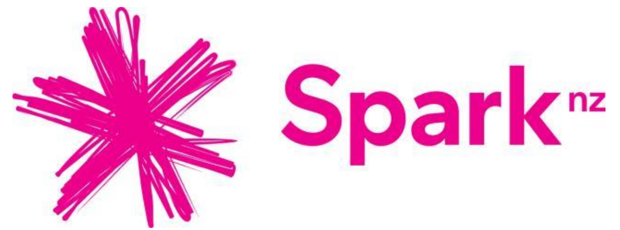

Further consultation draft (initial value of financial loss asset)

Submission | Commerce Commission

10 September 2020

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Executive summary

Financial losses

The Commission is tasked with identifying financial losses incurred by the provider in providing fixed fibre access services under the UFB initiative. While the Commission proposes to look across existing and UFB deployed assets to ensure Chorus is kept whole, Chorus proposes that the Commission look back to parties 2011 expectations and commercial arrangements to guarantee .

However, when you work through section 177 in its entirety, we consider that the scheme of the section directs the Commission to consider a narrow definition of losses. That is, only losses incurred when incremental investment is made to meet the requirements of the UFB Initiative, not losses that may be incurred more broadly or losses that may be incurred as a result of opportunity costs arising from the employment of assets in providing UFB services.

Vodafone, Vocus, Trustpower and 2Degrees have all urged the Commission to consider the s177(2) limitations and adopt a narrower incremental to UFB approach to assessing financial losses[1].

Section 177(2) provides specific guidance that losses must have been incurred in the provision of fibre services under the UFB initiative. Section 177(3) goes on to direct the Commission to take into account only unrecovered returns on *investments made under the UFB initiative* [our emphasis]. Again, this section points to investments and returns specific to UFB. As an interpretative guide it points further to a narrower approach to losses and supports the argument that the "losses" relate only to losses arising from the incremental costs of employing a service to provide UFB services.

Section 177(4) makes it even clearer that losses should not be considered broadly, stating that it is not the intention that LFCs should be protected from all risk of losses. Finally, section 177(5) makes it clear that direct cost of meeting the UFB requirements constitute losses for the purpose of this section. While Section 177(5) is framed as an "avoidance of doubt" provision, when read in the broader context of section 177, it helps to demonstrate that the emphasis is on which costs are direct costs to participate in UFB and therefore form part of the legitimate consideration set for the Commission. It does not suggest that direct and indirect losses could all form part of the consideration set.

A focus on financial losses incurred as a consequence of participating in UFB is consistent with the policy process which sought to avoid controversies associated with looking back to identify unrecovered returns, while ensuring specific UFB investments were recognised in the new regulatory framework.

We acknowledge Commission concerns that there may be legitimate expectations relating of continued returns on copper network assets[2], that copper network asset values would be under or over-recovered[3] or that an incremental approach may discourage future participants from re-purposing and sharing of assets in infrastructure bids[4]. However, these are wider issues that need to be considered in the context of an overall framework that doesn't seek to revisit past recoupment of cost, recognises existing assets going forward as they are employed to provide FFLAS and requires the Commission to review copper regulation by 2025. There is no evidence that these concerns are real.

The proposed approaches leave the Commission with the impossible and controversial task of looking back to identify the degree to which these assets have been recouped, or unpicking 2011 provider expectations and commercial models. This is the sort of controversy that s177 was specifically intended to avoid.

[1] Summarised in the draft reasons paper at 2.11 to 2.18
[2] Draft reasons paper at 2.77
[3] Draft reasons paper at 2.81
[4] Draft reasons paper at 2.82

We believe the draft reasons paper has gone far beyond the financial losses exercise anticipated s177 and the Commission should reconsider its approach, tying the wording of the IM closer to the incremental nature of the assessment anticipated by the Act.

Cost allocation

We agree with the draft that there is nothing to preclude pre-2011 assets from being considered for the financial losses assessment, provided the asset is consistent with the s177(2) limits and does not result in a double recovery or excess returns.

We further share the Commission's concerns that Chorus has strong incentives to maximise the allocation of costs into the financial losses' asset (**FLA**), and the FLA assessment itself has problems due to information availability and asymmetry concerns.

