Christchurch
City Holdings
Limited

New Regulatory Framework for Fibre

Response to NZCC consultation questions by Christchurch City Holdings Limited

21 December 2018

PUBLIC VERSION

Introduction

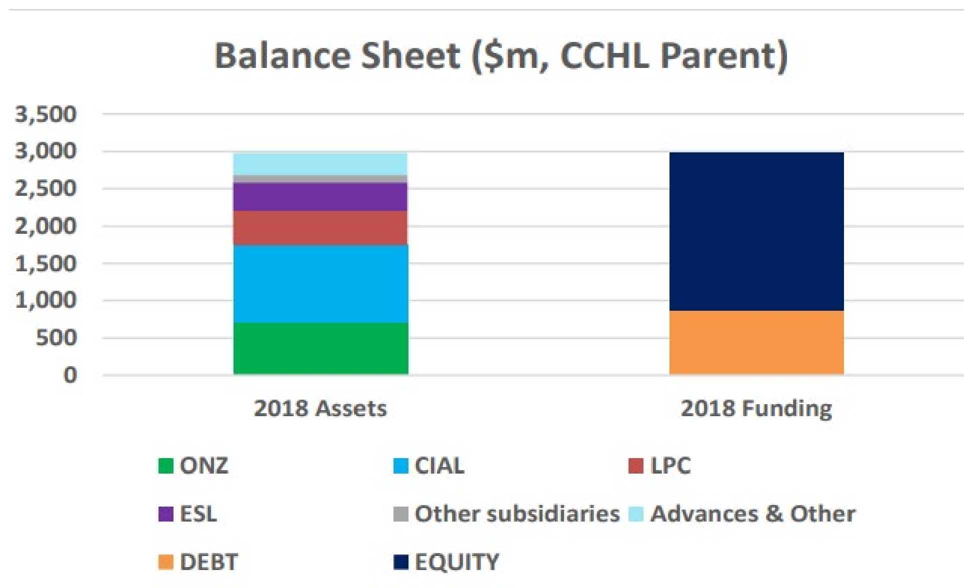
1. Christchurch City Holdings Limited (**CCHL**) welcomes the opportunity to respond to the Commerce Commission's *New Regulatory Framework for Fibre* discussion paper (**Discussion Document**).

2. In this submission, confidential information is contained in square brackets.

About CCHL

3. CCHL is the wholly owned investment arm of Christchurch City Council, and holds shares in eight council-controlled trading organisations that own and operate key infrastructure assets that are critical to the Christchurch and regional economy, including the seaport, the airport, and electricity distribution, recycling, and broadband services.

4. CCHL assets total $3 billion; the major investments are in Orion New Zealand Limited (**Orion**) (electricity distribution), Christchurch International Airport Limited (**CIAL**), Lyttleton Port Company Limited (**LPC**), and broadband provider Enable Services Limited:[1]



5. CCHL owns 100% of Enable Services Limited, which owns 100% of Enable Networks Limited (**Enable**), the local fibre company (**LFC**) responsible for the construction of the Ultrafast Broadband (**UFB**) fibre-to-the-premises network in Christchurch and Rangiora. Through CCHL, the ratepayers of Christchurch have invested ~ $500 million, in partnership with the Crown, to deliver fibre broadband connectivity across greater Christchurch to homes, businesses, schools and healthcare facilities.

6. It is just over seven years since Enable commenced the UFB network build, in Halswell on 8 November 2011. On 31 May 2018 the build was completed, 19 months ahead of schedule. The fibre-to-the-premises network serves more than 200,000 homes, businesses and schools across greater Christchurch. In recognition of this landmark, Enable doubled the speed of its 100Mbps service at no extra cost to its retailers from 1 July 2018.

CCHL's 2011 UFB investment decision

7. Our decision in 2011 to participate in the UFB Initiative, and invest in the fibre-to-the-premises rollout in the greater Christchurch area, was made for the following reasons:

   (a) the Christchurch City Council and CCHL had funded the establishment of Enable in 2007, recognising the potential of fibre services as an enabler for local business;

[1] CCHL, Fixed Rate Bond Offer Proposal, 19 November 2018.

(b) the UFB Initiative created the opportunity for CCHL to partner with the Crown in one of the largest and most significant infrastructure developments New Zealand would ever see;

(c) the partnership model meant that Christchurch City would own a significant share of this valuable asset once it was built; and

(d) the project was expected to generate many years of dividends to Christchurch City, estimated to total between $1.7 billion and $3 billion.

