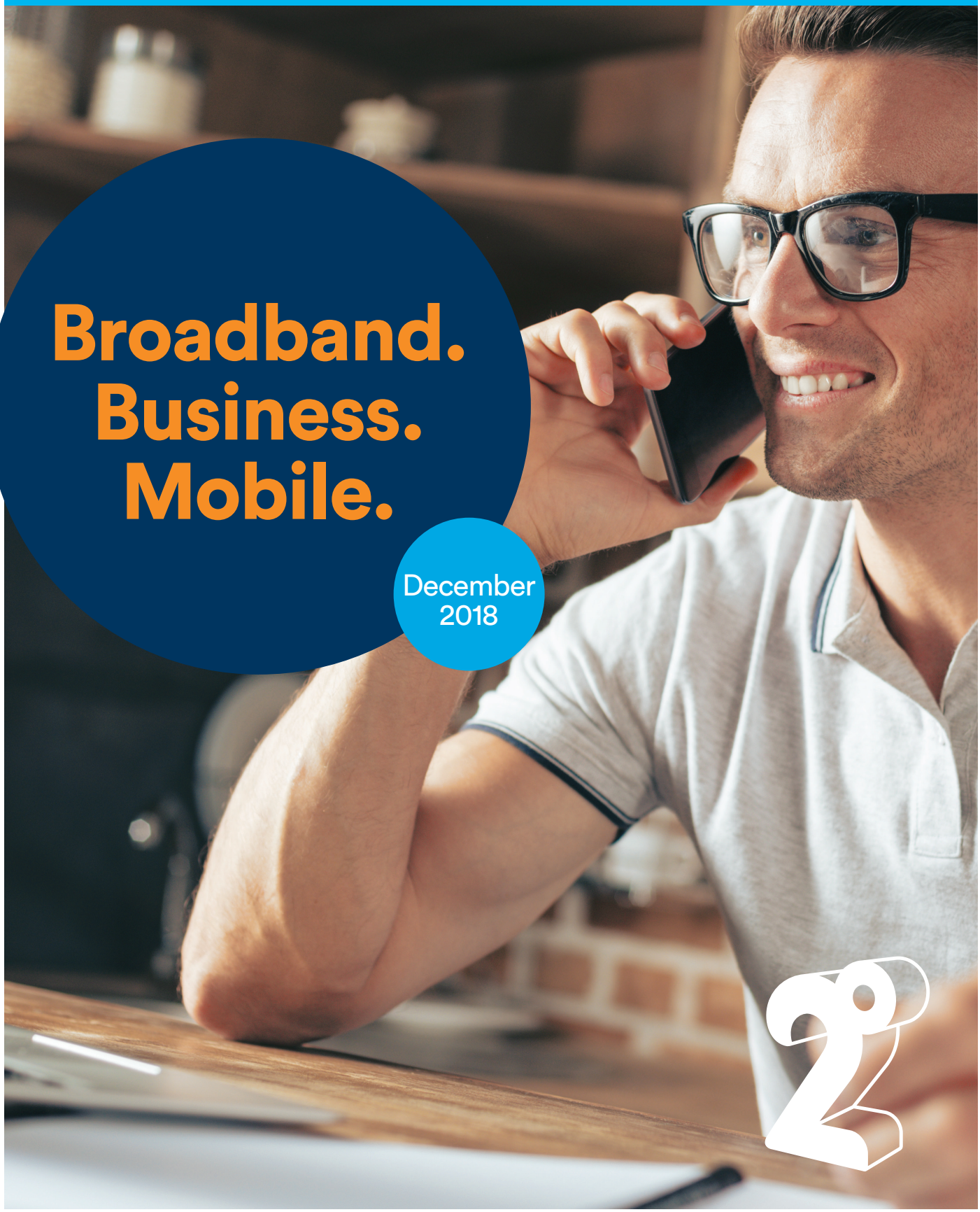
Submission in response to the Commerce Commission's proposed approach on the new regulatory framework for fibre

PUBLIC VERSION



1 Executive summary

- 2degrees considers that the Commerce Commission (**Commission**) has made a positive start to the development of a new fibre regulatory regime.
- We welcome the early release of the first consultation paper (**New Regulatory Framework consultation**).
- It is helpful that the Commission has mapped out the timeline it is planning to work to for establishment of the Input Methodologies (**IMs**), Information Disclosure requirements and the first fibre price determination.
- We consider establishment of an Expert Advisory Panel reflects regulatory best practice and should help the Commission achieve its delivery dates.

