Vodafone New Zealand Submission on Fibre Input Methodologies Further Consultation

13 August 2020

Thank you for the opportunity to provide further comment on the fibre input methodologies.

The changes made in this consultation paper are overall a step in the right direction, and we appreciate the Commission's care in considering these topics. Our submission is focussed on:

- the treatment of Crown financing;
- when assets enter the RAB;
- the scope of regulated services;
- the Impact of Covid-19; and
- other matters.

Treatment of Crown financing

We are pleased to see that the Commission has wound back the proposed allowance for Crown financing. Removes an unnecessary uplift and helps simplify the regime, which will ultimately mean better outcomes for end-users in the long term.

However, we consider that the current proposal is still very generous towards Chorus and the other LFCs. It is unlikely that the Crown financing could have been replaced at the WACC rate; it would have cost much more. As noted in our previous submission, Crown funding was only necessary because private investment was not available for the riskiest part of the project.

As per our last submission we continue to support the pragmatic approach of not attempting to calculate the positive or negative costs of Crown financing due to the inherent uncertainties of such a calculation. However, the Commission should recognise that it is more likely that the avoided cost of Crown financing was above the normal WACC rate, especially during the pre-implementation period. This should be taken into account when considering if other marginal uplifts are necessary.

We also consider that the 25 basis point uplift for the cost of Crown financing for Chorus from the beginning of the first regulatory period is unwarranted. The Commission considers this necessary because otherwise Chorus may pay back the Crown financing early if it can secure financing for less than the WACC rate. End-users would then have to pay the regulated WACC rate on what was previously the Crown financing. This is counteracted to some extent as end-users would also benefit from a reduced Crown funding burden, which should be returned by lower taxes, or improved government services. Ultimately the Crown funding costs are likely lower than the regulated WACC rate, so there would be a wealth transfer from end-users to Chorus.

The proposal from the Commission is to allow a 25 basis point return on the Crown financed part of the RAB to reduce the incentive on Chorus to pay the Crown financing back earlier than otherwise economically prudent. We have two concerns with this approach:

- it only minimises the risk, it does not remove it altogether; and
- it is a costly way to solve the problem, placing the entire burden on end-users.

Instead, we support the alternative option considered by the Commission to lock in the Crown financing portion of the RAB, whether it is repaid early or not. The entire WACC calculation is completed on a nominal basis to set a benchmark, we see no reason to step away from that approach. The Commission does not adjust the leverage to reflect the actual capital structure, there is no reason to treat this piece of finance structure any different.

We disagree with the assertion that using a nominal approach would 'undermine the contract between the Crown and Chorus' which allowed for early repayment. Chorus would still be free to repay the Crown financing earlier if it considered it was worth it to exit the terms of that contract. This is consistent with how a workably competitive market would operate.

For example consider a hypothetical market where no player has market power, and every firm was given interest free financing of $1b. If one firm chose to substitute that interest free financing for financing at the WACC rate they would incur a cost. Since that firm doesn't have market power, they couldn't pass on that cost to consumers, they would have to wear it. That may make sense, but only if there are particularly onerous terms of the interest free financing that they thought were worth incurring the costs to avoid.

The same incentives should apply to Chorus. They are free to pay down the Crown financing early as allowed for in the terms. But it would only be in end-users long term interests for Chorus to do that if it would somehow improve their efficiency by breaking away from the terms of the financing. The only way we will know that is true is if Chorus is faced with the right incentives.

Another way to consider the early repayment of Crown financing is to ensure that end-users are no worse off regardless of Chorus' decision. This could be achieved by capping the return allowed on any Crown financing repaid early at the risk free rate. This is roughly consistent with the benefit the Crown (and ultimately end-users) will see from having the financing returned early, so end-users would be, at worst, indifferent. It also ensures Chorus would only pay down the financing early if it would truly improve their long term efficiency, but softens the blow of exiting the financing early.

Assets should only enter the RAB when in use

We disagree with the proposal to bring costs into the regime when they are 'available for use', rather than when they are actually employed. This approach creates perverse incentives on the LFCs to deploy assets well ahead of the date they are needed, and simply pass the cost on to other end-users.

