Submission on Infrastructure for a Better Future

2 July 2021

CHORUS

Chorus context

1. We welcome the Infrastructure Commission's consultation on its strategy document, *He Tūāpapa ki te Ora – Infrastructure for a Better Future* (dated May 2021). Chorus supports the proposed vision and an infrastructure system that gets the best results for all New Zealanders both now and well into the future.

2. To achieve the proposed vision, considerable investment will be required, and we expect that the private sector will have a strong role to play in that investment. We think public-private partnerships (**PPP**) can be a good way to leverage private sector expertise and to manage and share risks between investors and taxpayers.

3. As a partner in what we believe to be New Zealand's largest ever infrastructure PPP, we know that PPPs work and our UFB network demonstrates this.

4. However, our experience is that New Zealand still has work to do in getting its policy and regulatory settings right if it wishes to attract private sector participation in future PPPs. After a decade of building the UFB network, we are currently in a transition phase from a contractual agreement with the Crown to a new regulatory framework administered primarily by the Commerce Commission. Unfortunately, the implementation of this phase is considered punitive by our investors and contrary to the spirit of the PPP.

5. The cost of building future infrastructure will increase if PPP investors believe they have been treated unfairly once their investment has been sunk.

6. While we can reflect positively on the success of the UFB initiative the reality is that Chorus and its investors took on considerable risk and the outcome could have been very different. Participation in the UFB initiative required:

   - Chorus demerging from Telecom, which required standing up an entirely new business solely to enable participation in the UFB programme;

   - Entering contractual arrangements including price caps, a long-term equity commitment to fund and manage UFB fibre rollout (i.e. investors gave approximately $3 for every dollar of Crown funding) and taking on demand and construction risks;

   - An initial contract period with set prices up to 31 December 2019 that was then extended to 31 December 2021 with very limited opportunity to renegotiate terms and prices over that period.

7. In exchange for these commitments Chorus was given access to favourable financing arrangements for approximately $1.3 billion, around a quarter of the funding required to build the network.

8. To support Telecom shareholders' decision to participate in the UFB programme a Government Policy Statement (**GPS**) was issued to reassure them that they would

have the opportunity to be compensated for the risks of taking on the build of, and investment in, the fibre network under price regulation.[1]

9. Today, UFB provides the backbone of New Zealand's telecommunications network supporting our social and economic resilience with fast, uncongested and reliable connectivity. Fibre enables transmission of ever-increasing amounts of data for the least carbon-related emissions relative to other technologies. It is critical infrastructure for supporting productivity growth.

Transition from Crown contract to regulation

10. With the UFB contract term finishing in 2020, the Telecommunications Act (**Act**) was amended in 2018 to transition Chorus into a new regulatory framework designed to treat Chorus in manner similar to that applied under Part 4 of the Commerce Act. This requires the Commerce Commission (**Commission**) to establish the value of the investment made in the UFB network and sets a revenue cap based around the return on and of that investment.[2]

11. Based on the legislative framework, government actions and the Commission's decisions to date, we are concerned the PPP's success will be undermined and deter ongoing investment in our fibre network. This is because the regulatory settings that oversee future fibre investment begins by rewriting history to the detriment of investors who entered the PPP in good faith. For example:

    - In determining the return on UFB assets, the Act removes the benefit arising from the favourable Crown financing arrangements. This means the key element used to encourage participation in the UFB PPP has been retrospectively removed. As a result, Chorus makes a reduced return on investment made with Crown financing. This disincentivises future participation in any similar arrangement because there is no benefit but there is residual risk.

    - In 2019, the GPS (described above) was revoked by the Government without consultation. As noted above, this was a key element in assuring investors that future regulation would recognise the start-up risks they faced. The Commission subsequently stated that *"the historical requirements of the UFB initiative itself are of limited relevance to the implementation of regulations under Part 6".*[3]

    - A key input in the regulatory framework is the Financial Loss Asset, which represents the unrecovered losses arising from building ahead of demand. The Commission's method for estimating this has resulted in asymmetric regulation where, due to the success of the UFB build, it has retrospectively transferred the "success benefit" from investors to consumers who did not bear the project risk. If the project had not succeeded, investors would have had to bear the loss of penalties applied under the PPP. The Commission's approach to WACC for this loss period ignored both the risk being faced by investors entering the agreement and the reality of the way that infrastructure is funded.

[1] New Zealand Government, *Statement to the Commerce Commission concerning incentives for businesses to invest in ultra-fast broadband infrastructure* (12 October 2011) New Zealand Gazette (No 155, p 4,440), Notice No 7120.
[2] See Part 6 of the Telecommunications Act.
[3] Commission, *Fibre input methodologies: Draft decision – reasons paper,* 19 November 2019, at [para 2.7].

12. While we acknowledge there is limited precedent for dealing with this type of investment under a regulatory framework, many of the Commission's decisions to date err on the side of underestimating the value of our starting asset base and removes and / or reallocates risk borne by investors during the UFB build.

13. We acknowledge that the legislative framework requires that the Commission remove the benefit of Crown financing and the legislative framework could have also more clearly articulated the commitments included in the GPS to ensure that investors start-up risks should be recognised.