Our key points in response to the Commission's invitation to comment are:

- It will be important for the Commission to be clear and transparent about where it exercises judgement. This includes the reasons for following and deviating from Part 4 of the Commerce Act, as well as relevant copper pricing precedent.
- One of the most important distinctions between Part 4 of the Commerce Act (**Part 4**) and Part 6 of the Telecommunications Act (**Part 6**) is the inclusion, in Part 6, of a statutory purpose regarding the promotion of competition. We anticipate this will be the area where making "judgements independently by reference to the purpose statements" is most likely to lead to the Commission taking a different approach to that adopted under Part 4[1].
- The three economic principles that the Commission applied under Part 4 sit well with the Telecommunications Act section 162 purpose statement, reflecting the consistency between section 162 and section 52A(1) of Part 4 of the Commerce Act. However, it is important to recognise that any economic principles are subjugated to, and must not override, the statutory purpose(s).
- Given the important addition of section 166(2)(b) in Part 6, we consider the economic principles need to be expanded to include competition effects.
- Another important distinction between telecommunications (fibre) and electricity is the availability of substitutes for fibre services. If there is a temporary fault in the supply of fibre services, most consumers are able to switch to mobile broadband. This is directly relevant when considering asymmetric risk arguments and the consequences of under or over-investment.
- The Part 4 IMs have undergone Merit Appeal challenge and recent statutory review, and as a result, provide a de facto 'safe harbour' option for the Commission for some aspects of the new fibre IMs. The potential to import elements of Part 4 precedent could be particularly useful for the Commission given the tight time-frame for developing and determining the fibre IMs. However, the Commission must also take into account the new competition purpose.
- The New Regulatory Framework consultation is clear about the relevance of the Part 4 WACC IM precedent, and also made reference to the relevance of the Cost Allocation IM and high-level approach to the RAB IM. There were other elements of the New Regulatory Framework consultation where we thought the Commission could have been clearer about

[1] Commerce Commission, New regulatory framework for fibre: Invitation to comment on our proposed approach, 9 November 2018, paragraph 5.13.

the relevance of Part 4 precedent, particularly given the substantial delays in the legislation being enacted, and the time pressures for delivery of the new regulatory regime. For example, we would be interested in understanding the Commission's perspective on the use of Independent Verification and the requirements for regulated suppliers to present price-quality path proposals. Such cross-sector experience and precedent provides useful context to the Commission's thinking. We encourage the Commission to recognise that there are varying degrees of knowledge and understanding about the operation of Part 4 within the telecommunications sector.

- We look forward to gaining a better understanding of the Commission's view on the extent to which other Part 4 IMs, or aspects of the other Part 4 IMs, can or should be used as the basis for the Part 6 IMs, particularly in relation to the Capex IM which is specific to Transpower and now Chorus.
- It will be important to ensure cost allocation rules result in competitively neutral outcomes which do not favour particular technologies or access services.
- The Commission needs to ensure it avoids double-counting costs between Chorus' copper services (and the Final Pricing Principle determinations) and the building blocks costs for its fibre services (set under Part 6). The Commission faced a similar issue when it dealt with 'multi-network' utilities under Part 4 of the Commerce Act.
- From a practical perspective, we welcome the Minister of Communications' decision to grant the Commission the full extension of the Implementation Date to 1 January 2022. Even with this extension, implementation of the new regulatory regime will be very challenging.
- 2degrees would be comfortable with the Commerce Commission making its final price-quality path determination up to, but no later than, 1 September 2021. This would provide the Commission with an additional 2 months to determine the IMs and/or Chorus' fibre price-quality path, if needed.
- 2degrees would also like to see the Commission adopt a staggered, rather than omnibus, approach to consultation on the draft IMs, as this will spread the burden of consultations on industry to the fullest extent possible. Some IMs will invariably be more complex and contentious than others, and thus will require more consultation. For example, adoption of the Part 4 WACC IM with a mid-point WACC should be straight-forward, based on the copper pricing determinations. The Capex IM (which could be the largest IM, based on Part 4 precedent) and the Quality Dimensions IM (which has no Part 4 equivalent IM precedent to draw on) could be a lot more complex and time-consuming to develop. This does not mean we support final decisions on some IMs before others. We recognise that while development of the IMs is likely to progress at different paces, the Commission will need to make final IM decisions together as a package given the important inter-relationships between different components of the IMs.

2 Introduction

The introduction of a new regulatory framework for fibre services is a significant change to the way our industry is regulated.

2degrees considers that the Commission needs to develop a robust and transparent regulatory regime for fibre services which supports a healthy communications sector, and at the same time respects investors' legitimate expectation of a reasonable return on investment over-time.

