

Commerce Commission Fibre information disclosure and price quality regulation

Proposed process and approach for the first
regulatory period

2degrees Submission, 14 October 2020





Executive Summary

2degrees is broadly comfortable with the process and approach the Commission has outlined in the consultation paper for setting of Information Disclosure (**ID**) requirements and the first Price-Quality Path (**PQP**) decision, including:

- The scope of the service subject to PQR is Chorus' FFLAS in its UFB areas, plus any FFLAS where there is no competition. This includes backhaul, transport and colocation assets used to supply PQ FFLAS customers.
- Signalling that while it is the Commission's preference to determine all elements of ID prior to the implementation date, some ID elements may not be finalised until after 1 January 2022. We consider this is likely to be a pragmatic way of dealing with the tight time constraints the Commission is operating to - but it will be important that the key ID elements are defined in 2021.

However:

- We are concerned the 4 to 6 week consultation period the Commission has signalled (and 2 weeks for cross submissions) will not be sufficient to properly and fully engage with the first fibre PQP decision, especially if this overlaps with the ID consultation (or other consultation timeframes). The Commission should allow for a longer submission period, and take into account other parallel consultations.
- We share the Commission's concern that it is unable to rely on Chorus' independent expert report as it would be an independent verification report. We consider it important the expert report is made available to stakeholders as part of the consultation on Chorus' expenditure proposal to inform responses.
- We consider the Commission should consult on Chorus' submission of its initial RAB valuation and Financial Loss Asset value prior to consultation on the draft Asset Value and PQP determinations. The Chorus RAB calculation and any associated expert reports could be released to stakeholders at the time the Commission receives this to allow concurrent consideration.
- We are concerned the Commission will be relying on Chorus' modelling of financial losses and asset valuation, given information asymmetries, incentives to increase valuations, and previous loss (TSO) and cost (TSLRIC) overestimation examples. It will be important the Commission has sufficient contingency, including time, to determine the appropriateness of Chorus' estimates and if not, alternatives. (In this respect we recognise practical options may include deferral and potential use of wash-up mechanisms)
- We do not agree that Chorus has weaker incentives to argue for quality standards that benefit them rather than end-users in the first regulatory period (RP1) because of the shorter timeframe: we expect RP1 quality standards to provide precedent for future regulatory periods, as well as impacting Chorus costs in RP1.



Introduction

2degrees appreciates the opportunity to submit in response to the Commerce Commission's consultation paper *Fibre information disclosure and price-quality regulation: Proposed process and approach for the first regulatory period*, dated 15 September 2020.

We are broadly comfortable with the approach the Commission has outlined in the consultation

At a high level, we are generally comfortable with the process and approach the Commission has outlined in the consultation paper for setting ID requirements and the first PQP decision.

We consider that signalling some elements of ID may not be finalised until after 1 January 2022¹ is likely to be a pragmatic way of dealing with the tight time constraints the Commission is operating to in order to implement the new Part 6 Telecommunications Act regime, but like the Commission, we would also prefer that these are determined in 2021. It will be important to make sure all key terms are determined in any case.

Likewise, we acknowledge the suggestion the initial PQP reset on 1 January 2022 - for the first year of PQP1 – could be based on the draft decision (initial PQ RAB), with wash-up used to correct for any difference between the draft and final decision.² 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.

We also note and agree with the Commission's statement that "... there are possible features of a PQ path that we will not be able to implement for PQ1, given the complexities involved and the uncertainties about the longer-term dynamics of the FFLAS market. Such features may be developed and added to the regime as it evolves, as has been the case with the development of PQ regulation under Part 4 of the Commerce Act 1986".

Regardless of the time the Commission has to develop the new Part 6 Telecommunications Act regime, and implement the first PQP determination, the regime will evolve and develop over time. The principle focus for the first PQP determination should be to ensure it does not enable or lock in excess returns, and ensure service quality reflects end-user demand.

¹ For example, the Commission has stated "While our preference is to determine all ID requirements prior to 1 January 2022, if necessary, certain aspects of ID could be deferred until after this date".

² For example, the Commission has stated "Given the constraints imposed by the timeline for the final decision, we intend to allow Chorus to set its prices for the first year of PQP1 based on the allowable revenues proposed in the draft decision. This would then be subject to a wash-up compared to the final decision" [footnote removed].



We agree with the Commission’s interpretation of the scope of Chorus’ PQ FFLAS business

We agree with the Commission that the PQ (regulated) part of Chorus’ FFLAS business includes Chorus’ UFB areas, plus any FFLAS where there is no competition.

We agree that “A critical consideration when determining the boundary of a geographical area where Chorus’ FFLAS will be exempt from PQ regulation under reg 6, is whether end-users are likely to enjoy the benefits of (actual or potential) competition between Chorus and the other LFC”. This sensibly interprets Regulation 6 of the Telecommunications (Regulated Fibre Service Providers) Regulations 2019 in a way that only captures the monopoly parts of the FFLAS business.

We also agree with the Commission that “If competition between Chorus and the other LFCs is not sustainable in the longer term and one of the providers exits the area, Chorus’ FFLAS in that area will be brought back under PQ regulation on the basis that the reg 6 exemption will no longer apply”.

We support the Commission’s intention that it “will be able to monitor for [house-by-house or street-by-street] granular pricing strategies by Chorus through ID regulation. If we find evidence of potential harm to end-users where Chorus’ and the other LFC’s fibre networks do not directly overlap (within the other LFC’s UFB coverage area), we can address this harm through modifying our implementation of reg 6 in future PQ periods to exclude the type of premises described in Scenario 2”.

