Submission on Fibre Regulation – Process and Approach

14 October 2020

CHORUS

Introduction

1. This is Chorus' submission on the Commission's, *Fibre Information Disclosure and Price-Quality Regulation – proposed process and approach for the first regulatory period* (**Approach Paper**), dated 15 September 2020.

2. We welcome the Commerce Commission's (**Commission**) commencement of its price-quality (**PQ**) and information disclosure (**ID**) regulation - the second phase of the fibre regime development as most of the input methodologies (**IMs**) are now finalised.

3. At this early stage in the process we have responded on matters of key concern. We look forward to further engagement with the Commission as it develops this phase of its work.

Context

4. The introduction of PQ and ID regulation of fibre fixed line access services (**FFLAS**) under Part 6 of the Telecommunications Act 2001 (**Act**) was not a response to a particular problem in the market but a mechanism to transition from a contractual arrangement to a regulatory model.

5. In 2011 we signed Ultra-Fast Broadband (**UFB**) contracts with Crown Infrastructure Partners (**CIP**) that, by design, created strong incentives to deliver long-term benefits for our customers and improve the suite of connectivity options for New Zealanders. In addition, our Deeds of Undertakings (**Deeds**) and business line restrictions guide our service delivery.

6. From late 2011, following shareholder approval of a demerger, Chorus changed from a business unit of the vertically integrated Telecom to become a stand-alone listed company oriented to fibre through a build and then transition process. Build under UFB contracts completes in 2022, but connection to the network and transition from copper is ongoing. Incentives to innovate and invest ahead of market demand have been with us since 2011 and will continue under PQ and ID regulation.

7. PQ and ID regulation seek to both replace CIP's oversight of FFLAS and implement the first fibre wholesale revenue cap under a building block model (**BBM**). This means that the determination of Chorus' initial regulated asset base (**RAB**) is unique and is to be determined within the context of a demerger and investment ahead of demand.

8. In designing and implementing the overall revenue cap, with the potential for price-capped specified services and other additional layers of regulatory constraints, the Commission must ensure that as a whole the regime is sustainable and works in favour of end-users, while providing a fair return to investors.

9. In particular, care needs to be taken to avoid unintended consequences for both end-users and our investors who took on contractual and construction risk to deliver the vision to keep New Zealand future-proofed through the UFB network for a large geographical footprint.

10. The Commission's recognition of the risk investors took on is being watched closely and will send long term signals about the attractiveness of investment in New Zealand and partnerships with the Crown. The context of the establishment of a new dual-listed wholesale-only company undertaking a generational upgrade of critical infrastructure must be recognised by the Commission as it establishes this regulatory

regime. A perception that the regulator has ignored this context, or not fully appreciated the risk faced by investors, would send negative signals to investors. This in turn will impact the long-term benefit of New Zealand consumers.

11. As a fibre access wholesaler operating within a broader telecommunications market, featuring competing alternative technologies, we're very different from other regulated industries that have traditionally been the subject of price and/or revenue caps supplemented by stringent quality standards under a PQ and ID framework.

12. This includes differences such as our need to:

    12.1. Generate uptake of a relatively new technology, while operating within constantly changing market dynamics and alternative technologies within a broader telecommunications market;

    12.2. Deliver a congestion-free network (absent any regulatory requirements to do so) and innovative new services to keep up with ever increasing consumer usage and expectations;

    12.3. Satisfy the expectations of investors who accepted the proposal for public-private partnership and committed their funds with the long-term view of investment under the UFB initiative. While the regime may contain mechanisms for addressing certain forecasting risk, every decision and signal the Commission sends impacts the assessment by debt and equity holders about infrastructure investment in NZ and incentives in this market. To such end, we continue to advocate for a transition to PQ & ID regulation that delivers no shocks for investors and end-users;

    12.4. Provide a level playing field to generate and promote retail competition over our network, while some of our largest customers offer competing alternative products;

    12.5. Deliver on our contractual terms, a price capped product suite with associated Service Level Agreements (**SLAs**); and

    12.6. Comply with a suite of constraints in the wider telecommunications framework, such as the Deeds, business line restrictions, potential price-capped specified services (i.e. anchor and DFAS services), voluntary Telecommunications Carrier Forum (**TCF**) Codes (i.e. Product Disclosure Code) and retail service quality.

13. These unique features of our telecommunications sector and the fibre regulatory framework need to be carefully considered by the Commission as it develops its FFLAS PQ and ID determinations.