The Commission has requested feedback on how it might mitigate these concerns. The Commission could consider:

- As above, amending draft input methodologies to bring them close to the words of the Act to minimise disputes by:
  - Specifying that that the relevant costs are those incurred as a consequence of providing FFLAS under the UFB initiative, and
  - Clarifying that the avoidance of double recovery and windfall gains will be a specific consideration when selecting the cost allocator (in addition to cost causality).
- Applying an overall cost allocation cap for any shared costs and assets based on the share of UFB fibre connections relative to overall connections. This would seek to approximate the implied allocators of the FPP model.
- Develop benchmarks as part of the price quality determination process to indicate whether the results are falling within valid range. For example, benchmarking operating costs against pure fibre or access providers to indicate whether the standalone cost has been exceeded, or applying the TERA cross check to confirm no material under or over recovery of costs.
- How it might ensure a wide and informed consultation process for determining the FLA, maximising transparency of claimed costs, revenues and cost allocators.

Introduction

1. Thank you for the opportunity to comment on the further consultation draft (initial value of financial loss asset) reasons paper (**the draft reasons paper**).

2. The reasons paper seeks further feedback on clarification and change the Commission proposes to make relating to the determination of the financial loss asset (**FLA**) under s177(2) of the Act.

3. In this submission, we comment on:

    a. Conceptual basis for the financial losses' asset.

    b. The allocation of existing assets and double recovery, and

    c. Protections against over-allocating shared costs.

Conceptual basis for the financial losses' asset

4. At this stage in the process, the parties don't appear to have a consistent and aligned approach to assessing financial losses and the Commission may wish to consider further the role of s177(2) is in the broader context of s177 and the regulatory framework.

Principles that underpin financial losses

5. Commission draft proposals and submissions suggest very different views of what s177 is seeking to achieve and these views can only be reconciled by applying consistent financial loss principles. For example, the parties place differing importance on claimed investor expectations:

    a. Dr Lally notes that financial losses comprise the ex post difference between the revenues and costs incurred by the provider in providing regulated fibre services[5] and recent Commission proposals draw on evidence of utility firms' actual financing practice for calculating the debt premium.[6]

       However, at the same time as drawing from actual practice to estimate losses incurred, the Commission entertains arguments that considerations of investor business case expectations[7] and recoupment of legacy asset costs[8] should influence financial losses.

    b. Chorus and Sapere[9], Chorus economic advisors, argue that financial losses should be applied in a way that ensures expected 2011 separation business case and UFB commercial arrangements outcomes are met, but use Chorus' actual credit rating when doing this. Enable submits that FLA must ensure the initial target return on investment[10].

6. We do not support Chorus' proposed approach. That approach leaves the Commission with the impossible task of sensibly reconciling achieved value against the original business case and UFB contracts, inflating or deflating the RAB to reflect residual values. The Commission would

[5] Dr Lally, 25 May 2020, *Further issues concerning the cost of capital for fibre input methodologies* at page 3
[6] Commerce Commission, 13 August 2020, *Further consultation draft (initial value of financial loss asset)* at paras 3.10 to 3.21
[7] Draft reasons paper at 2.76 and 2.79
[8] For example, draft reasons paper at 2.79
[9] Sapere for Chorus at para 16
[10] Enable submission on Dr Lally's export report, 20 August 2020 at 2.8

be in the position of second guessing the Crown contracts and facing calls for hypothetical returns on subjective expectations. For example, the Scheme Booklet sets out that the primary motivation for participating in UFB was that partnering with the Crown to deploy the fibre network was expected to deliver greater value than not partnering and being over-built by a Government backed competitor. As the Commission rightly observes *it is unlikely that in 2011 investors' expectations were framed in terms of what a BBM with a 10-year horizon might have delivered.*[11]

7. More importantly, it is not the intention of section 177 that Chorus is protected from all risk of not fully recovering financial losses over time.[12] Chorus and LFCs' proposed approach is unlikely to be consistent with the Act. The asset valuation guidance set out in section 177 was intended to avoid the controversy and complexity of revaluing assets, yet this is effectively the exercise Chorus now proposes.

8. However, at this stage, it is unclear what s177 financial loss outcomes the Commission is expecting to see.

Initial valuation of assets and financial losses

9. As it stands, we believe the Chorus and draft reasons paper proposed approaches likely go beyond that envisaged by s177 of the Act.

