Commerce Commission Fibre Price-Quality Regulation

• Consultation on Chorus' initial price quality RAB proposal

2degrees Submission, 28 May 2021

Executive Summary

2degrees thanks the Commission for its Consultation Paper, which provided a clear summary of the proposal and issues.

2degrees considers Chorus' Financial Loss Asset (FLA) and Regulatory Asset Base (RAB) proposal are likely to be substantially and materially inflated, such that a robust asset value will not be available to input into the draft and final fibre Price-Quality Path determination for 2022 (PQP1).[1]

Chorus hasn't provided conservative estimates in the past (where the Commission has had to very substantially revise down Chorus' estimates),[2] and we do not consider it likely it has done so now: As recognised by the Commission and multiple stakeholders, Chorus has incentives to inflate valuations, including the PQ RAB valuation, to levels not to the long-term benefit of end-users. This is a particular concern with the current fibre price-quality regulatory process given the significant information and resource asymmetries that exist.

We note, and are concerned that, the risk of over-inflation is especially high for the first regulatory period. As the Commission has pointed out "Chorus might have a greater incentive in PQP1 (relative to subsequent periods) to engage in forms of regulatory gaming". It's important to get the initial asset value right: If the RAB is over-inflated it will lock in Chorus' ability to charge excess prices and earn excessive returns, and create consumer harm, for an extended period of time.[3]

With the time and resources available, and lack of access to confidential information, we have not conducted a detailed review of Chorus' model. However, even with a higher-level review we are concerned Chorus has produced an 'ACAM-lite' asset valuation, which includes an unreasonable amount of shared assets and inflates the FLA loss calculation. We remain concerned that the RAB is being allocated unused legacy assets (e.g. from copper) as shared costs, and that Chorus is double recovering costs across copper and fibre.

We also note Chorus has not yet complied with some of the Commission's audit requirements and "To date, Chorus has not provided an independent audit of its initial PQ RAB proposal that reconciles the fixed asset inputs of Chorus' RAB model back to Chorus' financial reports".[4]

Given we don't consider the Commission has time to robustly correct and/or replace aspects of Chorus' RAB proposal prior to PQP1, we support the

[1] We note the draft decision on price-quality regulation for Chorus released on 27 May is based on Chorus' RAB and cost allocation and will need to be revised.
[2] For example, as part of the TSLRIC process Chorus submitted its own TSLRIC cost model developed by Analysys Mason. The Commission's determination was less than half Chorus' proposal.
[3] For example, the Commerce Commission is proposing that the FLA be depreciated over a 14-year period.
[4] Commerce Commission, Chorus' price-quality path from 1 January 2022 – Draft decision, Reasons paper, 27 May 2021.

Commission's intention to base the PQP1 determination on a draft or transitional RAB, with wash-up applied to correct for any difference between the draft and final RAB. As we have noted previously "This is broadly consistent with the mid-period reset the Commission adopted for the first Part 4 PQP determinations which were made prior to all aspects of the Input Methodologies being finalised". It is likely that after full scrutiny of the RAB proposal, the Commission may have to replace some of the modelling with its own,[5] and/or direct Chorus to resubmit elements of the proposal.

While it would be consistent with previous Chorus submissions if the Commission's proposed transitional approach was opposed on grounds of regulatory uncertainty, we reiterate our agreement with the Commission that regulatory certainty does not mean absolute certainty and is something that will develop over time. We also note that the Commission is in the position where it needs to adopt a transitional arrangement due to the limited legislative time-period provided for implementing the new regime (supported by Chorus) and the aggressively high RAB proposal Chorus appears to have submitted.

Our recommendations to the Commerce Commission

Having reviewed the Commission's Consultation Paper, and accompanying documents, the following is a summary of our recommendations to the Commission.

We consider the Commission should:

- Review the extent to which Chorus' proposal is treated as confidential, including against the Part 4 Commerce Act Customised Price Quality-Path (CPP) and Individual Price-Quality Path (IPP) precedent.

- Adopt its proposed transitional RAB, with the final RAB and wash-up to apply to address differences between the draft and final RABs.

- Follow the staged approach it adopted for the Input Methodologies (IMs), and consult separately on the RAB and FLA values.

- Note our concern that Chorus' RAB and FLA proposals would result in unacceptably inflated asset values, and capitalise future excess returns. We are concerned the Chorus proposal is effectively 'ACAM-lite', because it over-allocates shared and copper costs to FFLAS, and is not compliant with the IMs.

- Note our concern Chorus has not met the Commission's requirement that "The choice of allocators must also be objectively justifiable and demonstrably reasonable", demonstrated by Commission (and Spark) examples.