CCHL's UFB business case

8. The business case which supported our decision to invest in the UFB Initiative was based on a number of fundamental assumptions:

(a) as the Minister Steven Joyce stated on 24 May 2011, when he announced that the government would partner with Enable, "*Ultrafast Broadband is a key part of the government's economic growth plan. Broadband speeds of 100Mbps or more will revolutionise the way many businesses operate*";[2]

(b) Fibre was expected to replace the copper network, delivering broadband speeds that are not attainable using the existing copper, HCF, or wireless networks. MBIE described UFB as "a once-in-a-generation upgrade of the fixed broadband network";[3] and

(c) the business case assumed an uptake of [ ]. This reflected the fact that at December 2010, there were 1.88 million fixed line connections, but only 58% (1.09 million) customers subscribed to a fixed broadband service.[4] It was expected that this uptake level would increase over time with the faster fibre speeds available and development of services that required fast broadband, but there would remain a significant number of premises that would not take a fast broadband service.

Unforeseen risks

9. As noted above, CCHL has made its investment, and Enable, has over the last seven years, built the fibre-to-the-premises network, completing it ahead of schedule.

10. The business case recognised two key cost/revenue sensitivities, build costs, and uptake levels.

11. While we have been able to manage the build costs, we now face uptake risks that were unforeseen (and unforeseeable) seven years ago.

12. We did not anticipate that:

(a) Chorus would invest substantially to upgrade its copper service in the greater Christchurch area (but not in areas where it was building the fibre network) for the stated purpose of reducing migration from Chorus' copper network to LFC fibre networks.[5] In Christchurch Chorus offers a VDSL vectored UBA service on its copper network which improves VDSL downstream speeds by over 40% and upstream speeds by over 30% compared to the quality of service offered in Chorus' UFB areas.[6] Chorus has reported that this strategy has been successful in abating the loss of lines to the LFCs [.]

2 Hon Steven Joyce, Ultra Fast Broadband deal puts NZ ahead of the pack, 24 May 2011.

3 MBIE, Review of the Telecommunications Act 2001, Discussion Document, September 2013 at [153].

4 NZCC, Annual Telecommunications Monitoring Report 2010, April 2011 at p6.

5 "Chorus reports half year", Reseller News, 26 February 2018.

6 "Chorus boost broadband bandwidth with VDSL2 vectoring", Computer World, 15 October 2018.

(b) Vodafone would acquire TelstraClear, upgrade the cable network to offer broadband speeds above 100Mbps, market the network as FibreX, and mislead end-users that Enable fibre was not available in Vodafone's HCF area[7]; and

(c) wireless services would be upgraded to make fixed wireless an alternative for fixed fibre for a significant number of end-users, or that 5G technology, promising 1Gbps speeds, would become a commercial reality by 2020.

13. CCHL therefore agrees with the Commission that "*the allocation of demand risk, and the associated risk of economic stranding is likely to be particularly important in the context of FFLAS. This reflects the greater threat of competition relative to the sectors we regulate under Part 4*".[8] The competitive developments discussed above have the potential to significantly reduce uptake of the fixed fibre services, and demonstrate the risks faced by investors such as CCHL in new telecommunications services that involve significant capital investment.

Enable faces greater risks than Orion New Zealand Limited and Christchurch International Airport Limited

14. The Minister of Commerce has determined that EDBs, GDBs and the international airports have monopoly characteristics and accordingly the Commission regulates them pursuant to Part 4 of the Commerce Act.

15. CCHL owns 89.3% of Orion and 75% of CIAL, so we are in a good position to compare Enable's competitive risks relative to those companies.

16. Enable's market is highly competitive. As set out earlier in this submission, Enable has direct and dynamic competition from:

(a) Chorus's VDSL network;

(b) Vodafone's HCF network (marketed by Vodafone as 'FibreX');

(c) fixed wireless networks operated by Spark, Vodafone and 2degrees;

(d) potential new entrants; and

(e) new offerings (such as 5G wireless) from existing and/or new competitors.

17. Enable competes in a highly competitive market that has significant and dynamic wholesale/retail market structural conflict. Enable's major customers are Spark, Vodafone and 2degrees, who all own and operate significant competing networks. But unlike these major telecommunications retailers, Enable is restricted from providing retail services and therefore can't compete on a 'level playing field'.

18. As a consequence of the specific risk facing Enable, CCHL's internal weighted average cost of capital (**WACC**) for Enable is significantly higher than for Orion and CIAL.

Regulatory framework must provide the opportunity to earn a normal return

19. We agree with the Commission that:

(a) under the regulatory framework *"a regulated supplier has the opportunity to earn profits that compensate for its cost of capital over time (taking into account its exposure to risk) – ie, to earn a 'normal return"*;[9]

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[7] Vodafone "*pleaded guilty to [9] charges which allege that Vodafone's website misled consumers about the options of broadband services available to their addresses…It will now make it more clear on its website that people who live in FibreX areas also have a choice of UFB fibre*", NZ Herald, 16 November 2018.

[8] Above at [6.47].

[9] Discussion Document at [6.16.1].