In doing so, the Commission should consider that fibre providers are a part of an incredibly dynamic and changing industry. Operators such as 2degrees rely on their inputs to innovate and compete. The Commission should also consider that the large investments and risks RSPs such as 2degrees undertake are made with no guarantee of success. Settings that shield fibre providers from competition risk rewarding inefficiency. In short, no operator should get a guaranteed outcome.

As the Commission develops the new regulatory regime, including the IMs, it will be important to ensure the objective of promoting competition is given due recognition, and that regulatory certainty is provided for all market participants, including access seekers and end-users.

2degrees' as a full-service telecommunications provider

Since its launch in August 2009, 2degrees has made a significant and positive impact on the New Zealand telecommunications market. The company has built a nationwide 2G, 3G and 4G network and has substantially lowered the cost of mobile for Kiwis, with prices shifting from some of the highest in the OECD to below the OECD average. At the same time, we are well-recognised for our customer service, for example, winning the Canstar award for most satisfied customers for mobile plan providers for the fourth year in a row.

Over-time, and after years of investment, 2degrees now has over 98% mobile network coverage across the country. With the acquisition of Snap Internet in 2015, 2degrees is now a full-service telecommunications provider, offering fixed and mobile services nationwide. We now have over 1.3 million customers.

Looking ahead, we are planning for the launch of a FWA service and for substantial future investments in a 5G network upgrade.

This means that under the new regulatory framework 2degrees will purchase FFLAS for both UFB services and as key input services – in the form of DFAS and ICABS - to fixed and wireless networks. Alongside this, we also purchase ADSL and VDSL services for customers that are not able to receive fibre services.

As 2degrees continues to invest in its network, and ultimately serve its growing number of customers, it has a keen interest in ensuring the new regulatory framework developed by the Commission provides the certainty and ability it requires when investing.

Restrictions on the Commission's discretion under the new regulatory framework

While there have been a number of enhancements made by the Ministry of Business, Innovation and Enterprise (**MBIE**) and Parliament in transferring the Part 4 Commerce Act

provisions to Part 6 of the Telecommunications Act[2] we were disappointed that the Commission has been given less flexibility on some matters than it has under Part 4, including in relation to asset valuation, and whether a price or revenue cap is adopted.

There is nothing comparable to anchor services in Part 4 of the Commerce Act, but the general approach under Part 4 would have also left anchor service specification to the Commission.

The Government's willingness to override aspects of the Commission's role is a factor that could undermine regulatory certainty. These are matters on which the Commission, as industry regulator, is better placed than Parliament to make decisions. We are doubtful these restrictions will be to the long-term benefit of end-users, but understand they reflect what Chorus asked for. The revenue cap is likely to insulate Chorus from risk of slow transition from copper to fibre. This won't necessarily remove Chorus' incentives to transition end-users, which is based on a number of considerations and not just application of a revenue cap, but it could weaken the incentive rewards that would otherwise be available to Chorus for growing the fibre market.[3]

We also think setting a hard deadline for implementation, even with the two-year extension, will put the Commission and industry stakeholders under pressure, and prevent the Commission making genuine time-quality trade-offs in favour of a higher quality outcome. Shorter timeframes on complex and detailed issues, such as development of IMs, generally favour incumbent suppliers, such as Chorus, at the expense of smaller and lesser resourced operators and end-users.

2degrees submitted, unsuccessfully, for the legislation to follow Part 4 of the Commerce Act and allow the transition that occurred in electricity distribution without an imposed deadline. This allowed the Commission to initially roll-over network prices then undertake a mid-period reset with claw-back after the IMs were finalised. Chorus wanted, and got, a much more restricted timetable that will limit the Commission's flexibility. This means the Commission will need to act faster and more expeditiously than when it established the Part 4 regulatory regime and compared to the time it took to set copper prices (UBA and UCLL) under the Initial and Final Pricing Principles.

To the extent the Part 4 and copper pricing determinations set precedent which can be applied to Part 6, this will help reduce the time pressure the Commission and stakeholders will inevitably face. The example of application of the Part 4 electricity WACC IM, and use of mid-point WACC, in the copper pricing determination provides a good example where only limited work should be needed.

The New Regulatory Framework consultation is a positive start

The Commission has made a positive start to the development of the new regulatory regime for fibre, and establishment of IMs:

- The engagement with stakeholders prior to the legislation being finalised was welcome and helpful.
- We appreciated the early release of the first consultation paper and the fibre workshop.

