



Fibre Input Methodologies: further consultation draft

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Executive summary

The Commission is consulting on proposed changes to draft Fibre IMs (**consultation paper**). In parallel, the Commission has asked for comments on the WACC it should use for past losses and has released a further consultation relating to the calculation of these losses.

The consultation paper clarifies and modifies a number of proposed input methodologies (**IMs**). We support the Commission's proposals to:

- Align the proposed draft IMs with finalised regulations.
- Provide further guidance:
 - On how it will define FFLAS, including the treatment of transport services such as ICABs. The Commission should be open to providing further guidance over time as the regulatory framework is implemented, and
 - That it will set detailed quality requirements in PQ and ID determinations.
- Clarify that Crown funding has been provided as Crown financing (as defined in the Act) and other Crown funding vehicles. We expect the principles to be applied across all forms of Crown funding, including RBI and fibre lead-in grants, and
- Add transparency to cost allocations through a two-step allocation process.

However, the consultation paper also highlights the risk that the IMs may not be applied to promote workable competition as the Commission expects. For example, the consultation paper:

- Proposes to add a materiality threshold for applying the avoided cost cap to cost allocations based on whether the cost allocation has a material effect on the total costs allocated to FFLAS.

Cost allocations may have significant implications for competition in adjacent markets, and the Commission should also consider materiality in terms of the implications for workable competition.

- Highlights the risk of relying on accounting standards to deliver the economic and competition outcomes required by the Act.

For example, Chorus and LFC submissions referenced in the consultation paper highlight that draft asset disclosure requirements – which were initially developed to support Part 6 outcomes¹ – are inconsistent with existing GAAP based financial reporting and Table 3.2 highlights the significant variance in costs allocated to regulated services through the choice of allocators and sequencing. Many of the proposed default regulatory rules are based on GAAP compliance rather than the requirements of the Act.

The Commission has also requested feedback on:

- Whether Network services are a FFLAS.

We recommend the Commission clarify that where a “site investigation” is requested as a precursor to a fibre connection, it should be considered connection activity for FFLAS purposes.

¹ Consultation paper at 3.106

- Proposals to mitigate a possible perverse regulatory incentive for Chorus to repay Crown financing early by reducing the benefit of Crown financing below the regulatory WACC.

We believe that the direct approach discussed in the consultation paper – i.e. to lock-in the benefit of Crown financing up front – leaves UFB contracts unchanged and Chorus with incentives to make efficient funding decisions in practice.

Introduction

1. Thank you for the opportunity to comment on the Commission's consultation paper (**consultation paper**) on proposed changes it is considering to the draft fibre network Input Methodologies (**IMs**).
2. In parallel, the Commission is consulting on expert advice relating to the WACC used for past losses and possible changes to approach for valuing the s177 financial loss asset.
3. The Commission has asked for views on the matters outlined in the paper relating to:
 - a. The scope of fibre fixed line access service (FFLAS) and the impact of the Telecommunications (Regulated Fibre Service Providers) Regulations 2019 (**the regulations**) on the Commission's draft approach.
 - b. Specific reasoning or decisions relating to cost allocation, asset valuation, capital expenditure, and regulatory processes and rules, and
 - c. The potential impact of Covid-19 on the IMs, focusing on the cost of capital IM.
4. The Commission notes in the consultation paper that it does not intend to take account of submissions on matters that are outside the scope of the current consultation.
5. Our comments are set out below.

Defining FFLAS

Guidance on the definition of FFLAS in practice

6. The Commission provides more detailed guidance in the consultation paper as to how it expects the definition of FFLAS to work in practice.
7. We support the Commission providing further guidance as, while the demarcation between services and regulatory approach is not always clear, these demarcations can have significant implications for how the regulatory framework works in practice and competition outcomes. The Commission rightly confirms that transport services such as ICABs fall within the regulatory scope of the fibre network.
8. Given the complexity of telecommunications networks and regulatory frameworks, existence of shared platforms and costs, and regulated provider incentives, it's likely that further Commission guidance will be required over time. The Commission should continue to provide further guidance over time to support implementation of the framework.

Network services

9. The Commission has asked for views on whether "network services" should be considered FFLAS for the purposes of fibre regulation.
10. The consultation paper proposes that network services – i.e. services that could include fibre route surveys, cable locate services, site investigation services and network damage maintenance – not be considered FFLAS for Part 6 purposes. These services are not generally associated with a particular property and largely consist of charges to third parties in connection with work near, or damage to, Chorus network infrastructure.

11. These services do relate to the operation of the Fibre Network, but they may not be a specific component of an access service purchased by access seekers. Accordingly, they will need to be reflected in the regulatory framework in some way.

12. . The Commission should consider:

- a. Clarifying that, where site investigation activities relate to proposed connection to the fibre network, these services are a component of an FFLAS.

Access seekers can request a site investigation (typically for business customers) to obtain information about the infrastructure or services available at an address², and this information would typically be used to inform a customer's connection options to the network.

- b. Ensuring that a consistent approach is taken to third party revenue and costs.

While these items likely relate to charges for third party activities such as reconfiguring the network, similar costs will be incurred by Chorus for reconfiguring other networks to facilitate fibre network build. Third party costs and revenues relating to the operation of the fibre network should be captured consistently in the BBM.