[5] For TSO and TSLRIC the Commission relied exclusively on its own modelling, not Chorus/Telecom.

- Carry out its further assurance of Chorus' initial PQ RAB proposal, including via independent audit.
- Consider undertaking the type of review of the RAB (and expenditure) proposal that the Commission undertook for Chorus' TSO and TSLRIC estimates, which included review of whether it could rely on Chorus' estimates or would need to undertake its own calculations.
- Review Chorus' proposal against the level of asset sharing assumed in the copper TSLRIC determination, and the Analysys Mason copper TSLRIC estimate. This would help determine whether too much of shared costs has been allocated to FFLAS and/or double recovery is an issue.

Introduction

2degrees appreciates the opportunity to submit in response to the Commerce Commission's consultation paper *Consultation on Chorus' initial price quality RAB proposal*, dated 30 April 2021.

Stakeholder engagement

We welcome the Commission's decision to consult on Chorus' RAB valuation and FLA proposal prior to the draft asset value and PQP1 determination. We reiterate the importance of getting the asset value right. If the RAB is over-inflated it will lock in excess prices and returns.

The Commission may have had little option but to limit consultation on Chorus' RAB to 4 weeks given the timeframes for a price-quality determination that must take affect from 1 January 2022. We note though that the large volume of material of the proposal (both documentation and spreadsheets) necessarily means stakeholders cannot realistically robustly review the information in this time.

Over-use of confidentiality

Consistent with the expenditure proposal, we consider a large amount of the material Chorus has submitted to support the initial asset value proposal has been inappropriately treated as confidential and shielded from stakeholder and customer review e.g.:

Figure 7.17: Overview of the "Shared with copper connections" UL allocator, based on connection ratio [Source: Analysys Mason, 2021] [Figures Chorus CI]

Allocator type	FY12	FY13	FY14	FY15	FY16	FY17	FY18	FY19	FY20	FY21	FY22
Shared with copper, national	[Chorus CI]										
Shared with copper, won											
Shared with copper, lost											
Shared with copper, non											

The large amount of confidential information, and the restrictions on access to the information, substantially limits the extent to which internal subject matter experts can review the material and further limits the extent to which we can engage with Chorus' proposal. Spark made similar observations in relation to the expenditure proposal:[6]

> "… only limited information has been made available to interested parties – significantly less than is typically made available in the context of Part 4 electricity line company – and this makes it difficult to provide specific feedback on the expenditure proposal."

[6] Spark, Fibre information disclosure and price quality-regulation: Chorus expenditure proposal, 12 March 2021.

Risk to consumers from locking in an inflated RAB

The Commerce Commission should be mindful of the High Court statement “An initial RAB value would, in our view ... be fundamentally flawed if it generated prices that were inconsistent with the achievement of the s 52A(1) purpose and outcomes, in particular if it failed to limit suppliers’ ability to extract excessive profits over time”.[7]

Stakeholders have expressed similar concerns throughout the development of the new fibre regulatory regime. For example, Vector Fibre submitted “We note that, if financial losses are overstated, then customers will be burdened with excessive prices for years to come, which would also be inefficient and inequitable”.[8]

Independent verification will be important

We support - on the grounds it is essential - the Commission’s view it will “seek further assurance (via independent audit and from our own assessment) of Chorus’ initial PQ RAB proposal”.

Caution is needed with the statement “Chorus has sought testing/verification by independent parties”. The testing Chorus commissioned does not meet the Commission’s independence requirements. We reiterate “Chorus’ use of an ‘independent expert’ cannot be relied on as a substitute for independent verification” and agree with the Commission that “Given our lack of involvement in the appointment process, and since the independent expert does not owe us a duty of care, we are unable to rely on Chorus’ independent expert report in the same way as we might rely on an independent verification report as per the capex IM”.

2degrees supports the adoption of a transitional RAB

2degrees supports the Commission’s intention to use an interim RAB for the initial PQP1 determination with a subsequent wash-up for differences in the draft and final RAB. This is given the limited time to make the first PQP determination in time for 2022 and the substantial issues the Commission has to address with Chorus’ RAB proposal. For the avoidance of doubt, we do not agree with Chorus that its RAB proposal “should enable the Commission to move reasonably rapidly in progressing its draft Price-Quality Determination”.[9]

The Commission should follow the staged approach it adopted for the IMs and consult separately on the RAB and FLA values.