10. Vodafone, Vocus, Trustpower and 2Degrees all urge the Commission to consider the s177(2) limitations in its approach to FLA and allocation of shared costs.[13]

11. We agree. While the Commission has some discretion in identifying costs and determining losses, it should look to the words and broader purpose of s177. S177 was the product of a long policy development process that reflected:

    a. A conscious move away from the Part 2 TSLRIC model to a new fit for purpose utility regulation approach[14].

    b. A desire to avoid contentious asset valuation processes necessary to establish the initial RAB by providing specific legislative guidance to the Commission, and

    c. Investor concerns that early UFB investments should be recognised in any new regulatory regime. These concerns were considered as early as the initial 2011 reforms [15] and led to the May 2017 policy decisions[16]. Assets employed to provide FFLAS would be valued in 2020 at depreciated actual/historic cost and to promote the policy of widespread deployment of fibre and take up

    > 28.3 the value of the opening RAB is increased by the financial losses incurred by suppliers prior to 2020 to the extent that those losses arose from meeting specific requirements under the UFB or UFB extension programme contracts (including the timeframes for rollout and the prices that can be charged);

12. Accordingly, when you work through section 177 in its entirety, that the policy approach is reflected in the scheme of the section that directs the Commission to consider a narrow

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[11] Commission draft at 3.29
[12] Section 177(4) Telecommunications Act 2001
[13] Summarised in the draft reasons paper at 2.11 to 2.18.
[14] Government release 2016 www.beehive.govt.nz/sites/default/files/Fact sheet - Announcements on the future of communications regulation.pdf
[15] Officials' report on the Telecommunications (TSO, Broadband, and other matters) amendment bill 1 April 2011. https://www.parliament.nz/resource/en-NZ/49SCFE_ADV_00DBHOH_BILL10470_1_A180435/4a786161ea4c6a48f5c81c1124a2d2d46fb32b9d
[16] Cabinet Minute May 2017 **EGI-17-MIN-0087.01**

definition of losses. That is, only losses incurred when incremental investment is made to meet the requirements of the UFB Initiative, not losses that may be incurred more broadly or losses that may be incurred as a result of opportunity costs arising from the employment of assets in providing UFB services.

Section 177(1) provides that asset employed to provide FFLAS will be valued on the basis of depreciated actual or depreciated historic costs

13. The Government decided, after significant policy debate, that the fibre RAB would be determined by the Commission on the basis of the unrecovered historic costs incurred by the regulated supplier.[17]

14. Accordingly, s177 sets out that the initial value of fibre assets is cost to construct or acquire the assets or, if the fibre asset was owned by Chorus before 1 December 2011, the value in the financial statements (adjusted for accumulated depreciation or any impairment losses (applying accounting rules)). Fibre assets are assets employed in the provision of fibre fixed line access services (**FFLAS**).

15. This was a conscious choice to "draw a line" under asset values, avoiding controversial arguments relating to economic value or overall values of wider arrangements. The approach does not seek to calculate the unrecovered costs of existing 2011 assets. There were concerns whether unrecovered costs could even be calculated and, even if they could, whether it be appropriate to do so as that would result in a RAB that either claws back past profits or protects the firm from the adverse consequences of past risks[18].

16. Therefore, proposals have the effect of revaluing assets through the FLA on the basis of expectations or to provide a "seamless" transitioning of the prior regulatory framework[19] are concerning. This exercise would likewise require an impossible assessment of what the relevant expectations might have been and degree to which these expectations have been recouped.

Section 177(2) provides specific guidance that losses must have been incurred in the provision of fibre services under the UFB initiative

17. Section 177(2) specifically provides for a subset of assets – those with costs incurred due to participating in the UFB initiative. It ensures that earlier losses on these investments are recognised in the new regulatory regime, without requiring a wider revaluation.

18. As BBM regulation was being applied part way through the life of UFB investments, financial losses may have incurred during the initial period of operation. For example, while financial depreciation rates reflect the return of capital to investors, S177(2) recognises that the actual recovery of the capital deployed may differ. Any deficit or surplus would be recognised as an asset in the RAB.

19. Therefore, financial losses have the specific purpose of recognising the investment incurred by parties as a consequence of their participation in the UFB initiative. Further, if 100% of an asset is used to provide UFB services and the costs to deploy or acquire that asset is not recovered through UFB revenues through to the implementation date then a loss can be recorded. If however the asset is shared between UFB and other services and that shared use changes over

[17] Cabinet minute [EGI-16-MIN-0361] at 24 and discussed in the associated cabinet paper from para 32
[18] Chorus explored a comparable concern relating to efficiency in its February 2017 submission, *Submission on post-2020 review discussion paper*, at para 52
[19] Chorus 3 September 2020, *Chorus cross-submission on the Commerce Commission's fibre input methodologies –further consultation draft reasons paper* at para 3

time, only the losses that can be attributed to that portion of the asset used for providing FFLAs forms part of the losses provided for in section 177.