For example Chorus has recently announced that they have 72,387 fibre installs that are not in use, and this is growing by 1,000 connections per week. The cost per install is roughly $1,000, which means there will be about $150m of stranded fibre assets deployed by the time the regime begins at the start of 2022.

Many of these connections are the result of a campaign by Chorus to connect customers ahead of demand. This door to door campaign asks customers who are happily connected to another technology if they want a fibre installation, but leave it unused.

Under the current proposal these costs will then be entered into the RAB and charged on to end users with an active fibre connection. Chorus bears no risk if the installation cost is not converted into an actual connection.

This specifically targets the key advantage that many alternative technologies have over fibre – ease of install. It is considerably harder to sell a customer a fixed wireless connection for example, if fibre is already installed. In this way, Chorus is using its dominant market position, and the regulatory settings, to create conditions that favour itself over its competitors.

Chorus may argue that this is efficient because installs are cheaper at this early stage of the network because of a scale advantage to installs. But we simply do not know if this is true because Chorus is not exposed to the right incentives. If they were to bear a risk of losing some asset value if some of those connections are never converted to active fibre users, then we would know the efficient level of deployment. At the moment the efficient level of deployment for Chorus is as many as they can possibly do. But this is certainly not the efficient level for New Zealand as a whole economy.

Entering assets into the RAB on the date they are available for use may also distort the cost allocation between copper and fibre. All copper assets that will be re-used for fibre may be defined as 'available for use' from December 2011, despite most of these assets not being at all connected to the fibre network until a much later date. This appears inconsistent with the treatment proposed by the Commission elsewhere for these assets.

We note that Chorus' rational for suggesting the 'available for use' approach is to align with GAAP treatment. We agree that assets must be depreciated from the date they are 'available for use' consistent with GAAP. However, these assets should only enter the regulatory regime (at their depreciated value) when they are being used for FFLAS services.

We also propose that all communal assets are considered 'in use' from the date they are deployed. These assets were required to be deployed under the contracts with the Crown. It would be inconsistent to not allow the LFCs a return on these costs.

Scope of regulated services

We appreciate the additional clarity the Commission has provided on the scope of regulated FFLAS. In particular we support the confirmation that ICABS is included within the regime. This is a bottleneck service that the LFCs could have exploited to undermine competing mobile services if it was outside of the regime.

However, we are concerned that 'network services' are proposed to be excluded from the regime. As noted by the Commission, these largely consist of third party charges in connection with work near, or damage to, Chorus' network. Often the only provider that can carry out these services is the LFC themselves, so they are a bottleneck service that has the potential to be exploited.

For example, as we begin to roll out more dense mobile networks we will need to get 'network services' from the LFCs to ensure that any backhaul we roll out does not damage their network. They could use the 'network services' charge to create a cost barrier to making these investments.

More fundamentally we disagree with the Commission's reasoning. The services in question are necessary functions of responsibly operating a telecommunications network. You could not operate a telecommunications service as defined in s 5 without providing 'network services'. It is therefore fundamentally different to property development services, which are an optional add-on service that could be performed by a number of service providers.

