Chorus cross-submission on the Commerce Commission's fibre input methodologies – further consultation draft reasons paper

3 September 2020

EXECUTIVE SUMMARY

Overview

1. This cross-submission responds to submissions on the Commerce Commission's (**Commission**) fibre input methodologies further consultation draft - reasons paper, published on 23 July 2020 (**Revised Paper**). The Revised Paper consults primarily on post-implementation issues, while a separate consultation paper (with submissions due next week) focuses primarily on matters related to the financial loss asset.

2. This is the last stage of consultation for most of the Commission's input methodologies (**IMs**) decisions, and it's critical that the Commission gets the balance right. That is, ensuring Chorus has the opportunity to achieve real financial capital maintenance (**FCM**) to support continued investment and innovation for the benefit of end-users of fibre fixed-line access services (**FFLAS**). Our cross-submission focuses on achieving a workable regulatory regime to ensure this outcome.

3. It's important to recall that this regulatory exercise is about transitioning oversight of FFLAS from a Crown arrangement to a utility framework – it is not an exercise in response to problems in the market.

4. Ultimately, this transition must deliver on Parliament's objective. That is, to provide certainty and stability for consumers through the setting of anchor services, ensure Chorus can recover a fair return on and of its investment through a revenue cap and to provide flexibility and investment incentives to meet the ever-changing demands of the end-user, commercial and technological environment.[1]

5. The final IMs will send strong signals to current and future investors of New Zealand. As well as being the foundation for determining our maximum allowable revenue (**MAR**), they will demonstrate how the Commission views investment in infrastructure in this country.

6. Since entering into our partnership with Crown Infrastructure Partners (**CIP**), Chorus has reoriented from being a business unit wholesaling copper to constructing and wholesaling New Zealand's first open-access fibre network. We have strong incentives to deliver long-term benefits for our customers and improve the suite of connectivity options for New Zealanders.

7. Delivery of our build and service offerings was guided by incentives under our contractual CIP arrangements, business line restrictions, Deeds of Undertaking and incentives to earn an early return for our investors. This resulted in us minimising costs and actively promoting fibre uptake. In other words, we have always operated

[1] Telecommunications (New Regulatory Framework) Amendment Bill, First Reading Speech, Minister of Communications. https://www.parliament.nz/en/pb/hansard-debates/rhr/combined/HansDeb_20170816_20170816_28

under commercial imperatives to be efficient while delivering on regulatory and contractual compliance.

8. The unique features of our telecommunications sector and the new fibre regulatory framework need to be carefully considered by the Commission to ensure it delivers the purpose as set out under section 162 of Part 6 of the Telecommunications Act (**Act**), and sets the incentives intended and delivers a sustainable regime.

9. This cross-submission focuses on key issues that, if not appropriately addressed, will under-compensate the real risks taken by investors during the UFB programme. The outcome of under-compensation will not only be detrimental to our investors, but end-users of fibre broadband services.

10. If the regime appropriately recognises the actual risks taken, all parties will benefit. Consumers are protected by the presence of anchor services and the market dynamics mean Chorus is incentivised - without prescriptive regulation on every product – to generate uptake and revenue efficiently and with as much improvement in customer experience as possible. Considering the risk to investors in a way that reflect the actual risk faced in 2011 does not disrupt any of this.

11. We urge the Commission to carefully consider our submissions on its revised decision in light of our journey with the Crown, and the benefits of fibre services brought about by this partnership.

Summary of submission

12. **Treatment of Crown financing:** The Commission's reversed position is wrong in fact and does not align with the principle of real FCM, the statutory intent, or the view of its experts and ours. Applying the correct treatment is critical for ensuring a reasonable opportunity for a return on capital, and compensating investors for the risks they have taken. Having an opportunity to make a fair return is the key to ensuring end-users benefit from continued investment and innovation. In our view:

    12.1. The Commission's task is to reflect the actual costs of Crown financing, as required by the Act;

    12.2. The Commission's recent reversal of its position is wrong and inconsistent with the Act - Crown financing was not costless;

    12.3. Given the identical wording of "the actual financing costs incurred by the provider" is used in sections 171(2) and 177(3)(b), the Commission has no discretion and must equally apply its position to both the pre-implementation and post-implementation periods; and

    12.4. If the Commission ensures the IMs implement the requirements in the Act, the right incentives will be in place and there is no need to introduce additional incentives or to lock in the Crown financing benefit.