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[7] WELLINGTON INTERNATIONAL AIRPORT LTD & ORS v COMMERCE COMMISSION [2013] NZHC [11 December 2013], para [770].
[8] Vector Fibre, Submission to Commerce Commission on the Fibre Regulation Emerging Views Paper, 16 July 2019, para 24.
[9] Chorus presentation, Initial Asset Value Model, 26 March 2021.

Finalising the RAB separately to the price-quality determination will support a stable regulatory environment

While we do not know Chorus' view, based on comments in previous submissions it is possible they may object to adoption of transitional arrangements or amendment of the IMs. For example, Chorus submitted on the new regulatory framework that:

> "Early certainty on our initial regulated asset base (initial RAB) and our cost of capital are key drivers for our investors who want certainty after five years of policy review. We propose changes to the Commission's process to achieve this objective. We ask, in particular, that the Commission prioritise the initial RAB and provide a clear process and timing to achieve this."[10]
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> "The Commission has stated that the asset valuation IM will not contain a 'dollar value' for determining the initial RAB. Given this view, it's important that a base 'dollar value' for the initial RAB is set by the Commission in a PQD as soon as possible after the final IMs are set. Our view is that the Commission is required to determine a value for the initial RAB as early as possible because the BBM cannot be facilitated without the Commission determining the RAB well ahead of setting the MAR."[11]

As we have previously noted, "Regulatory certainty is not something which can, or should, be automatically created on the Implementation Date, despite what Chorus might want or think". Nor does "regulatory certainty … mean absolute certainty of outcome (an output)",[12], rather certainty "is something that will evolve and improve over-time. The Commission has noted "while increased certainty is an important objective of the regime, the regime does not aspire to absolute certainty".[13]

Consistent with this, the Commission has noted in its draft price-quality determination that "Our aim is to provide Chorus and other stakeholders with progressively more certainty" and "Further certainty will come with more time and experience of the new regime – just as it did for the other sectors that are subject to building blocks regulation – along with the greater stability and predictability this form of regulation provides".[14]

We consider there is a reasonably straightforward trade-off between providing immediate or short-term certainty of a bad outcome, against allowing certainty to develop over-time with more robust regulatory settings and outcomes. Chorus has acknowledged "The level of certainty currently proposed could reflect the constrained timetable the Commission is operating under".[15]

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[10] https://comcom.govt.nz/__data/assets/pdf_file/0020/111971/Chorus-Submission-on-new-regulatory-framework-for-fibre-21-December-2018.pdf
[11] https://comcom.govt.nz/__data/assets/pdf_file/0021/166440/2-Degrees-Fibre-Emerging-Views-cross-submission-31-July-2019.pdf
[12] https://comcom.govt.nz/__data/assets/pdf_file/0033/217977/Chorus-Submission-on-Fibre-input-methodologies-Regulatory-processes-and-rules-draft-decision-29-May-2020.pdf
[13] Commerce Commission, New regulatory framework for fibre: Invitation to comment on our proposed approach, 9 November 2018, paragraph 5.62.
[14] Commerce Commission, Chorus' price-quality path from 1 January 2022 – Draft decision, Reasons paper, 27 May 2021.
[15] https://comcom.govt.nz/__data/assets/pdf_file/0033/217977/Chorus-Submission-on-Fibre-input-methodologies-Regulatory-processes-and-rules-draft-decision-29-May-2020.pdf

To the extent any uncertainty results from delay of the final RAB determination this is at least in part Chorus' own making: Chorus and its proposal have created uncertainty about what future fibre prices should be, by putting forward a RAB value as high as possible rather than being fit for the Commission's price-control purposes, and we expect Chorus may have created unrealistic and unreasonable investor expectations. For example, Chorus has claimed it has submitted a "solid, conservative RAB of $5.5bn" and stated that alternative cost allocation approaches, "support a range of $5.5 to $6 billion" – but it is aware that the higher estimates are based on ACAM/stand-alone cost, which is not permissible under the RAB IM.[16]

We are not aware of any Chorus precedent which would suggest it could credibly claim it would propose a "Conservative base case RAB". Chorus hasn't provided conservative estimates in the past and this experience suggests it has not done so now.

The Commission should consider the extent to which it is safe to rely on Chorus' proposed RAB and FLA values

While the Commission has signalled its "approach relies on Chorus modelling that will be complemented by a comprehensive package of assurance", the Commission should be open to the prospect that, consistent with TSO and TSLRIC modelling, it will not be able to rely on the Chorus' estimates or all elements of Chorus' estimates.

We recommend the Commission consider undertaking the type of review of the RAB (and expenditure) proposal that it undertook to determine whether it could rely on Chorus' TSO and TSLRIC estimates.