[2] The improvements/enhancements include the addition of a Quality Dimensions IM, ensuring the Commerce Commission has discretion to introduce new IMs in the future, greater flexibility in setting the length of the regulatory period, enabling revenue smoothing across regulatory periods, and the addition of the new competition purpose.
[3] Gas Pipeline Businesses operate under a price cap and can improve profitability by increasing greater uptake within the existing footprints of their networks.

- The use of an Expert Advisory Panel reflects regulatory best practice and is something we welcome.
- The New Regulatory Framework consultation maps out the Commission's thinking on process, and timing, the Commission proposes to establish the IMs, Information Disclosure requirements, and the first fibre price determinations.

The importance of being clear about the relevance of regulatory precedents

We would have liked to have seen the consultation paper explore in more detail, the extent to which existing Part 4 IMs may specifically provide relevant precedent for the Part 6 IMs, without the need to necessarily reach definitive views.

The New Regulatory Framework consultation was clearest in relation to the Part 4 WACC IM, which is a straight-forward matter given the decisions the Commission made on WACC in its copper pricing determinations. The consultation also made reference to the relevance of the Cost Allocation IM and high-level approach in the RAB IM but was otherwise silent on the other IMs.

We note consideration of the capital expenditure (**Capex**) IM has been left entirely as an issue for discussion in later papers. Based on Part 4 precedent the Capex IM could be one of the more substantive and complex IMs and could take longer than some of the other IMs to develop. We are particularly interested in understanding the extent to which the Commission thinks the Transpower Capex IM framework could be adopted for the Chorus Capex IM. The Transpower Capex IM includes competition benefits as part of the Investment Test. We will be interested in understanding how the Commission considers the promotion of competition purpose may affect the specification of the Chorus Capex IM.

These are important elements of the Commission's recognition of the need to get to work "as early as possible given the statutory timeframes for implementing our new regime".

The Commission has been clear that "[w]here judgements are required, [it] must make those judgements independently … and cannot simply import the approach [it has] adopted under Part 4". We caution it is important that the Commission is clear and transparent about where it is applying judgements and the reasons for following or deviating from Part 4 (and copper pricing) precedent and welcome the commitment that "When we [use other previous work], we will clearly identify where we are relying on previous work and will make the relevant material available to stakeholders".

Being clear about when previous precedent is not being used will be just as important as being clear about when previous precedent is being used. We also note the High Court Part 4 Merit Appeal decision was clear about the importance of evidence-based analysis, and that the Commission should minimise reliance on subjective judgement.[4]

Another way to think about existing Part 4 IMs (and copper pricing determinations) precedent, (paraphrasing the recent decision-making framework for Default Price-quality Path **(DPP)**,[5,6])

[4] Wellington International Airport Ltd & Others v Commerce Commission [2013] NZHC [11 December 2013].
[5] Default price-quality path (**DPP**) for electricity distribution businesses (**EDBs**) for the third regulatory period beginning 1 April 2020 **(DPP3)**.
[6] Commerce Commission, Issues Paper, Default price-quality paths for electricity distribution businesses from 1 April 2020, 15 November 2018, paragraph 2.14.

is that the Commission should adopt existing precedent where they are fit-for-purpose, except to the extent an alternative approach would:

- better promote the purposes of Part 6;
- better promote workable competition in telecommunications markets for the long-term benefit of end-users of telecommunications services;
- better promote certainty for regulated fibre service providers, access seekers and end-users in relation to the rules, requirements and processes applying to the regulation, or proposed regulation, of fibre fixed line access services under Part 6; and
- avoid unnecessary complexity and compliance costs.

We anticipate the area where making "judgements independently by reference to the purpose statements" is most likely lead to the Commission taking a different approach to that adopted under Part 4[7] is in relation to the promotion of competition.

One of the most significant differences between Part 4 of the Commerce Act and Part 6 of the Telecommunications Act, in terms of the way the energy (electricity and gas) and telecommunications are regulated is the addition of a statutory purpose to consider the promotion of competition.

The following sections sets out 2degrees' initial responses to the Commission's specific questions, where we further discuss the implications of this and other aspects of the Commission's proposed IM approach.

We look forward to continuing to work with the Commission as our understanding of the New Regulatory Framework develops.

[7] Commerce Commission, New regulatory framework for fibre: Invitation to comment on our proposed approach, 9 November 2018, paragraph 5.13.

3 Responses to specific questions

Q1 What changes to our process (if any) would you suggest to enhance the opportunity for you, and other stakeholders, to provide input and views to us as we develop the fibre input methodologies?

2degrees appreciates that the Commission is operating under tight deadlines to complete implementation of the new regulatory regime. 2degrees would be comfortable with the Commission making its final price-quality path determination (including final access prices) up to but no later than 1 September 2021, if this would help facilitate a more robust determination.