13. **Cost of capital and Type II asymmetric risk:** The estimation of these parameters underpin the FCM principle and the recognition of asymmetric consequences of under-

and over-investment. If these parameters are properly estimated, firms will be given the opportunity to recover a fair return and will be incentivised to innovate and invest. Getting this right is critical if end-users are to benefit from Part 6 implementation. Therefore, we maintain and reiterate:

13.1. The allowance for Type II asymmetric risk should be applied for the pre- and post-implementation periods, consistent with the recommendation presented by Sapere;

13.2. We do not support the cost of capital parameters contained in the draft IMs for the price-quality (**PQ**) path. In particular: the asset beta should be 0.60, the credit rating should be BBB (consistent with leverage of 31%), the debt issuance cost should be 0.25% (for a 5-year term) and the 67th percentile should be applied to reduce the probability of under-estimating the cost of capital and to maintain incentives for further investment and innovation in FFLAS;

13.3. Parliament legislated for separate regimes due to the dynamic differences and characteristics of each industry. We do not support an industry alignment of a full cost of capital review; and

13.4. It is important to ensure the cost of capital IM is fit for purpose. Therefore, if appropriate, we would support the Commission bringing forward our cost of capital review given the current economic environment.

14. **Cost allocation:** The cost allocation framework must be workable, provide certainty and stability, and incentivise efficiency and innovation. For these reasons we consider:

14.1. A shared cost cap isn't required if justifiable casual and proxy allocators are used, which is consistent with the ABAA approach currently prescribed under the draft IMs. As currently proposed, there's considerable uncertainty as to how this cap would apply;

14.2. If adopted, it should apply only to new services, on a forward-looking and objective basis only; and

14.3. The materiality threshold should not be extended to impose additional requirements, such as an assessment of competition impacts in other markets. Doing so would prematurely build in additional requirements before establishing a real issue exists. This could undermine future investment decisions.

15. **Timing of commissioned assets:** We support the Commission's revised decision that assets become regulated once available for use for FFLAS, which is consistent with Part 4 and GAAP. This is important for ensuring the appropriate return on and of capital can be recovered in a manner consistent with maintaining real FCM.

16. **Regulatory framework:** A workable framework is critical for ensuring the section 162 purpose of Part 6 and its various regulations are implemented.

16.1. Determining which services are FFLAS is purely an exercise of statutory interpretation for the Commission and not a matter of discretion;

16.2. We note UFF's and Enable's two-step approach is required to determine whether a service is or is not FFLAS, and they agree that network services and new property development are not FFLAS under the Act; and

16.3. Chorus has commercial freedom outside of anchor and mandatory services to encourage innovation. We agree with the Commission's earlier position that requirements for wholesale services agreements are not within the scope of Part 6 regulation.[2]

[2] Commerce Commission (19 November 2019) *Fibre input methodologies - draft determination reasons paper*, at [3.1486].

TREATMENT OF CROWN FINANCING

17. As outlined in our submission,[3] the Commission's recent reversal of its position suggests that Crown financing is costless. This is simply wrong. It does not align with the principle of real FCM or the section 162 purpose of the Act. We also note that the Commission's own expert advisor, Dr Lally, agrees that Chorus bears a residual risk in relation to Crown financing.[4]

18. The treatment of Crown financing is a significant decision the Commission must make. It is clear the Act requires the Commission to reflect the actual financing costs incurred in determining financial losses and does not give the Commission discretion in undertaking this task.

19. The Commission's position must apply equally to both pre-implementation and post-implementation. Given the identical wording in section 171(2) and section 177(3)(b) ("the actual financing costs incurred by the provider"), the Commission has no discretion under the Act.

20. The Commission's task is to ensure that the IMs implement the requirements of the Act. If the IMs achieve this there is no need to introduce incentives such as the discounted financing rate or locking in the Crown financing benefit based on the repayment schedule agreed between Chorus and the Crown.