20. We do not believe that the very specific task set out in s177(2) was intended to be applied in a way so that guaranteed the recovery of costs across UFB and other services or imply a revaluation of RAB assets. In fact, section 177(4) goes on to make that clear.

<u>The remainder of S177 reinforces that financial losses are those incurred under the UFB initiative</u>

21. Finally, s177 reinforces that there must be a clear nexus between the financial loss assessment and provision of FFLAS under the UFB initiative:

    a. Section 177(3) goes on to direct the Commission to take into account only unrecovered returns on *investments made under the UFB initiative* [our emphasis]. Again, this section points to investments and returns specific to UFB. As an interpretative guide it points further to a narrower approach to losses and supports the argument that the "losses" relate only to losses arising from the incremental costs of employing a service to provide UFB services.

    b. Section 177(4) makes it even clearer that losses should not be considered broadly, stating that it is not the intention that LFCs should be protected from all risk of losses.

    c. Finally, section 177(5) makes it clear that direct cost of meeting the UFB requirements constitute losses for the purpose of this section. While Section 177(5) is framed as an "avoidance of doubt" provision, when read in the broader context of section 177, it helps to demonstrate that the emphasis is on which costs are direct costs to participate in UFB and therefore form part of the legitimate consideration set for the Commission. It does not suggest that direct and indirect losses could all form part of the consideration set.

22. Accordingly, s177(2) and broader framework limits the relevant costs to actual costs incurred by the provider that are incremental to the UFB initiative.

23. In this context, we believe the currently proposed approaches and considerations would extend financial losses far beyond the narrow limits anticipated by s177. For example, at various stages through the process, Chorus has asked the Commission to solve through the FLA for the 2011 business case, the UFB commercial agreements, and for a retrospective application of the BBM and residual copper assets. Alternatively, the Commission's draft cost allocation approach is based, in part, on concerns that the FLA should be applied in a manner that ensures Chorus receives a normal return on its investment in reused and common copper assets[20] and that existing assets are ascribed value to reflect their opportunity cost[21].

24. The FLA is not a mechanism to guarantee past returns or ensure returns across copper and fibre businesses, it is about costs incurred to provide FFLAS services under the UFB initiative.[22] These approaches would further leave the Commission with an impossible task akin to a revaluation exercise of forming a view of returns across both multiple regulatory periods and multiple businesses. The sort of complexity and controversy that s177 sought to avoid.

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[20] Commission November 2019 draft reasons as 3.379.5, and 3.480 to 3.488
[21] Draft reasons paper at 2.75
[22] The Commission draft approach gives significance to a "transition period" where return across copper and fibre is given weight from para 2.65

Section 177(5)

25. The draft reasons paper notes that s177(5) was introduced in response to concerns that the Commission might review historic costs for efficiency. Accordingly, the subclause is an enlarging (ensuring costs incurred in meeting specific UFB requirements are captured) rather than restricting (to preclude pre-2011 assets) provision[23] and not an instruction to take an incremental cost approach to allocating costs to the UFB initiative.

26. While the draft reasons paper approach is based, in part, on the Departmental Report to the Select Committee which refers to a requirement that costs be efficiently incurred[24].

27. However, the earlier May 2017 Cabinet paper to which the departmental report may have been referring considered a much more specific efficiency issue.[25] The Minister noted that (using the same text at paragraph 38[26])

> 38 I have also re-considered the requirement that costs of regulatory assets must have been 'efficiently incurred'. Chorus and the LFCs have argued that there is no justification for a backward-looking efficiency test to be applied to the opening value of regulated assets at 2020. They contend that the contract with Crown Fibre Holdings (CFH) required them to roll out in specific ways (such as passing schools and hospitals first) to meet policy objectives. In hindsight, the Commission may not consider this to be the most efficient way of building the network. The contracts were competitively tendered and CFH subjected them to intense scrutiny throughout the deployment process.
>
> 39 I agree that a backward-looking efficiency test is an unorthodox element in a BBM regulatory approach, which is concerned with ongoing incentives to innovate, invest and improve efficiency. Assessing the efficiency of past investment has no direct effect on future incentives and arguably simply results in a transfer of value from suppliers to consumers with no efficiency impact.
>
> 40 I therefore propose to omit a specific 'backward-looking' test, which reviews the efficiency of past investments. This will align the proposal with Part 4 of the Commerce Act where the Commission did not consider the efficiency of historic investment.