This would provide the Commission with an additional 2 months to determine the IMs and/or Chorus' price-quality path, if needed, while still allowing a 4-month notice of price changes for wholesale fibre services.

2degrees appreciates the Commission's intention to phase its work to ease consultation for stakeholders. Both the Commission and industry stakeholders have multiple government and regulatory processes taking place in 2019, alongside other substantial work programmes. This puts significant pressure on industry commercial and technical resource, so to the extent that consultation processes can be distributed, within the timeframe restrictions the Commission faces, that is welcomed and likely to result in a greater ability for stakeholders to provide more considered input.

To further assist this, we would prefer the Commission to consult, or start consultation, on individual IMs, or groupings of related IM components, on a staggered basis and not wait until there are drafts of all the IMs before releasing and consulting on them in a single omnibus.

Our expectation is that some IMs will take longer to develop than others:

- The WACC IM should be more straight-forward given Part 4 of the Commerce Act and the copper pricing determination precedents.[8]
- Experience with the statutory review of the Part 4 IMs suggests that the Cost Allocation IM could be contentious. The potential for regulated suppliers to over-allocate costs to the regulated business (and into the RAB) or to particular services, including from unregulated services, and how this could impact on competition is particularly relevant to telecommunications given the promotion of competition statutory purpose. We raised this point at the December Fibre Workshop.
- The Capex IM and Quality Dimensions IMs are likely to take longer, and may require more consultation steps, reflecting that the Part 4 Capex IM is the most complex and largest Part 4 IM, and there is no existing Part 4 Quality Dimensions IM.

If the Commission was to consult on the draft IMs, for the first time, as an omnibus draft decision, which consisted of the draft fibre IMs determinations in their entirety, the proposed six weeks to make written submissions and two weeks for cross-submissions would be wholly inadequate. At least double this time would be required. Alongside other business

[8] We note there have been changes to the Part 4 WACC IM subsequent to its application to the copper price determination. For example, the risk-free rate is now calculated over 3 months rather than 1 month. This does not impact the applicability of the Part 4 WACC IM precedent for Part 6.

workstreams and commitments we consider it would be very challenging for industry to respond to a full-package of IMs in condensed timeframes in a robust manner.

This does not mean that we support a process which would lead to the Commission making final decisions on some IMs before others. We recognise that while development of the IMs is likely to progress at different paces, the Commission will need to make its final IM decisions together, as a package, given the important inter-relationships between different components of the IMs. For example, the decision on whether to adopt an indexed RAB will determine whether a nominal or real CAPM WACC is needed. This is simply to spread the consultation burden on industry to the fullest extent possible.

Q2 What input methodologies (if any) could be progressed to draft or final decisions earlier to provide more certainty to stakeholders on the new fibre regulatory regime?

We are unclear at this stage whether progressing some IMs earlier would have any material impact on regulatory certainty, but as set out in our response to Q1:

- It would be helpful for stakeholders if the draft IMs are consulted on a staggered basis;
- From a practical perspective, some IMs will take longer to develop than others; and
- We do not consider the Commission should make final decisions on any specific IMs separately from other IMs. Final decisions will work best as a package.

Given that the Capex IM and Quality Dimensions IM could take the longest to develop and require more consultation steps than some of the other IMs (see Q1), there may be merit in progressing drafts of these earlier than for other IMs.

The cost allocation IM is likely to have implications for the economics of different access options (e.g. layer 1 versus layer 2) and the extent to which the purpose of promoting competition is achieved. These facts may warrant progressing the cost allocation IM ahead of some of the other IMs.

The cost allocation IM may also be more complex than its Part 4 equivalent, due to the need to consider cost allocation between different regulated services (which impacts on promotion of competition) and not just issues of allocation between the regulated and unregulated services. We are particularly mindful of the need for the Commission to ensure Chorus is unable to use allocation of costs (and assets) to prop up (and/or cross-subsidise) competitive market activities, or to recover the same costs from its regulated copper and fibre prices (double-recovery).

Q3 What are your views on our proposed interpretation of 'end-users of telecommunications services' in s 162 and s 166(2)(b)?

2degrees is interested to understand what the Commission considers is the practical implication of the reference to end-users in Part 6 rather than consumers or acquirers. We are also interested to understand if any of the Commission's Part 4 decisions were impacted by the distinction between consumers and end-users in the statutory objective.

Q4 What are your views on our preliminary views on how s 162 and s 166(2)(b) interact?