21. As we stated in our submission, the annual benefit of Crown financing for a regulatory year in a regulatory period should be determined based on the following:[5]

    21.1. The avoided cost debt rate that takes into account the credit rating that is one notch below the actual qualifying rating of the regulated provider; and

    21.2. The forecast amount of Crown financing outstanding for that regulatory year.

22. For the sake of clarity, the forecast amount of outstanding Crown financing does not need to reflect the repayment schedule agreed between the regulated provider and the Crown. Rather, it needs to reflect the regulated provider's forecast of the outstanding obligations in relation to Crown financing. Any potential difference between the forecast and actual amount of Crown financing will then be reflected in the wash-up amount under PQ regulation, as per the Commission's proposal.[6]

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[3] Chorus submission on the Commerce Commission's (23 July 2020) *Fibre input methodologies – further consultation draft - reasons paper.*

[4] Dr Martin Lally (25 May 220) *Further issues concerning the cost of capital for fibre input methodologies*, page 8.

[5] Chorus (13 August 2020) *Appendix A: Chorus proposed amendments to the further IM determination*

[6] Commerce Commission (23 July 2020) *Fibre input methodologies – further consultation draft - reasons paper*, at [3.31]

COST OF CAPITAL

Cost of capital parameters and Type II asymmetric risk

23. Estimating the cost of capital parameters underpins the FCM principle and recognises asymmetric consequences of over- and under-investment. It is critical that these are set appropriately because if underestimated, firms will be deprived of the opportunity to earn a normal return on capital and will not be incentivised to innovate and invest. Getting the IMs right is therefore crucial if end-users are to benefit from our incentives to invest and innovate.

24. It is important, given all decisions will ultimately add up to outcomes and send incentives, to note that:

    24.1. The allowance for Type II asymmetric risk should be applied for the pre- and post-implementation periods, consistent with the recommendation presented by Sapere;[7] and

    24.2. We do not support the cost of capital parameters contained in the draft IMs for the PQ path. In particular: the asset beta should be 0.60, the credit rating should be BBB (consistent with leverage of 31%), the debt issuance cost should be 0.25% (for a 5-year term) and the 67th percentile should be applied to reduce the probability of under-estimating the cost of capital and to maintain incentives for further investment and innovation in FFLAS.

Impact of COVID-19

25. We disagree with Vodafone's assessment that the Commission should reconsider the asset beta based on the effect of COVID-19 on Chorus and comparator firms' share prices.[8] Vodafone's chart depicts share prices of comparator firms in different (overseas) markets - it does not provide information about the relative asset betas of the comparator set and Chorus. In any case, beta refers to equity returns, not share prices. This has been confirmed by cost of capital expert, Sapere.

26. We also do not agree with the underlying observation in Vodafone's submission that Chorus has been unaffected by the downturn. Stock markets around the world experienced a sharp decline in the first quarter of 2020 and since then have recovered to varying extents. Both indexes in Vodafone's chart show this pattern. The comparator firms' recovery will depend on the strength of the recovery in their home share market (among other things).

[7] Sapere (27 January 2020) *The cost of capital input methodologies for fibre,* at [79-82].

[8] Vodafone New Zealand (13 August 2020) *Submission on fibre input methodologies further consultation*, at page 5.

Aligning industry reviews

27. Parliament elected to have a separate regulatory regime for telecommunications services, reflecting the different dynamics and characteristics of this industry. We therefore do not support the proposal that the Commission should align the processes for full cost of capital reviews under Part 6 of the Act and Part 4 of the Commerce Act 1986 for other industries.

28. Furthermore, separating out the Part 6 cost of capital IM review from the rest of the Part 6 IMs means the Commission would lose the ability to consider the IMs as a whole package in order to determine whether they achieve the section 162 purpose statement and reflect the Commission's economic principles. We support Vector's position that the proposed alignment would undermine the certainty in the respective regulated regimes.

29. Notwithstanding the above, and as discussed in our submission on the Revised Paper, it is important that the Commission ensures the cost of capital parameters are fit for purpose. To this end, we would support bringing forward the Part 6 cost of capital review if appropriate given the current economic environment.