28. Cabinet had earlier agreed in December 2016 principles for determining costs incurred for the RAB. Following the Minister's reconsideration, Cabinet agreed to omit references to efficiency from the earlier decision[27].

> 28 agreed that in determining costs incurred for the RAB, the Commerce Commission must have regard to the government's objectives of accelerating the widespread deployment of fibre-to-the-premise and encouraging end-user uptake, including by ensuring that:
>
> > 28.1 [~~efficient~~] costs incurred as a direct result of meeting specific requirements in UFB or UFB extension programme contracts are included;
> >
> > 28.2 [~~efficient~~] costs of 'standard' and 'non-standard' installations are included;
> >
> > 28.3 the value of the opening RAB is increased by the financial losses [~~efficiently~~] incurred by suppliers prior to 2020 to the extent that those losses arose from meeting specific requirements under the UFB or UFB extension programme contracts (including the timeframes for rollout and the prices that can be charged);
> >
> > [annotated for words subsequently deleted from the earlier 2016 by the May 2017 reconsideration]

[23] Commission draft at 2.36
[24] Commission draft at 2.37
[25] The referenced paragraph appears at para 38 of the May 2017 Cabinet paper.
[26] At para 2.37 of the draft
[27] Cabinet paper reference [EGI-16-MIN-0361]

29. While references to efficiency were deleted, there was no change to the policy principle that financial losses are incurred to meet specific requirements under the UFB programme contracts.

30. Therefore, if anything, policy decisions point to s177(5) requiring that financial losses incurred relate to meeting specific requirements, rather than being an enlarging provision as suggested in the draft. Section 177(5) may be better viewed as a reminder that the relevant costs for asset valuation purposes (including past losses) are those incurred as a direct result of meeting specific requirements of the UFB initiative, i.e. ensuring relevant costs are captured, but equally ensuring that care is taken to reject costs that are not specifically incurred to meet specific UFB requirements.

The approach to existing assets (including pre-2011)

31. The draft reasons paper also considers whether pre-2011 assets should form part of the s177 financial loss assessment. The draft reasons paper concludes that the Commission can consider pre-2011 assets for a number of reasons, i.e.

    a. There is nothing in the language of s177(2) that precludes the Commission from taking pre-2011 assets into account, and therefore it is able to exercise its judgement to give best effect to s162[28].

    b. Further, there is no express exclusion of pre-2011 assets in the wording of s177(3) and, therefore, it is not constrained from taking in to account these assets even if these investments do not qualify as "investments made by the provider under the UFB initiative"[29].

    c. Finally, several elements of s177 appear to suggest it permits the inclusion of pre-2011 assets in the calculation, including the s177(1)(a) reference to pre-2011 assets, s177(2) wording that losses are incurred "for the period" suggests a GAAP accounting approach, and the perverse implications of taking strict temporal approach to losses period costs[30].

32. We agree that pre-2011 assets could logically contribute to the FLA provided the assets are consistent with the s177(2) limits. The only distinction relating to when assets were constructed is in s177(1) which providers that while pre-2011 assets employed in the provision of FFLAS would be valued at their reported value, other assets post 2011 would be valued on that basis of construction or acquisition value (adjusted for depreciation and impairment as per financial reporting).

33. This does not mean that all pre (or post) assets should be considered for FLA purposes. For example, Chorus started to roll out the UFB network in anticipation of finalising UFB arrangements and amendments to the Act and, conceptually, the costs of these could form part of the FLA. Conversely, Chorus invested in fibre assets after 2011 that were not incurred under the UFB initiative and these costs should be excluded from the FLA.

34. However, while the draft reasons paper outlines strong reasons why pre-2011 assets could be considered for the purposes of the FLA, it does not address RSP concerns that the Commission's proposed approach recognises costs that are not consistent with the s177(2) limits. Vodafone, Vocus, Trustpower and 2Degrees all submit that s177(2) directs the

[28] Draft reasons paper at 2.28
[29] Draft reasons paper at 2.31-2.32
[30] Draft reasons paper at 2.35

Commission to adopt an incremental to UFB basis[31]. We agree, the Commission should consider its approach to identifying the relevant assets further.

Cost allocation

35. The draft reasons paper further considers the allocation of costs between FFLAS and other services. It will be necessary to allocate costs irrespective of whether the Commission takes an incremental to UFB approach. For example, Chorus has invested in assets for the purposes of the UFB initiative, and these assets have been employed to provide UFB and other services. These shared costs will need to be allocated to regulated and other services.