Sections 162 and 166(2)(b) require the Commission to promote the long-term benefit of end-users in two ways:

- "promoting outcomes that are consistent with outcomes produced in competitive markets" for services where there is little or no competition; and
- promoting workable competition where the Commission's decisions could impact on competition or the likelihood of an increase in competition.

Given that fibre is a key input to multiple services (including not only UFB but fixed wireless and mobile services), we agree that section 162 and section 166(2)(b) contain generally complementary, rather than competing, objectives. Both provisions strive for outcomes produced by workable competition for the long-term benefit of end-users.

What we would say though is that promoting competition, where competition is possible, is expected to deliver better benefits to consumers than trying to replicate the outcomes of competition (the second-best solution).

While section 166(2)(b) is only mandatory in cases where the Commission considers it is 'relevant', 2degrees expectation is that it will be highly relevant to a wide range of the Commission's decisions. For example, section 166(2)(b) will be relevant to:

- Asset valuation;
- Cost allocation (including related party transactions);
- Price relativities between different services; and
- Consideration of line of business restrictions.

The matter of promoting competition played out in the statutory review of the Part 4 IMs in relation to cost allocation and related party transactions, despite Part 4 having no comparable provision to section 166(2)(b). The amended Telecommunications Act makes it clear that the consideration of the impact on competition in wider telecommunications markets is a key consideration for determining issues under the new Part 6.

2degrees supported inclusion of a competition objective in the amended Telecommunications Act because of the impact Part 6 regulation could have on competition in telecommunications markets, broader than just fibre, for example mobile and fixed wireless competition.

One example where section 166(2)(b) could come into play is in relation to section 69SA, which allows the Commission to grant exemptions to Chorus from the line of business restrictions placed on it under the Telecommunications Act.

Q5 What are your views on our preliminary view on how s 173 applies when we set the input methodologies?

As a party that is making substantial investment commitments, 2degrees considers regulatory certainty to be a critical element of the regulatory regime.

It must be recognised that regulatory certainty is important for access seekers and end-users, and not just for access providers. Operators such as 2degrees are making substantial

irreversible investments and value having confidence that they can reasonably expect to earn a normal return on their investment.

We make this comment in response to the Commission's statement that "[a] more certain and predictable regulatory environment should allow *regulated suppliers* to make irreversible investments with increased confidence that they can expect to make a normal return on the investment made" [emphasis added].[9]

Regulatory certainty is also important for ensuring that consumers have confidence that services will be provided reliably and at a quality which reflects consumer demands (including through promotion of competition), and that the prices they pay do not include excessive profits.

However, there are limits on the function of regulatory certainty:

- Regulatory certainty does not over-ride promotion of the long-term interests (benefit) of end-users. We agree with the Commission's views that certainty is not the predominant consideration and is "conceptually subordinate" to the purpose of the new Part 6.
- Certainty about a bad outcome would be less desirable than an uncertain but potentially better outcome (this would also be contrary to the long-term interests of end-users).
- Regulatory certainty can mean certainty about regulatory processes (an input) rather than an outcome.
- We agree that regulatory certainty does not mean absolute certainty of outcome (an output) and is something that will evolve and improve over-time: "while increased certainty is an important objective of the regime, the regime does not aspire to absolute certainty".[10]

The establishment of the IMs will help improve regulatory certainty as will any subsequent statutory reviews and Merit Appeal decisions. The first price determination and subsequent price resets will also improve regulatory certainty. All this will occur and evolve over a number of years. Regulatory certainty is not something which can, or should, be automatically created on the Implementation Date, despite what Chorus might want or think.

Q6 What are your views on our preliminary view that a BBM approach similar to that adopted under Part 4 would best give or be likely to best give effect to the objectives in s 166?

We agree that "[t]he framing of the legislation, together with the background material (including the Minister's review under s 157AA), demonstrates that Parliament contemplated that [the Commission] would adopt BBM under Part 6".

The IMs the Commission is required to set, particularly in relation to cost of capital, valuation of assets, allocation of common costs and treatment of taxation, form the building blocks for establishing the costs of Chorus' (or the LFC) fibre business.

[9] Commerce Commission, New regulatory framework for fibre: Invitation to comment on our proposed approach, 9 November 2018, paragraph 5.60.
[10] Commerce Commission, New regulatory framework for fibre: Invitation to comment on our proposed approach, 9 November 2018, paragraph 5.62.

The BBM under Part 6 will require additional dimensions to that under Part 4. A critical difference is that the Commission is not just producing a single building block but will need to determine the building blocks for different regulated services e.g. layer 1 versus layer 2 services.