In relation to Chorus' copper TSLRIC modelling (developed by Analysys Mason), for example, the prices Chorus produced were a multiple higher than the Commission's determination, and the Commission concluded "Chorus' cost model is not consistent with our framework" and "Chorus has not presented us with an appropriate TSLRIC model that can be used to set the prices of the UCLL and UBA services in New Zealand". Specifically, the Chorus model calculated prices $74.10 for UCLL, and $16.57 for UBA (total = $90.67). The Commission's determination was less than half Chorus' proposal with the highest price being in year 5 and set at $42.35.[17] The Commission did, however, consider "how aspects of Chorus' cost model can inform our modelling" though and was able to use Chorus' cost model to update "some aspects" of the Commission's own model.[18]

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[16] Chorus presentation, Initial Asset Value Model, 26 March 2021.
[17] Commerce Commission, Final pricing review determination for Chorus' unbundled bitstream access service, 15 December 2015.
[18] https://comcom.govt.nz/__data/assets/pdf_file/0027/60669/2015-NZCC-37-Final-pricing-review-determination-for-Chorus-unbundled-copper-local-loop-service-15-Dec-2015.pdf#page514

In the case of the TSO, Telecom [now Chorus] managed to more than double the estimate it had provided under Information Disclosure. The Telecom TSO net cost estimate was originally $167m (2000/2001), when it was used for information disclosure only, then jumped to $408m (2001/02), after the Telecommunications Act enabled Chorus to recover a share of the net costs from its competitors. Each of Chorus' TSO cost claims were substantially higher than the Commission's determinations of the network cost of the TSO: $65.57m (2001/02), $56.75m (2002/03), and $69.72m (2008/09, draft) in the final year the Commission calculated the cost.

We are concerned Chorus' RAB estimate may be grossly inflated

Based on review of Chorus' proposal, the concerns the Commission, 2degrees and other stakeholders have raised that Chorus may attempt to game the regulatory regime with an inflated RAB proposal may have been realised.

2degrees, for example, expressed concern at the outset of the process for developing a new regulatory framework for fibre that:[19]

> "The Commission will need to be careful to ensure Chorus' fibre RAB/costs are not inflated (and its profits are not masked), by:
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> - Allocating copper assets and costs, including stranded copper assets, which have limited value to fibre, to the fibre business; and/or
> - Allocating assets and costs from competitive market services to the fibre business (which would raise s 166(2)(b) issues)."

We are concerned history may have repeated itself, with Chorus/Telecom's grossly inflated TSO loss and copper TSLRIC price/asset valuation and now a claimed "conservative" $5.5 billion fibre asset valuation. Chorus' models for the TSLRIC copper and fibre valuations have been supported by the same external consultancy firm.

Examples of how Chorus appears to have inflated its RAB estimate

Even the limited, relatively high level review we have been able to undertake has given cause for substantial misgivings about the inflated RAB:

- The asset valuation appears to be 'ACAM-lite'. The Chorus asset valuation of $5.5 billion is only slightly less than their estimate of the 'stand-alone' asset valuation of $6 billion. If there are few shared assets, which the allocation of $500m shared assets implies, this should also be reflected in a moderate or low

[19] https://comcom.govt.nz/__data/assets/pdf_file/0022/111982/Two-Degrees-Submission-on-new-regulatory-framework-for-fibre-18-December-2018.PDF

financial loss calculation because the FLA would not include much copper or pre-2011 assets, which the fibre network subsequently shared.[20]

- It appears the issues Spark raised, in relation to Chorus' expenditure proposal, about over-allocation of shared costs to fibre is reflected in the asset value as well e.g. Spark commented: [21]

  > "While difficult to draw conclusions based on the information provided, it does suggest that the expenditure proposal over-specifies the shared capability necessary for FFLAS, and then over-allocates the costs of that capability to FFLAS. We believe such an approach signals an intention to act on the incentives it already has to distort competition from alternative technologies – by funding Chorus activities in adjacent markets through guaranteed FFLAS returns – and double recovery of costs."
  >
  > "The proposed cost allocation methodology – the proposal does not include competition or double recovery considerations and these considerations need to be applied by the Commission so it can make decisions that best promote the purposes of the Act."

- It doesn't appear that Chorus has met the Commission's requirement that "The choice of allocators must also be objectively justifiable and demonstrably reasonable". The approach Chorus is proposing for allocators/proxy allocators appear to systematically result in a higher allocation of shared costs/assets to FFLAS. For example, the proposal to use 12-year forecasts of revenue as an allocator for marketing expenditure rather than actual revenue would inflate the shared costs/assets allocated to FFLAS. Marketing expenditure to promote uptake of fixed line services will benefit near-time uptake of fixed services. The most accurate and objective way to estimate the benefits to fixed services is the current uptake and revenue for the services. The allocator should either be customer numbers or actual revenue.