Incentives

14. We encourage the Commission to recognise that since Chorus' inception, we have operated under strong commercial incentives and contractual requirements with CIP that at their core have sought to promote the long-term benefits of end-users.[1] In doing so, we have successfully managed risks and incentives that do not govern standard regulated infrastructure investments.

[1] Controller and Auditor General (June 2016) Crown Fibre Holdings Limited: Managing the first phase of rolling out ultra-fast broadband.

15. This and the wider context in which we operate (described above), means that the theoretical framework that traditionally underpins a PQ regime - depicted in figures 3.1 and 3.2 of the Approach paper – do not accurately reflect either our incentives or our market reality.

16. The Commission notes that PQ regulation creates incentives to better align the interests of regulatory providers with those of end-users.[2] It also states that in the first regulatory period Chorus might have higher incentives for "regulatory gaming" as a result of information asymmetry between the regulator and the regulated supplier.[3]

17. We disagree with the Commission's statements about the potential for "regulatory gaming" because we have been operating under intense scrutiny since we began to build the fibre network. Chorus has put significant effort into encouraging fibre uptake, developing new products and making customer experience improvements. This effort has been driven by natural commercial incentives that are in existence now and will continue post 2022. From our perspective, there is a greater risk of regulatory distortion than of regulatory gaming, particularly within a highly dynamic telecommunications sector.

18. The Commission also considers that information asymmetry is compounded with the incentive and potential ability for Chorus to set baselines for expenditure and quality that favour us, but not end-users.[4] We disagree given our context of tight financial conditions and a focus on build.

19. Our reality has always been that price, expenditure and quality must work together to maximise value for our customers and end-users. We want to encourage our customers and end-users to use and value our fibre services over any existing or future alternative technologies.

Establishing the new regime

20. The Approach Paper demonstrates that there is a substantial amount of work and consultation planned over the next year to develop and finalise the regime.

21. This involves several moving elements, which will develop at different pace. For example, some elements were already underway, by necessity, well ahead of the final IMs (e.g. our expenditure proposal is required before Christmas, followed by the initial RAB and quality workshop in the new calendar year). Some elements will be developed during this phase (e.g. the wash-up mechanism). Others require a mix of the application of the IMs and the exercise of the Commission's discretion as to what is appropriate for RP1 (e.g. quality dimensions and measures).

22. It is important that decisions on discrete elements are made with a view to the holistic set of outcomes that are expected to deliver a transition, without shocks, from a contractual model to a regulatory model that is sensible, sustainable and workable.

23. It is difficult for us to comment on the Commission's proposed timeframes for the PQ and ID processes as they are broad and indicative only. We hope the Commission will provide consultation timeframes that allow us to make fully informed responses on discrete issues and mechanisms.

[2] Commerce Commission Approach Paper at [3.93].
[3] Commerce Commission Approach Paper at [3.95].
[4] Commerce Commission Approach Paper at [3.94].

24. Below is a summary of our views on key elements of the Approach Paper.

Input Methodologies

25. **Application of IMs** – in addition to the Commission's task of correctly applying the relevant IMs (i.e. cost allocation and asset valuation), the Commission must also exercise limited discretion within the IMs and the PQ process.[5]

26. To this end, we support the Commission's intention, when exercising its discretion, to apply the same economic principles used during the development of the IMs including real financial capital maintenance (**FCM**), allocation of risk, and asymmetric consequences of under-/over-investment, and an appropriate incentive framework.

27. **IM amendments** – we support the Commission's view that the PQ and ID processes may require the IMs to be amended to either implement decisions, or to correct for technical errors.

28. Given the significant task ahead it is important to adopt a flexible and pragmatic approach to addressing errors or gaps in the IMs that may only become apparent as we work through the detail of PQ and ID processes.

Price-quality regulation

Initial RAB

29. **Initial transitional PQ RAB** – we broadly support the Commission's proposal to determine an initial PQ RAB in Q2 2021 based on Chorus' model to help meet the implementation date, including scrutiny and assurance. As previously outlined, the Commission should use actual data up to 30 June 2020 rather than two-years of forecast data.[6] This will improve certainty as it will enable the transitional PQ RAB to include the most available audited data. A 'true-up' of the initial RAB is also required to reduce uncertainty and to comply with section 177 of the Act.