We note when the Commission developed building block calculations of the costs (and asset values) of regulated suppliers that owned both electricity and gas (or gas distribution and transmission) networks it had to make sure there was no double-counting of costs (or asset valuations) i.e. common costs were not allocated to both the electricity and gas network businesses.

The Commission will face a similar issue in ensuring there is no double-counting of costs (and assets) used to establish the TSLRIC price for copper services, and that for Chorus' fibre business.

We raised this issue at the 10 December Workshop and were not persuaded by the suggestion it would not be an issue or would only be a temporary issue. It should be recognised that Chorus is likely to operate both copper and fibre networks for some time. As well as areas supplied by the LFCs, and where fibre is not being rolled out, the revenue cap mechanism insulates Chorus from the risk of slow transition of end-users from copper to fibre.

Q7 How relevant to the fibre input methodologies are the three key economic principles used under Part 4?

It is important for the Commission to be clear and transparent about the principles that underpin its thinking and the judgements it will make in setting the fibre IMs.

While we consider the three economic principles the Commission applied under Part 4 sit well with the section 162 purpose statement, reflecting the consistency between section 162 and section 52A(1) of Part 4 of the Commerce Act, it should be recognised:

- Any economic prices are subjugated to, and must not over-ride the statutory purpose(s);
- The High Court decision on the Part 4 IMs Merit Appeal also provides relevant guidance. For example, a key element of the High Court decision on the RAB IM was that no evidence was provided that regulated suppliers would be unable to recover the costs of their past prudent and efficient investments; and
- The addition of section 166(2)(b) means promotion of competition is an important element, which should be recognised by the Part 6 principles.

Subject to these qualifications, we have the following observations about the three economic principles used for Part 4:

- We would welcome clarification as to the difference, if any, between the principle of real financial capital maintenance (**FCM**) and "reasonable investor expectations".[11]
- FCM does not guarantee that Chorus or the LFCs will be able to fully recover their costs and earn a normal rate of return.

[11] Wellington International Airport Ltd & Others v Commerce Commission [2013] NZHC [11 December 2013], at [605].

- The Commission has explained that achievement of FCM is conditional on the firm being efficient.[12] Just as "[s]uppliers who improve their efficiency at a rate greater than expected make profitability gains", suppliers who are not operating efficiently should not expect to earn a normal rate of return.[13] It should also be recognised that Chorus and the LFCs bid for, and won, provision of UFB at a price that they considered was appropriate at the time. It is not the role of access seekers or end-users to compensate parties for the consequences of commercially-agreed arrangements.

  2degrees agrees with the Commission's observation "It is important that a regulatory regime designed to protect end-users does not end up being used to protect regulated suppliers".[14]

- The economic principle that risk should be allocated to the party best placed to manage it, is undermined by the legislative requirements set out in section 177 for the "Initial value of fibre assets" to include "financial losses … incurred by the provider in providing fibre fixed line access services under the UFB initiative …", and by the requirement that a revenue cap rather than price cap be applied. The effect of these requirements is to transfer risk from Chorus to RSPs and end-users.
- The asymmetric consequences of under-investment and over-investment will vary across industries and services. This is well illustrated by the decisions (and debate) on WACC percentile for Chorus' copper services and airports, versus the WACC percentile for electricity and gas networks.

Q8 How does the prospect of infrastructure-based and access-based competition affect the application of the three economic principles in the fibre input methodologies?

Part 4 is focussed on "promoting outcomes that are consistent with outcomes produced in competitive markets". In comparison, Part 6 is also concerned with the "promotion of workable competition" (s 166(2)(b) Telecommunications Act).

The inclusion of "promotion of workable competition in telecommunications markets for the long-term benefit of end-users of telecommunications services" effectively adds an additional economic principle for the Commission to apply when developing the fibre IMs. This is a statutory acknowledgement of the importance of competition in telecommunications markets, and that the regulation of fibre has a key impact on competitive services.

The prospect, or actuality, of infrastructure and access-based competition also directly affects the application of the three economic principles from Part 4.

The Commission partially answered its own question with the observation that "It is important that a regulatory regime designed to protect end-users does not end up being used to protect regulated suppliers from competition, or from the effects of competition." This is explicitly acknowledged in section 177(4) of the amended Act, which states "It is not the intention … that regulated fibre service providers should be protected from all risk of not fully recovering those financial losses through prices over time".

[12] EDBs-GPBs Reasons Paper at [2.6.28], 3/7/001020-21; Airports Reasons Paper at [2.6.28], 2/6/000636.
[13] Commerce Commission, New regulatory framework for fibre: Invitation to comment on our proposed approach, 9 November 2018, paragraph 34.
[14] Commerce Commission, New regulatory framework for fibre: Invitation to comment on our proposed approach, 9 November 2018, paragraph 6.33.