(a) *"if suppliers are not compensated for risks that are outside their control, this may have a detrimental impact on investment incentives"*;[10] and

(b) *"the allocation of demand risk, and the associated risk of economic stranding is likely to be particularly important in the context of FFLAS. This reflects the greater threat of competition relative to the sectors we regulate under Part 4".*[11]

20. In light of those statements, we are surprised at the Commission's statement that "*consistent with the Part 4 approach, we propose to estimate a sector-specific beta, leverage and credit rating when determining the cost of capital input methodologies for FFLAS. We expect this process to build on the telecommunications comparator sample analysis undertaken in the UCLL and UBA FPPs*."[12]

21. A sector-specific approach is inappropriate where one of the regulated entities (Chorus) is an infrastructure competitor of Enable and the other LFCs (thereby increasing the systemic risk faced by them relative to Chorus), and where Enable faces greater infrastructure competition than the other LFCs in the form of Vodafone's HCF network, which covers one third of Enable's UFB footprint. For that reason the concept of a sector-specific risk beta must be abandoned. It will result in a significant under-estimation of the demand risk and risk of economic stranding facing Enable, so that CCHL would not have the opportunity to earn a normal return over the life of the regulated assets.

22. In addition, the UCLL and UBA FPP comparator sample used by the Commission in 2015 is not an appropriate starting point for the Commission's analysis, as it primarily comprises incumbent service providers. For the LFCs, the comparator firms should be new entrants who are providing a fixed line telecommunications service in competition with an incumbent's copper fixed-line service.

23. If the Commission is going to use any figure as a starting point, it should be with the 8% - 10% range, and mid-point WACC of 9%, utilised by Crown Fibre Holdings Limited in establishing Enable's wholesale pricing under the UFB contract, rather than the mid-point WACC of 5.56% selected by the Commission for its UCLL and UBA FPPs.

24. We note that section 21 of the Amendment Act requires that the Commission in the exercise of its powers under the new Part 6 must have regard to any economic policy of the Government that are transmitted in writing to the Commission by the Minister. The relevant policy statement is the Statement to the Commerce Commission Concerning Incentives for Businesses to Invest in Ultra-fast Broadband Infrastructure[13] dated 13 October 2011: "*the Government's economic policy objective is that businesses have incentives to innovate and invest in new or upgraded ultra-fast broadband infrastructure for the long term benefit of end users*."

25. This requires that the Commission ensure that CCHL has the opportunity to earn profits that compensate for its cost of capital over time (taking into account its exposure to risk) – ie, to earn a 'normal return'.

26. While the Commission says that "*price-quality regulation does not guarantee a normal return over the lifetime of the regulated supplier's assets*",[14] the documents footnoted explain that this is because under a price-quality regime prices are set part-way through the lifetime of the assets utilised and information about past performance may not be known,[15] and where average prices are pre-specified, suppliers can potentially earn higher or lower than normal returns, and increase profitability through reducing costs.[16]

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10 Discussion Document at [6.28].

11 Above at [6.47].

12 Above at [7.99].

13 New Zealand Gazette No 155, 13 October 2011, 4440.

14 Above at [6.16.1].

15 Input Methodologies Reasons Paper 22 December 2010 at [2.6.28].

16 NZCC, Setting the customised price-quality path for Orion NZ Ltd, 29 November 2013 at [A.28].

27. These conditions do not apply for FFLAS, where the assets are new and costs and past performance are known; as a consequence of the information disclosure regime in Part 4AA of the Act, the Commission holds six years of data which goes back to the launch of UFB in 2011.[17] Consequently, the input methodologies for information disclosure should be accurate enough to ensure CCHL has the opportunity to earn a normal rate of return on Enable's regulated assets over their lifetime.

28. An under-estimation of the demand risk and risk of economic stranding faced by Enable would reduce incentives to invest, be contrary to the Government's Economic Policy Statement, and would not be in the best interests of end-users of FFLAS (s162) or end users of telecommunications services generally (s166).

CCHL RESPONSE TO SELECTED CONSULTATION QUESTIONS

Q20 How should we consider the involvement of related parties to the funding arrangements (eg, LFC parent companies)?

In our view the converse of Method 2 proposed for Crown financing should be applied: that is, the present value of the overall benefit of concessional funding provided to Enable by CCHL should be added to the amount of financial losses at the implementation date.

Q23 What is your view on our proposal to use the Part 4 and UCLL/UBA FPP approach as the starting point when determining the cost of capital input methodologies for FFLAS?

As discussed above, CCHL disagrees strongly with the proposed approach, which would reduce incentives to invest, be contrary to the Government's Economic Policy Statement, and would not be in the best interests of end-users of FFLAS (s162) or end users of telecommunications services generally (s166).

Q24 What matters do you think will differ from the Part 4 approach, are novel for the regulated fibre sector, or will require re-estimation/a different approach? Should we re-estimate parameters that apply across sectors, such as the TAMRP?

As set out above, the differences include:

(a) the competitive nature of the broadband access market compared with Part 4 markets which have little or no competition;

(b) the differing risk profiles of the FFLAS regulated entities, with one (Chorus) engaged in infrastructure based competition with the others; and

(c) the Government Policy Statement which requires a focus on the risks faced by UFB investors.

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[17] Discussion Document at [2.48].