Discriminatory pricing practices, such as street-by-street pricing, is a possibility. This is a strategy Chorus’ predecessor adopted in its response to the entry of TelstraSaturn in the Wellington residential telephony market.

Backhaul transport and co-location are clearly part of Chorus’ PQ FFLAS business

We note and support the Commission’s dismissal of Chorus’ suggestion backhaul, transport and co-location assets physically outside UFB areas are excluded from price control. We agree with the Commission that what matters is whether the assets are used to supply PQ FFLAS customers, not the physical location of the assets.³

³ For example, the Commission stated “For example, the question of whether PQ regulation applies to a co-location or transport service should depend on whether the service is used to support the provision of FFLAS to an end-user within an LFC’s UFB geographical area, even if the activity involved in the service, such as the transmission of signals on the transport network to the Point of Interconnection, takes place (in part) outside that area”.



Chorus' use of an 'independent expert' cannot be relied on as a substitute for independent verification

We 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".

We also agree there is "value in considering the conclusions in Chorus' independent expert report and scrutinising the findings to inform our own analysis. In particular, we propose to acknowledge areas where the independent expert identified expenditure that may not meet the assessment criteria when we determine the focus of our assessment".

It will be important the expert report is made available to stakeholders as part of the consultation on Chorus' expenditure proposal.

We also agree with and support the Commission's position that "We will aim to understand the assumptions and approach taken by the independent expert to understand the potential gaps in their analysis and areas of focus. We will not rely, without supplementing with our own further consideration, on the conclusions of the report when determining whether proposed expenditure has met the expenditure objective and reflects good telecommunications industry practice".

Elements we are worried about

Consultation

The Commission should consult on Chorus' submission of its initial Regulatory Asset Base (**RAB**) valuation and Financial Loss Asset value prior to consultation on the draft Asset Value and PQP determinations. This will be particularly important given that if the RAB value is over-inflated it will permanently lock in excess prices and returns.

As the Commission has noted "... information asymmetry and potential lack of information on the approach presents risks to the PQ RAB valuation being in the long-term benefit of end-users. Chorus holds most if not all the information needed to create the initial PQ RAB" and "Chorus might have a greater incentive in PQP1 (relative to subsequent periods) to engage in forms of regulatory gaming".

The consultation paper expressly states the Commission will consult on the Chorus' expenditure proposal and the same approach should be adopted for the RAB. This should include release of the Chorus RAB calculation at the time it is submitted to the Commission, along with any expert reports etc.



Reliance on Chorus' Modelling

Related to this, we are concerned the Commission considers it will need to rely on Chorus' modelling of its financial losses and asset valuation and does not consider it could do "all" the modelling itself.

Various of our submissions have raised concern about the experience with Chorus' loss (TSO) and cost (including asset valuation) (TSLRIC) estimates and how this compares, unfavourably, with experience under Part 4 of the Commerce Act. We welcome the Commission's statement that "... decisions about allowable revenue and quality standards, and the inputs used to derive them are for the Commission to make, and that our decision may depart materially from what Chorus proposes ..."

It will be important the Commission has sufficient contingency, including time, to determine the extent to which Chorus' estimates and proposals are safe to rely on and, if not, to determine the Commission's own alternatives.

In this respect, we welcome the Commission's consideration of options "if a robust estimate of the initial PQ RAB is not available in time for the draft determination". We consider the most likely option that might need to be adopted is "separating the timeline for the draft determination for determining the expenditure allowance (ie, capex and opex), and [to] defer the draft determination for allowable revenues (which incorporates the initial PQ RAB)".

While it would be by far more preferable, and result in greater certainty, we acknowledge the practical constraints the Commission is operating under. As a consequence, we support the Commission's position that if there is "insufficient time to scrutinise and assure the initial PQ RAB before the final determination" it would consider "using an 'initial PQ RAB estimate' ... that is scrutinised and assured after the final determination; and ... where any differences between revenue consistent with the 'initial PQ RAB estimate' and revenue consistent with the 'initial PQ RAB' are washed up". It will be important to be clear about the status of the initial PQ RAB and what subsequent steps will be taken after the determination.

Length of the regulatory period should not impact the importance of getting service quality standards right for PQP1

We do not agree with the consultation paper statement that "The shorter duration of PQP1, relative to a longer regulatory period, might imply weaker incentives for Chorus to argue for quality standards that would benefit them rather than end-users. This is because any consequences to end-users (that benefit Chorus instead) from setting inappropriate quality standards in PQP1 would be corrected sooner at the reset after 3 years (rather than later)".

This is because:

- The weaker the quality standards are, the lower the expenditure requirements will be in order to meet the requirements, regardless of the length of the regulatory period.



- The quality standards for PQP2 will be a function of the quality standards in PQP1, so the weaker the PQP1 quality standards the weaker the PQP2 standards are likely to be.

We also do not consider it should be assumed that if the quality standards in PQP1 are inappropriate this will necessarily be detected by the Commission and corrected in PQP2.

Next steps/Process

The Commission has signalled that there will be a 4 to 6 week consultation period for submissions on the draft PQP decision, and 2 weeks for cross-submissions. We are concerned this will not be sufficient to properly and fully engage with the PQP decision. This is particularly the case if the consultation overlaps with the ID consultation (or other consultation timeframes).

It is relevant this will be the first PQP decision the Commission will make in relation to fibre, so issues will be a lot less 'bedded down' than they are under Part 4 of the Commerce Act, which has now had the benefit of three price resets. We consider the Commission should allow for a longer submission period, and that in deciding the time period it takes into account whether stakeholders are expected to respond on ID, or other matters, over the same timeframe.