Current outlook

14. The result of these legislative and regulatory decisions is that investors and industry commentators now characterise New Zealand's regulatory approach to sunk investment as punitive and a warning for future PPP involvement. Feedback from international investors and market commentators is particularly negative, referencing risk of regulatory failure and perverse outcomes.

15. This has two sets of implications relevant to the Infrastructure Commission's infrastructure plan: (1) international capital market distrust of New Zealand PPPs; and (2) disincentivising fibre network expansion. We address these below.

Capital market distrust

16. New Zealand's infrastructure deficit means that considerable sustained investment is required over coming decades to meet the requirements of the Infrastructure Commission's plan. This will require a mix of private and public capital which will likely require a number of PPPs.

17. Based on international infrastructure investors' views of Chorus' PPP we expect greater pressure on both the availability of capital for future investment and the cost. We see that this could have a knock-on effect for other infrastructure projects requiring private sector investment.

18. The quotes below gives a sense of the concerns expressed by investors and analysts:

- *"[Chorus] has been impacted by a punitive determination by the New Zealand Commerce Commission on the allowed rate of return for Chorus's fibre assets. The very low allowed rate of return severely underestimates the real risks investors have taken on building and operating the fibre network.*

  We are hopeful this will be corrected through a much more commercial approach to the assumptions underlying the asset base and a re-examination of other assumptions through the rest of this year. Failure to do so would send a strong signal that there is a huge risk in entering into long term public private partnerships with the New Zealand Government and that New Zealand is not a reliable destination for investing in regulated assets." - L1 Capital, Investment Report 2021

- *"If we were investors in Telecom/Chorus being presented with the same fibre investment case again — and were aware the Commission would apply the* *interpretations currently proposed for the key components of the loss asset— we would be strongly against investment in the project.*

We encourage the Commission to recognise the substantial contribution investors have made to New Zealand's fibre public-private partnership, by considering the broad implications of its approach to the financial loss asset. Infrastructure investment requires providing the opportunity for a fair return." – River Capital, Letter to the Commission 2020

- *"Should CNU end up in a situation where it is unable or unwilling to invest in or promote increased penetration and or the introduction of new services, the government would be left in an embarrassing situation, where having co- invested in the UFB rollout, it will see sub-optimal levels of fibre penetration. The current situation and regulatory outcome would also serve as a serious disincentive for any future planned public-private partnerships." – Market analyst report*

Growing the fibre footprint

19. Chorus wants to continue expanding its fibre network where commercially viable and with the right regulatory settings. With our unique geography, future PPPs will likely be required to help bring fibre closer to homes and businesses who need it, to support digital capability and enable local industries to thrive.

20. Digital equality was recently listed in the top 3 of the Agribusiness Agenda, where the report identified the lack of rural digital connectivity as a significant issue and impediment to business - as well as a barrier for helping maintain rural communities. KPMG describes this priority area as an "urgent need for high speed broadband equality for all".[4]

21. Our nation's recent experience during COVID-19 lockdown periods also highlighted the importance of stable infrastructure to help preserve consumer and business demands during peak times. Last year, the Minister described the benefits of the UFB as:

    "The UFB network is futureproof. It has not experienced any capacity constraints and performed extremely well during the COVID-19 lockdown period…Where available, UFB represents the 'gold-standard' for internet connectivity".[5]

22. Under existing settings there is no direct benefit to Chorus entering into further UFB style arrangements with government to expand the fibre footprint. This is because of the legislative requirement that any benefit arising for Chorus from such arrangements are removed by the Commission through the regulatory framework. This works against the objectives of the Infrastructure Commission and the needs of end users currently not able to access fibre. We think this represents a significant missed opportunity for New Zealand and we will engage further with the Government on this issue in coming months.

23. There is still time to achieve a transition that will deliver the full potential of fibre for New Zealand. Although we have concerns regarding decisions made to date, there are still crucial decisions to be made and we hope that the final outcome will be one that

[4] Agribusiness, *Agenda Report 2021*: https://assets.kpmg/content/dam/kpmg/nz/pdf/2021/06/agribusiness-agenda-report-2021.pdf (June 2021) p 17. The report provides a local and global snapshot of the food and fibre industry and its Top 10 priority areas are based on its industry leader's priority survey.

[5] Beehive media release by Hon Kris Faafoi, *Ultra-fast Broadband programme hits major milestone with more than one million connections* (August 2020).

preserves the reputation of UFB and the UFB PPP success and encourages future PPPs to help deliver projects that support New Zealand's economy to thrive.

24. We will continue engaging with the Government and the Commission to help ensure the appropriate incentives exist to support innovation and investment in our fibre network.

25. The lesson for New Zealand more generally is that up-front certainty around the sharing of risk and reward for infrastructure projects is critical. It is also important that these are not then overridden or diminished by subsequent legislative changes. We think government policy statements can be useful tools for supporting certainty but their role in informing later policy decisions should not be underestimated.

26. We would be happy to discuss any of the matters in this submission and look forward to reviewing the final strategy document.