36. There appears to be agreement that, in allocating costs, the Commission should avoid double recovery of shared costs across copper and fibre services[32]. However, there continues to be different views on how the Commission should control for this risk.

Commission concerns with TERA proposed cross check for misstatement of costs

37. TERA has advised that where regulated controls apply to two services that shares costs, the inconsistencies between cost models raises the potential for a misstatement of costs, i.e. an under or over recovery of costs. Accordingly, the Commission should seek to align the model parameters or apply a cross check across both copper and fibre services to identify whether a misstatement of costs has occurred.

38. The draft reasons paper sets out concerns with TERA's proposed approach:

    a. TERA incorrectly assumes the FPP mode fully allocated all shared costs to copper services when, in fact, the model captures all copper and fibre demand implying a sharing of costs across that demand. In which case, the FPP approach to allocating shared costs is broadly consistent with that proposed in the draft decision[33].

    b. It fails to account for important differences between fundamentally different standard used to set regulated copper price caps from that which will apply to fibre services[34].

    c. It appears to have the effect of revisiting the TSLRIC price, clawing back some of the revenues earned by Chorus from the FPP services. Chorus revenues would be based on ducts valued at their historic cost rather than the TSLRIC standard (which was replacement cost)[35].

39. A key concern being that a pure incremental approach to calculating financial losses would risk under-recovery of costs of providing FFLAS as it fails to recognise the migration of demand from copper to fibre services. Further, excluding the cost of assets constructed prior to the UFB agreement, but used to support FFLAS, could lead to an under-recovery of the cost of these shared assets[36].

40. However, we did not read the TERA report as suggesting that any shared cost allocation to fibre services would be a double recovery and that only an incremental approach is permitted. Rather, TERA's key insight is that where you have two cost controls with fundamentally different

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[31] Summarised at 2.11 to 2.18 of draft reasons
[32] Draft reasons paper at 2.41
[33] Draft reasons paper at 2.56
[34] Draft reasons paper at 2.61
[35] Draft reasons paper at 2.62
[36] Draft reasons paper at 2.64

modelling approaches applied to services with shared costs, there is the potential for a misstatement of costs (under or over recovery).

41. TERA approach recognises that there are significant differences between the FPP and BBM cost models[37] – as observed by Analysys Mason and the Commission – and that it is these differences that can lead to a misstatement of cost. In other words, , these differences are the source of a potential misstatement of cost rather than detracting from the principle concern[38].

42. TERA suggests some practical measures the Commission could apply to mitigate potential double recovery, including prescribing the prescription and granularity with which data is provided, ensure BBM cost categories are as granular as those of the TSLRIC model and applying a double recovery cross check by, in short, comparing total costs allocated to regulated services through the BBM model to revenues across copper and fibre services.

43. While the Commission acknowledges potential double recovery of shared costs across copper and fibre, it has reservations with the proposed cross check as copper prices were not set using a BBM approach and the comparison may result in under or over recovery[39]. However, without a cross-check, we are left with no means of being satisfied that under (or over) recovery of shared costs has been addressed.

Principles underlying the proposed allocation of shared costs

44. The draft reasons paper acknowledges that bringing in pre-existing assets as shared costs raises the prospect of windfall gains and losses. Further, recognising existing assets as shared costs potential draws in the impacts of actions that pre-date FFLAS regulation and raises the issue of reasonable investor expectations.

45. Nonetheless, the Commission drew on two perspectives in concluding that the total exclusion of pre-2011 assets is not justified:

    a. Chorus' possible legitimate expectations that, for the purposes of their UFB bid, would have expected to achieve the opportunity cost of existing assets, i.e. ability to repurpose assets or sell assets to other bidders. As the opportunity cost of existing assets is not zero[40] an incremental approach to UFB fibre assets would not be appropriate[41].

    b. The residual value of these assets (value in use), i.e. the assets may have already been fully recouped[42]. However, RAB values were not assigned in the FPP and identifying any over-recovery is not straight forward[43].

46. The Commission did not need to form a final view on these matters beyond inferring that some allocation was required[44]. An underlying concern being that an incremental approach may discourage future bidders re-purposing and sharing of assets in bidding for infrastructure projects that may be subject to regulation[45]. Therefore, it rejects submissions that a pure incremental approach which would exclude pre-2011 assets is justified[46].