  There also appears to be a disconnect between Chorus' unwillingness to publicly disclose its expenditure forecasts beyond the first regulatory period, we understand on the grounds it does not have confidence in their reliability and accuracy, and its position that marketing costs should be allocated on the basis of 12-year revenue forecasts for copper and fibre services.

- We consider the example the Commission identified where Chorus has inflated the allocation of CTO overheads and corporate personnel costs is an example of the approach Chorus has taken to over-inflate its FFLAS costs (including FLA) and asset value:

  > "Chorus' fibre connections were less than 1% of total connections in June 2012, increasing to 53% by June 2020. By comparison, Chorus' ratio of UFB FFLAS expenditure to total expenditure —which is the allocator proposed by Chorus for CTO overheads and corporate personnel costs— appears to be significantly higher.

[20] We have previously documented our concerns about the calculation of the FLA.
[21] Spark, Fibre information disclosure and price quality-regulation: Chorus expenditure proposal, 12 March 2021.

… Chorus report capital expenditure on fibre of $548 million, out of total capital expenditure of $663 million."

- Likewise, we agree with the Commission's observations about the inconsistencies in Chorus' justifications for various allocators:

  "We also note that Chorus has stated publicly that the "FFLAS proportion of opex is expected to increase significantly as fibre uptake grows and the copper network is retired." This suggests that operating costs are related to uptake, which appears to be at odds with Incenta's comment that the ratio of customer connections may not be an appropriate allocator".

- Based on our review, it is not clear Chorus has applied, or properly applied, the shared cost allocation cap safeguards. For example, the Incenta commentary seems to indicate Chorus is interpreting "asset values or total forecast operating costs that the regulated provider <u>could not have avoided if it ceased supplying services</u> that are not regulated FFLAS" as "could not have avoided <u>in the immediate or short-term</u>". The approach that should be adopted – consistent with ACAM principles – is to consider what costs could be avoided in the long-term or, equivalently would have been avoided if the regulated supplier had not provided services that are not regulated FFLAS. It is not the role of FFLAS prices to recover the cost of potential stranded non-FFLAS (copper) services.

  The Commission also needs to ensure the shared cost cap is only applied to assets that are shared with the FFLAS service and fully excludes assets directly attributable to services that are not regulated FFLAS even (or especially) if they become stranded.

- The Commission has identified various elements of the asset value proposal that do not comply with the IMs, and other issues, which all result in over-inflation of the asset value. For example, we share the Commission's concerns that shared assets are not being allocated between different services using ABAA. The Commission has observed Chorus is allocating some shared assets fully to FFLAS e.g. "Post-2012 capex on (otherwise shared) power assets in the Won area is allocated using "Full allocation" (100% to in-scope FFLAS at all times), whereas power assets employed pre-2012 are always allocated based on power usage (shared with copper property power)".

- The following observations are illustrative of the types of concerns 2degrees and other RSPs raised in relation to how FLA would be calculated, and the risk that it would be used to recover costs Chorus would have incurred regardless of whether it provided UFB/FFLAS:

  "Chorus' proposed allocator of exchange space is based on the footprint of UFB FFLAS equipment as a proportion of total equipment footprint. This appears to result in any vacant floorspace being apportioned across services that are delivered from the exchange. Under such an approach, in a scenario in which copper equipment in an exchange had been fully replaced by fibre equipment, the entire cost of the exchange building may end up being allocated to UFB FFLAS, even though the FFLAS equipment only occupies part of the exchange floorspace."

Chorus' proposed $1.5 billion FLA includes compensation for surplus and unneeded sunk and historic investments, which are not needed to provide fibre services and therefore should not be included in the FLA calculation. In relation to the specific example of exchange space the maximum allocation should be based on actual space used for UFB/FFLAS, with the allocation reflecting that Chorus' "buildings were built to house copper assets, which need more space than fibre network electronics. As a result, we have more floor space, and land area, than we require".

We also note that we expect Chorus has already recovered much of this cost, as part of copper returns, previously.

Conclusion

2degrees thanks the Commission for its Consultation Paper, which provides a clear summary of Chorus' RAB proposal and outline of issues.

As set out in this submission, 2degrees does have significant concerns regarding the inflation of Chorus' RAB, and strongly supports the Commission's greater scrutiny of this proposal, which is not expected to be completed before PQP1.