COST ALLOCATION

30. It is important to ensure the cost allocation framework is workable and provides certainty and appropriate cost and asset value recovery, in line with the economic principles that underpin the regime. We maintain our position that there should be no shared cost cap.[9] In its current state there is considerable uncertainty about the scope of the cap and how the cap would apply. We agree with the Commission's proposed materiality threshold if a shared cost cap is imposed. However, imposing additional constraints on the materiality threshold will also distort future investment decisions.

Shared cost cap application

31. FFLAS and its end-users benefit from sharing copper infrastructure.[10] Any shared cost cap should not limit justifiable cost recovery or retrospectively reduce those benefits. The draft IMs require us to use justifiable causal and proxy allocators to allocate shared costs and asset values, consistent with the ABAA approach - and we are preparing our first regulatory expenditure proposal on this basis.

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[9] Chorus (28 January 2020) *Submission on Fibre input methodologies: Draft decision – reasons paper dated 19 November 2019 and Draft fibre input methodologies determination 2020 dated 11 December 2019,* at [186].

[10] Commerce Commission (19 November 2019) *Fibre input methodologies: draft decision - reasons paper*, at [3.166].

32. It's unclear what hypothetical scenario the Commission wants to test via the application of a shared cost cap.

33. There is also economic rationale for common costs to exclude any costs that are incremental in providing non-FFLAS. As we have previously noted, costs that are identified as directly attributable to non-FFLAS services are already removed and would not be subject to the cap.[11]

34. If the shared cost cap is imposed, we're concerned this would introduce uncertainty about how the shared costs are to be recovered and how the cap is applied. Further to our previous submissions,[12] we propose a workable shared cost cap must:

    34.1. Only be used for new services. The ordinary objective of these type of tests is to assess whether a new (usually unregulated) service will bear at least the incremental cost that it causes. As noted above, new services benefit from reusing assets since this provides the opportunity to reduce cost below the standalone cost, and equally FFLAS will benefit if that new service bears anything more than the incremental cost it causes;

    34.2. Not apply retrospectively. Applying a shared cost cap to copper costs does not provide any additional incentives to reduce costs that have already been incurred. Additionally, these costs are largely unavoidable even in a hypothetical scenario since we are still subject to regulatory obligations for our copper access services, which means there are practical limitations on reducing shared cost; and

    34.3. The assessment of avoidable cost must be based on objective data, rather than hypothetical scenarios; i.e. the cap should only apply where there is data to show if a shared cost is avoidable. If this is not the case, then there will be considerable uncertainty about the scope of the cap and the nature if hypothetical scenarios are considered. For instance, the scope of the cap becomes uncertain in the post-implementation period if the value of shared costs are capped based on a hypothetical removal of copper services since we can only guess which costs could be avoidable, rather than observe those that are actually avoidable. This problem of using a hypothetical scenario is exacerbated in the pre-implementation period where the assessment becomes more speculative. It also appears at odds with the design of the regime which seeks to align with the real world and not hypotheticals.

Materiality assessment for the shared cost cap

35. We do not support a proposal to include further cost allocation constraints. It is premature and unjustified to consider introducing a second threshold assessment before the regime has even begun, and any actual risk has been clearly demonstrated.

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[11] Commerce Commission (19 November 2019) *Fibre input methodologies: draft decision - reasons paper*, at footnote 115.

[12] Chorus (28 January 2020) *Submission on Fibre input methodologies: Draft decision – reasons paper dated 19 November 2019 and Draft fibre input methodologies determination 2020 dated 11 December 2019,* at [189].

In any case, genuine sharing of assets or costs between services is efficient and therefore good for end-users. It does not seem appropriate to begin with the premise that sharing will lead to inefficiencies and introduce constraints that will deter innovation and risk benefits being passed on to end-users. Therefore, we do not support a proposal such as Spark's.[13]

36. Imposing additional constraints will also artificially reduce incentives to innovate and provide new services. Innovation and investment in new services, especially those that reuse FFLAS assets, benefits end-users by reducing the amount of cost that needs to be recovered by FFLAS.[14] This could also improve competition in other markets, which will benefit from the lower costs afforded by asset reuse.