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[37] Discussed in detail at pages 6 to 12 of TERA's report.
[38] Discussed in detail at pages 12 to 20 of TERA's report.
[39] Draft reasons paper at 2.63
[40] Draft reasons paper at 2.74
[41] Draft reasons paper at 2.75
[42] Draft reasons paper at 2.79
[43] Draft reasons paper at 2.81
[44] Draft reasons paper at 2.76
[45] Draft reasons paper at 2.82.
[46] Draft reasons paper at 2.83

47. As noted above, it is unclear whether s177 permits the Commission to consider wider recovery of costs, whether that is to align with opportunity costs or across the residual value of existing shared assets. However, even if taking a wider approach were possible, there is nothing to suggest that this would best promote the purposes of the Act. There is nothing to suggest that:

    a. Allocating wider cost recovery to financial losses is necessary to recoup investments across the Part 2 and Part 6 regulated services. Over their lives, these assets will have been subject to no, "light handed", retail minus, TSLRIC and Part 6 regulation, and these models tell us little about the actual recovery of deployed assets.

    b. Investors overall 2011 expectations – i.e. that partnering was better than competing with Crown – have not been met.

       Vodafone provides evidence that suggests, if anything, Chorus remained highly profitable over the UFB pre-implementation period[47], suggesting that Chorus has likely over-recovered across its assets and business case expectations.

    c. Applying a specific UFB investment lens to s177(2) will discourage re-use of assets in future PPPs. Section 177(2) has a specific purpose within an overall regulatory framework. However, it is the overall framework that provides for appropriate recoupment of investment over time. In the overall framework, existing shared assets are recouped under the prior regulatory regime, in the new regime RAB as they are employed to provide FLAS and any residual can be considered in the copper regulatory review to be completed by 2025.

48. For the Commission to adopt an approach that implies significant cost for end users, it would need to establish that this approach was in end user interests. At this stage, there is nothing to suggest that this is the case.

49. The Commission intends to rely on adopting cost allocators in the price quality determination that it believes will mitigate possible double recovery. We recommend that the Commission augment this approach by amending the draft IM so that the working is closer to that required by the Act:

    a. Specifying that, for the purposes of financial losses, that the relevant costs are those that are incurred as a consequence of providing FFLAS in the UFB initiative.

    b. Clarifying that the avoidance of double recovery is a specific consideration when selecting a cost allocator (in addition to cost causality).

Protections against over-allocating shared costs

50. The Commission has further set out practical concerns relating to allocation of shared costs[48]. Chorus has strong incentives to maximise the allocation of the costs of existing assets in to the financial loss calculation, and this risk is heightened by the age of some assets, the ability to configure the network to over-allocate costs and the information asymmetries held by Chorus.

51. We agree that this is a significant concern and that applying filters to the assets and costs that could be considered shared will reduce the scope of concerns[49], i.e. applying filters relating to

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[47] Vodafone outlines that Chorus return on equity from 2011 to 2018 is 24.4% on average, allowing them to recover over $300m more than would have been possible using a Commission regulated utility return on equity. Vodafone submission on proposed approach 21 December 2018[ref] at page 3

[48] Draft reasons paper at 2.85

[49] Draft reasons paper at 2.88

geographic footprint of the UFB networks, usability, timing and allocation of costs between services.

52. Nonetheless, the choice of allocator will make a significant difference to the FLA and there are several ways that a motivated provider could disproportionately allocate costs to regulated fibre services for a windfall gain as set out in the draft[50]. The Commission sets out a number of potential tools intended to mitigate the providers incentives in the draft and requests further submission on how these might be augmented[51]. While the Commission refers to pre-2011 assets, we believe the principles apply to any existing shared asset and shared new UFB asset constructed.

53. In particular, the Commission has asked for submissions on the following points:

<u>2.101.1 Is there anything further that should be done in the IMs to be more certain about the appropriateness of cost allocation for pre-2011 assets in calculating the FLA?</u>

54. We agree that the options set out in the draft reasons are worth pursuing further[52]. However, the Commission could consider further:

    a. As above, specifying that the relevant costs for the purposes of the FLA relate to those specifically incurred as a consequence of providing FFLAS in the UFB initiative.

    b. Clarifying in the IMs that the avoidance of double recovery and windfall gains is a consideration for selecting the allocator (in additional to cost causality).

    c. Applying an overall cost allocation cap for any shared costs and assets based on the share of UFB fibre connections relative to overall connections (see below).

    d. Developing benchmarks as part of the price quality determination process to indicate whether the results are falling within valid range. For example, benchmarking operating costs against pure fibre or access providers to indicate whether the standalone cost has been exceeded[53], or applying the TERA cross check to confirm no material under or over recovery of costs.

    e. Ensuring that the Commission determines the FLA, informed by a wide consultation process and measures that increase transparency over what is proposed.

