessary, rather than Chorus alone. The decision on backdating also removes any incentive for RSP's to expedite the conclusion of the regulatory process and exposes Chorus shareholders to the potential for further loss in the event the final determination is delayed beyond December 2015.

Despite having views on the assumptions used in the modelling process, we have focused purely on the more material issues. Additionally, we would hope that these issues are considered in the government framework review given the crucial importance of progressing towards a more stable and sustainable long-term regulatory regime.

Yours sincerely,

M Conlon

Martin Conlon
Head of Australian Equities
Schroder Investment Management Australia Limited