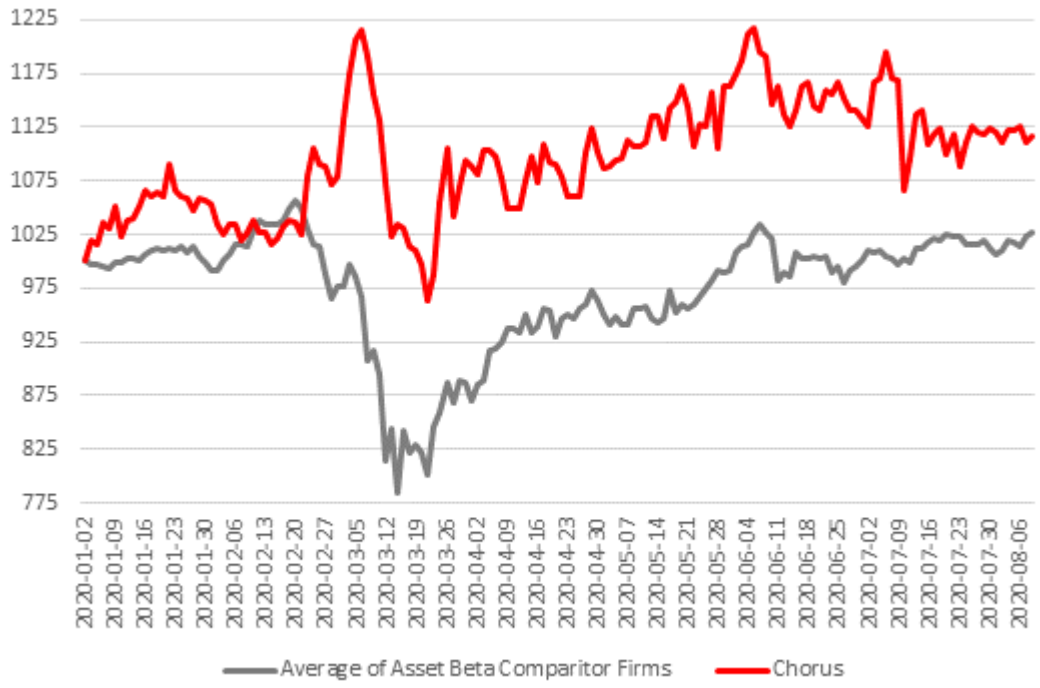
Impact of Covid-19

Covid-19 has shown that the LFCs are fundamentally less risky businesses than most. Throughout this year, their valuations have remained remarkably stable, even increasing, during the largest economic downturn we are likely to see in our lifetimes. Most LFCs are also proposing to go ahead with price rises on 1 October, something that few, if any, other businesses could achieve in the current economic environment.

In contrast, as a retail operator we have faced a significant impact from Covid-19. We have seen certain retail products vanish like international roaming; backhaul costs have increased as demand surged; we have had to temporarily close stores; and some of our business and consumer customers have not been able to pay resulting in an increase in bad debt.

This provides a natural experiment of the nature of risk faced by the LFCs, which shows that they are not in the same category as the comparator set used to calculate their asset beta. This is demonstrated in Figure 1 below, which looks at the share price of Chorus since the start of 2020 compared to the average of the comparator firms. It shows that the comparator group has been hit hard by the pandemic, while Chorus has been largely unaffected.

Figure 1: Index of share price of Chorus and the average of the comparator set used to calculate the asset beta



This outcome is exacerbated by the Commission's decision to over-weight the integrated telecommunications firms in the comparator set. It is clear that the LFCs face risks much more closely aligned with wholesale only providers, and the integrated set has little if any relevance.

Based on this new information the Commission must, at a minimum, reconsider its decision to ignore CEPA's advice to weight wholesale and integrated firms equally. Previously the Commission had argued that this approach would 'place too much weight on the estimates of wholesale companies'.[1] However, current evidence now shows that the Commission's proposed approach places too much emphasis on the integrated set, which is shown to have little relevance for the type of risk faced by the LFCs.

Other matters

We provide the following comments on other matters.

- We support the decision to treat consumer payments for non-standard installs as a capital contribution.
- We support the decision to allow for reopeners where the Commission was provided false or misleading information.
- We are disappointed that no changes are proposed to the quality regime. We understand that many of the factors raised in the joint submission from the major RSPs can be addressed in ID and PQR determinations, but we considered them to be of sufficient importance to be included within the IMs. We are also concerned that some of the factors we are most interested in such as contract related metrics may not fit well within the quality dimensions proposed by the Commission, so may be considered out of scope in later determinations.
- By omission we assume that the Commission proposes to retain the allowance for the risk of asset stranding. As per our last submission, we consider that this risk is very unlikely to materialise, and should not be part of the regime, at least for the first regulatory period.

[1] Commerce Commission, 19 November 2019, 'Fibre Input Methodologies: Draft decision – reasons paper, para 3.911.