TIMING OF COMMISSIONED ASSETS

37. We support the Commission's revised decision that assets will enter the RAB when they are commissioned, consistent with the electricity distribution services IM under Part 4. This means that assets will enter the unallocated RAB when they are available for use with respect to FFLAS. This is consistent with the definition applied under GAAP and is required to ensure the expectation of *ex-ante* FCM is maintained. We note Enable and UFF also support this approach.[15]

38. We disagree with Vodafone's view that assets should depreciate when they become available but not enter the RAB until they actually are used to provide FFLAS. That approach is inconsistent with the principle of real FCM since the depreciation of FFLAS assets outside of the RAB would mean that some value would be excluded from recovery (i.e. result in considerable under-recovery).

39. For clarity, this does not distort the allocation of costs where assets are reused for FFLAS. Only shared assets that are subsequently allocated to FFLAS are included in the allocated RAB and therefore only the proportion of depreciation that is allocated to FFLAS is recoverable.

REGULATORY FRAMEWORK

40. As discussed in our submission on the Revised Paper, Chorus supports the following key components of the regulatory framework. We reiterate these points in response to other submissions.

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[13] Spark NZ (13 August 2020) *Fibre Input Methodologies: further consultation draft Submission*, at [29].

[14] Commerce Commission (19 November 2019) *Fibre input methodologies: draft decision - reasons paper*, at [3.147]

[15] Enable and UFF submission (13 August 2020) on the *Fibre input methodologies – further consultation draft - reasons paper*, at [7.1].

FFLAS classes

41. We support distinguishing between FFLAS subject to PQ and FFLAS subject to information disclosure (**ID**), as well as ID-only FFLAS given there are specific rules for depreciation and cost of capital. We also support the Commission's decision not to impose further FFLAS classes until after the first regulatory period. If this changes in the future, a clear need should be identified, and the purpose should be outlined for workability and certainty.

42. We note Vocus considers it appropriate for the Commission not to exclude the possibility other services might be included within FFLAS over time given the dynamic nature of telecommunications services and markets. We agree, and we will need to determine whether any new services we propose to introduce meet the definition of FFLAS.

43. However, determining which services are FFLAS is purely an exercise of statutory interpretation and not a matter of discretion. A service cannot change from being FFLAS to non-FFLAS (or vice versa) without a change to the regulations under section 226 or definitions set out in the Act.

Scope of FFLAS

44. We maintain our view in previous submissions that transport / backhaul, network services and new property development are not FFLAS under the Act. Enable and UFF also support the view that new property development services cannot be considered FFLAS as they are not telecommunications services as defined in the Act. They also agree that network services are not FFLAS. We agree with the two-part method they propose for determining FFLAS is required to determine if a service is FFLAS.

45. As discussed in our submission on the Revised Decision, notwithstanding whether a service is or isn't FFLAS under the Act the Commission will have oversight of these insofar as they involve costs or revenue associated with FFLAS. For example, costs and revenue/contributions related to the deployment of new fibre access network will be accounted for under the regulatory framework and governed by expenditure proposals.

46. We reiterate that there are no reasonable policy arguments for including new property developments, which are currently unregulated, within the scope of regulated services. We agree with Vodafone's statement that property development services are an optional add-on service that could be performed by a number of service providers.

Specification of terms

47. Under the Act, Chorus must provide regulated anchor services and direct fibre access services which may include service descriptions.[16] Outside of these services, Chorus has freedom to supply other FFLAS without regulated terms and specifications.

[16] Telecommunications Act 2001 as amended, sections 227 and 228.

Vector's proposal to apply a standard terms determinations approach under Part 6 is simply wrong and will distort competition rather than promote it.

48. We note the Commission has already made it clear that it does not consider requirements for wholesale services agreements between third parties to be within the scope of the quality IM, or price-quality and information disclosure regulation.[17] We agree with the Commission's position. Detailed reasons why service specifications and non-price terms are not appropriate under IMs, ID or PQ are set out in our cross-submission on the Commission's Draft IMs Determination.[18]

[17] Commerce Commission (19 November 2019) *Fibre input methodologies - draft determination reasons paper*, at [3.1486].

[18] Chorus (17 February 2020) *Cross-submission in response to the Commerce Commission's Fibre input methodologies: Draft decision*, at [36].