Revenue path

30. **Roll-over approach** – we agree a building block approach for setting the revenue cap is preferable to a 'roll-over' approach. However, we acknowledge that a roll-over approach could be a viable regulatory backstop for the transition into a building block method if meeting the implementation date is at risk. This would also require a 'true-up' to be applied via the wash-up mechanism.

31. **Asset stranding risk** – we support the Commission's recognition that our asset stranding risk is potentially material and its decision to address this via the inclusion of an *ex-ante* allowance in the IMs.[7] We note the Commission's stylised depiction of the BBM approach doesn't include the *ex-ante* allowance for asset stranding. In order to be consistent with the IM Determination,[8] figure 5.1 will have to be amended as shown in the illustration attached in Appendix A.

[5] Commerce Commission Approach Paper at [5.23].
[6] Chorus submission on Commerce Commission (23 July 2020) Fibre input methodologies – further consultation draft - reasons paper, at [35–47].
[7] Chorus submission on Commerce Commission (23 July 2020) Fibre input methodologies – further consultation draft - reasons paper, at [49-52].
[8] Commerce Commission Fibre Input Methodologies Determination, at clause 3.3.5.

32. **Revenue smoothing** – we agree the Commission should consider various options for achieving smoothing of the revenue path over two or more regulatory periods. We look forward to participating in future consultations as the Commission develops its approach.

33. **Additional controls –** we would not support a limit on the rate of growth in total revenue for non-anchor product services.[9] It is also not clear what problem this 'control' is trying to solve. For example, if actual demand for non-anchor services is higher than forecast this would be the result of positive end-user responses to our price and service offerings or the result of user or technology requirements. If this results in actual revenue being higher than forecast, we would expect to see this reflected in the wash-up balance (i.e. as a decrease).

34. Adequate controls already exist and mitigate the risk of over-recovery or price-shocks for end-users (e.g. anchor services, information disclosure, revenue smoothing and the wash-up mechanism). Anchor services were specifically included in Parliament's design of our transition to a regulatory regime. Their role is aimed at ensuring our prices for non-anchor services have an economic relationship to the price of anchor services – i.e. it anchors our pricing. It is also a control for reducing the likelihood of price shocks to end-users, as we can only change the price of non-anchor services to meet our MAR. Revenue smoothing also has a key role to help ensure that MAR reflects likely demand.

35. **Wash-up mechanism** – we support the Commission's proposed approach for an unconstrained and symmetric wash up. This is consistent with our interpretation of section 196 of the Act, and our view put forward in previous submissions.[10] We also agree with the Commission that the wash-up mechanism should be used to mitigate risks and uncertainties, such as those outlined in paragraph 5.91.

36. **Compliance with revenue cap** – the broad outline of compliance reporting for PQ1 in paragraph 5.199 looks consistent with how we understand a revenue cap with wash-up would operate; i.e. revenue cap compliance is reported *ex ante* based on forecast revenue/demand. We support this in principle and will consider in more detail as the process to develop the PQ determination continues.

37. However, paragraph 5.199 seems inconsistent with the specification of price IM (clause 3.1.1 of the Fibre IM Determination), which states that the total FFLAS revenue must not exceed allowable revenue in a regulatory year. For firms regulated under Part 4 that have a revenue cap, the equivalent clause refers to '**forecast** revenue', not actual revenue. If Chorus' revenue cap is to be specified based on actual revenue then this would (a) create a material compliance risk for Chorus, and (b) not be consistent with paragraph 5.199 as it would not be possible to provide a revenue compliance statement before the start of the regulatory year where compliance is assessed on actual rather than forecast revenue. We assume this is an oversight in the IMs that can be addressed through the IM amendment process before the implementation date.

Expenditure

38. **Incentive settings –** without expenditure incentive settings for RP1, our ability to make efficient substitutions between operational and capital expenditure will be

[9] Commerce Commission Approach Paper at [5.82].
[10] For example, Chorus submission on Commerce Commission (23 July 2020) Fibre input methodologies – further consultation draft - reasons paper, at [20].

limited because the incentives are unbalanced. We support a balanced incentives regime being in place for RP2 and note the Commission will need to plan for development of this in 2022.

Quality

39. **Measures and standards** – as we've previously stated, our UFB SLAs are a useful starting point for our PQ and ID quality requirements but we would not support the Commission transposing them directly into the regime. This is because quality obligations in the SLAs were commercially negotiated and drafted for a specific purpose that does not align with the Commission's current task. E.g. the UFB agreements were commercial infrastructure construction contracts under which an SLA default does not carry the potential for a pecuniary penalty, and SLAs could be changed with industry consultation and CIP agreement. We have attached up to date UFB1 and UFB2 SLA schedules and request the Commission refers to these for accuracy (because the Appendices to the Approach Paper contain errors).