<u>2.101.2 Is there a 'rule of thumb' that could be applied for the purpose of cost allocation for pre-2011 assets in calculating the FLA?</u>

55. The Commission could apply an overall cap at the FFLAS proportion share of all connections, replicating the implied allocation of the TSLRIC model. For example, the maximum allocation of shared costs to the fibre network is the percent of actual demand it reflects of Chorus' overall demand.

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[50] Draft reasons paper at 2.93
[51] Draft reasons paper at 2.101
[52] Draft reasons paper at 2.96
[53] The Commission has previously rejected a standalone cost cap. However, a standalone cap is a standard cost allocation principle adopted in economics and the Courts. It should be a key principle for the purposes of allocating costs to the fibre network, particularly where providers have incentives to expand regulated costs.

2.101.3 Are there properties of pre-2011 assets that would impact the rules for cost allocation in calculating the FLA relative to post-2011 assets?

56. There is likely to be significant excess capacity and this excess capacity shouldn't be allocated to the fibre network RAB. The Government decided to specify a separate fibre RAB due to concerns that a single copper/fibre RAB would bring existing inefficiencies into future fibre services.

57. While there has been a concern that the Commission not assess UFB deployed assets for efficiency (which may have been inefficiently deployed due to UFB requirements), this does not extend to the efficiency of assets that were not deployed in order to meet the requirements of the UFB initiative. The Commission should ensure that assets are not inefficiently allocated into the fibre RAB.

2.101.4 Should there be a cap on the allocation of pre-2011 assets to the FLA during the transition period?

58. The Commission could apply an overall cap at the FFLAS proportion share of all connections, replicating the implied allocation of the TSLRIC model. For example, the maximum allocation of shared costs to the fibre network is the percent of actual demand it reflects of Chorus' overall demand.

Other

59. The Commission has also proposed a number of changes to financial model used to assess past loses.

Underlying financial assumptions

60. The Commission proposes to draw on evidence of utility firms' financing practice and adopt a risk-free rate with a five-year term in each year's WACC[54].

61. We agree the Commission should look to evidence of actual practice when setting return parameters. The Commission is required to make decisions that best support the purposes of the Act, but the Commission should also look to costs incurred for the purposes of the financial loss asset. For example, the Commission observes that the cost of debt changes as the debt portfolio is refinanced periodically, and firms have incentives to keep their costs of debt as low as possible to remain competitive[55].

62. However, to consistently apply the principle, the Commission should look at re-setting the risk-free rate after 5 years. For example, the 2012 rate should be reset at 2017 when it would be expected to be refreshed rather than fixed until implementation day. This would be a single adjustment to the indicative model released by the Commission.

Crown capital contributions that are not Crown financing

63. The Commission revised its decision on the funding of non-standard connections in the July 2020 updated draft reasons paper[56].

64. The Commission concluded that the commercial arrangement between the Crown and Chorus (in particular, CIP's use of liquidated damages, implicitly applied as a grant to UFB partners)

[54] 3.10
[55] 3.32
[56] 3.55 of July 2020 draft

should be treated as capital contributions[57]. The Crown's surrendering of its liquidated damages claims constituted consideration, therefore bringing it within the ranging definition of a "capital contribution" for the purposes of the determination.

65. We agreed with the Commission's approach to capital contributions. Crown UFB funding relates to the specific UFB equity and debt funding arrangements, and this does not limit recognition of other Crown grants and concessions. The Commission should be alive to adjusting for RBI and other Crown grants (liquidated damages) in PQ determinations[58]. However, Chorus has submitted that it disagrees with approach and intends to engage further on the issue through the PQ determination process[59].

66. The Commission has proposed draft amendments to input methodologies[60] to clarify that capital contributions include the $20 million fund established by Chorus for financial loss year 2013 in respect of non-standard installations.

67. We support the Commission draft approach. However, the Commission may wish to further clarify that capital contributions from other parties *includes any other Crown contribution except where it is Crown funding as defined by the Act*.

68. We believe that substantive assets have been funded through Crown funding over time, and these contributions should be recognised in the RAB in the same way as any other capital contribution.

[End]

[57] 3.63
[58] 3.55 of July 2020 draft
[59] Para 48 of sub on updated draft.
[60] [page 12 of the financial loss consultation draft IM]