Asset valuation

Treatment of the benefit of Crown funding

13. The Commission indicated in the draft decision that it would recognise Crown financing by:

- a. Calculating the return on assets using the conventional WACC applied to the total RAB, and
- b. Apply an additional building block to reflect the benefit of Crown financing. The benefit of Crown financing would be calculated by multiplying the avoided cost of financing by outstanding concessionary financing, reducing the maximum allowable revenue.

14. The Commission proposes, for the purposes of estimating the avoided financing cost, to use the regulatory WACC discounted by 25 basis points in the post implementation period. The proposed discount is intended to mitigate a potential regulated firm's perverse regulatory incentive to repay Crown financing early to boost allowable revenues (i.e. where Chorus actual financing costs are less than the regulatory WACC).³

15. It is unclear whether the proposed mechanism – i.e. reducing the estimated benefit of Crown financing – is the best means to mitigate an incentive to inefficiently repay concessionary Crown financing early. While the proposed approach results in end users paying an unquantified premium in order to mitigate a regulatory incentive, it also distorts efficient Chorus funding decisions by bringing actual financing decisions in to the BBM.

16. We recommend that the Commission consider the third option discussed in the consultation paper whereby the benefits of Crown financing are locked in irrespective of whether or not this is repaid ahead of the agreed repayment dates⁴. Locking in the value of Crown financing specifically addresses the regulatory incentive risk, while leaving regulated providers efficient

² For example, see para 8.15 of the Chorus DFAS operations manual

³ See consultation paper at para 3.46

⁴ See consultation paper at para 3.48

incentives to reduce their overall financing costs in practice. Accordingly, this approach is likely a more effective and lower cost means of mitigating perverse regulatory incentives.

17. The consultation paper sets out a concern that locking in the benefits of Crown financing up front could be seen as undermining the contract between the Crown and Chorus which provides for early payment of equity securities.
18. However, locking in the benefit of Crown financing for the purposes of establishing the MAR does not undermine the UFB arrangements. The UFB arrangements remain in place and Chorus is free to negotiate or take up early payment options where this is beneficial to Chorus or more efficient. Accordingly, its difficulty to see how setting a baseline regulatory value for Crown financing would undermine the UFB arrangements and Chorus options.
19. In practice, the proposed approach which seeks to influence Chorus actual financing decisions through the regulatory setting is more likely to undermine the UFB contracts. This is because the proposed discount (i.e. regulatory setting) is specifically intended to prevent Chorus from exercising an option in the UFB arrangements to repay Crown financing early.
20. Locking in the benefits of Crown financing is also likely to be more efficient as it does not (unlike the proposed approach) undermine Chorus options to repay Crown financing early where this lowers Chorus' costs or is more efficient.

Clarification of capital contributions

21. The consultation paper also usefully clarifies the Commission proposed approach to specific Crown financing in terms of s164 and capital contributions from the Crown in other circumstances.⁵
22. Section 164 provides that Crown financing is debt or equity financing provided by the Crown under the UFB initiative. The further Crown contribution to for non-standard installations through a grant would be considered a capital contribution.
23. The approach should be consistently applied to all Crown capital contributions and we expect that, for example, Crown RBI and fibre lead-in grants will also apply to the relevant Chorus Fibre Network assets.

Cap on the allocation of shared costs

24. The consultation paper proposes to add a materiality test to the application of a cap on the allocation of shared costs. The total shared costs that a regulated provider can allocate to FFLAS must not exceed the costs the regulated provider would have had to occur if it ceased supplying services that are not regulated FFLAS.
25. We do not support the avoided cost cap as - if applied on its own - it will result in FFLAS underwriting Chorus' activities in competitive markets. Under this model, Chorus would know that it could optimise its business across regulated and competitive markets and, if competitive activities fail, the regulatory framework will work to redirect costs into the regulated asset. A standalone cost cross-check, while likely rarely applied, could discourage these incentives.
26. The proposed materiality threshold based solely on the effect on total costs allocated to regulated FFLAS further diminishes the promotion of workable competition requirements of the Act. In other words, the threshold for cost allocations to competitive activities is based solely on

⁵ Consultation paper at 3.54

the materiality of total costs allocated to the regulated network rather than impact on workably competitive markets.

27. The proposed approach may result in cost allocations with material implications for workable competition in competitive markets not being made transparent or exposed for a specific decision. For example, as set out in our equivalence and non-discrimination submissions, Fibre providers have choices relating to the functionality and cost of Optical Networking Termination (ONT) equipment. While Chorus has deployed an ONT that supports layer 1 functionality amongst other capabilities such as switching and wi-fi connections (it is developing a wi-fi service),⁶ Openreach has taken a different approach and introduced an ONT with specific service-focused capability. Openreach report that the new ONT, albeit with minimum functionality, was a third of the cost of its existing ONT.⁷
28. The ONT likely represents a small proportion of the total cost of the fibre network. However, it may have material implications for workable retail competition as Chorus provides functions that are currently provided by retail service providers. These costs should be made transparent and regulatory incentives carefully considered, but the proposed materiality threshold is unlikely to expose these issues.
29. Therefore, we recommend that the Commission consider adding a second requirement to the materiality threshold so that materiality is determined by having a material effect on total costs allocated to regulated FFLAS or on workable competition in any market.

[End]

⁶ Spark submission on layer 1 compliance at page 9.

⁷ <https://www.ispreview.co.uk/index.php/2019/09/a-look-at-openreachs-compact-ftp-broadband-ont-and-mini-olt.html>