40. It will not be practical for quality requirements to mandate a step-change in quality for RP1 because:

    40.1. Quality requirements are ultimately reflected in our fibre reference offer, where significant changes are multi-year processes to agree with the industry (where the resulting reference offers are published and widely available) and may also require operational changes for Chorus and our service companies. We are currently engaging on our fibre contracts for 2022 and cannot reasonably make significant adjustments for 2022 in response to a PQ determination issued in Q4 of 2021; and

    40.2. We need to submit the expenditure proposal ahead of the Commission's industry consultation. It will be based on maintaining the current level of quality with no material deterioration. A change to quality requirements would require a change in expenditure.

41. **Principles** – the Commission sets out characteristics of best practice regulation it would seek to apply in setting quality measures and standards. We agree with application of these principles, but we have recommended changes in how they are described.[11] We have also recommended additional principles,[12] including no duplicative regulation. Given the layers of constraints that are relevant, quality cannot be looked at in isolation. Instead it is important the Commission applies a holistic view and consider all the constraints, including potential specified services, when setting our quality requirements.

42. **Incentive schemes** – we agree that it would be complex and costly to develop and embed a workable and meaningful incentive scheme in time for the first regulatory period.

Information disclosure regulation

43. **Use of existing ID determination** – historical Chorus ID under the pre-existing regime is not appropriate to use for this process. As the Commission is aware, it was

[11] Chorus submission on Commerce Commission (19 November 2019) Fibre input methodologies: draft decision - reasons paper, at [288-289]

[12] Chorus submission on Commerce Commission's EV sub, at [284]; and submission on Commerce Commission (19 November 2019) Fibre input methodologies: draft decision - reasons paper, at [290].

created for an entirely different purpose and the information disclosed as a result, or its form, cannot be relied upon for the purposes of Part 6.[13] The pre-existing ID uses a simple cost allocation approach to meet compliance requirements as its purpose is unclear, which has been discussed a number of times during the policy reviews and delivery of that ID. Applying the same requirements for the new ID regime would not be consistent with the proposed cost allocation IMs. Similarly, its scope applies to all of Chorus' fibre and is not limited to FFLAS.

44. **Balance date** – we support the Commission's draft Regulatory Processes and Rules IM decision to align balance dates for PQ and ID. This is a pragmatic approach given ID requirements will likely be inputs in our PQ. However, the Commission is now considering aligning all ID balance dates to 30 June – this was not signalled in its updated draft IM decision.[14] Had we known this was a possibility we would have submitted very differently in July. The Commission's view is that there might be benefit in having Chorus and LFCs reporting ID on the same date for comparability but in doing so it would lose a far more meaningful and useful level of comparability between Chorus PQ and ID. If the Commission wishes to align all regulated suppliers' balance dates, we consider it should be 31 December, or align other LFCs' balance dates only.

Determining geographical areas of PQ and ID-only regulation

45. **ID-only FFLAS** – we support the Commission's approach to determining Chorus' ID-only FFLAS for new FFLAS and marginal cases. That is, where it is arguable that another LFC "has installed a fibre network under the UFB initiative", FFLAS supplied by Chorus to an end-user will be only be subject to ID regulation.

46. **Location of supply** – we do not support the proposed approach to determine the location of supply for co-location and backhaul by reference to the end-user. This is not a practical solution and at present we cannot do this. We would expect that any transport/backhaul services (which have no end-users and are not access services) within an LFC's UFB coverage area (e.g., Chorus ICABs inside an LFC's coverage area) would be subject to ID only. Similarly, a co-location service at a location inside an LFC's coverage area would be subject to ID only.

47. **Use of SFA database** – we support the Commission's use of information submitted by LFCs and Chorus for the purposes of constructing the SFA database, but we do not support the use of the database itself to determine the extent of PQ regulation. This is because the purpose of the database is for withdrawal of copper under Part 2AA of the Act. As a result, the Commission's assessment and exclusions applied to our SFA information to date is not fit for the purpose of determining the boundary of PQ regulation.

[13] As we outline each year in our cover letter to our annual ID.
[14] Commerce Commission (23 July 2020) Fibre input methodologies – further consultation draft - reasons paper.

Appendix A: Chorus amendment to BBM Revenue Approach diagram