Between 2degrees' establishment in 2009 and the end of 2015, we accumulated losses of almost $400 million. This reflected the cost of investing heavily in a national mobile network and moving into fixed line phone and broadband services to allow us to compete across a fuller range of telecommunications services. Consistent with the outcomes in workably competitive markets, there is no guarantee that we will recover this cost, and neither should there be for Chorus.

In essence, application of FCM, or reasonable investor expectations, does not, and should not, extend to protecting regulated suppliers from the effects of competition or inefficiency.

We also note the consequences of under or over-investment depend on a number of factors. The impact of under-investment will not be as significant where there are substitute services or providers, or where under-investment may encourage investment by other infrastructure providers. In relation to fibre this can include alternative fibre operators operating in the same area (e.g. Vector in Auckland), alternative services including fixed wireless and mobile broadband services (which in the future will include 5G services) as well as copper services and Vodafone's hybrid fibre coaxial service.

One of the key considerations for the Commission, in relation to the asymmetric impact of under-investment in electricity network services, was the impact on service outages: "… we use the 67th percentile WACC estimate when setting price-quality paths for regulated energy businesses, given the significant costs to consumers of major supply outages resulting from under-investment". The impact on end-users of a temporary electricity outage can be quite different to the impact of a fibre outage, where the end-users can switch to mobile broadband services until fixed line services are restored. The same argument was made in relation to the copper WACC percentile.

Q9 What other economic principles should we have regard to when developing the fibre input methodologies? For example, should we include pricing efficiency as an economic principle for fibre?

Our responses to Q7 and Q8 detail that we consider promotion of competition to be a key economic principle which the Commission should take into consideration. This encompasses elements of "pricing efficiency" and ensuring the relative prices of different access services do not favour one particular service over another.

Q10 What are your views on our approach to determining the activities and/or services that fall within the scope of FFLAS (including the treatment of copper-based services, POIs, and services provided above layer 2)?

Q11 Are there any further key implications of the scope of regulated services for the setting of input methodologies for price-quality or information disclosure regulation?

The Commission will need to be careful to ensure Chorus' fibre RAB/costs are not inflated (and its profits are not masked), by:

- Allocating copper assets and costs, including stranded copper assets, which have limited value to fibre, to the fibre business; and/or

- Allocating assets and costs from competitive market services to the fibre business (which would raise s 166(2)(b) issues).

We are interested to understand how the scope of FFLAS will change over time, for example if use of assets or competition arises during the term of a regulatory period.

Q12 Do you agree with our application of s 166(2)(b) in practice as illustrated in the example? Where else may s 166(2)(b) be relevant in setting input methodologies?

As set out in our response to Q4, while section 166(2)(b) is a mandatory consideration only in cases where the Commission considers it "relevant", 2degrees expects it will be highly relevant to a wide range, if not most, of the Commission's decisions. This includes matters relating to asset valuation, cost allocation and related party transactions, and price relativities between different services.

We are not persuaded the trade-off between cost and competition is as clear cut as the Commission's example implies. The "more expensive or higher specification solution" could restrict the options available to access seekers to provide their own solutions and differentiate their products. An outcome could be a higher cost 'vanilla' solution applied by Chorus (contrary to section 162 objectives) and lessening of competition (contrary to section 166(2)(b)).

Q13 What are your views on our proposal to determine only those input methodologies listed in s 175(1) by the implementation date? What additional matters should be determined as input methodologies by the implementation date?

At this stage, we agree that "[d]etermining only these input methodologies [listed in s 175(1)] will assist [the Commission] with meeting the implementation deadline". The tight timeframe for establishment of the IMs means it may limit the extent to which it is reasonably practicable to determine additional IMs by the Implementation Date. 2degrees submitted for the inclusion of section 178(2) of the Telecommunications Act which provides that "[t]he Commission may, at any time after the implementation date, determine further input methodologies for fibre fixed line access services". If there are additional IMs which the Commission considers it would be desirable to establish, but doesn't have time to do so initially, the Commission will be able to do so in the future.

We would appreciate it if the Commission was clear about potential additional IMs it may have considered developing initially if it had more time before the Implementation Date.

We note in respect of Part 4 there was a lot of debate about whether there should be a Starting Price Adjustment (**SPA**) IM and that the Commission had undertaken considerable work on this (including production of an unpublished draft SPA IM). There may be merit in revisiting whether this would be desirable and help improve regulatory certainty.

Q14 Which of the fibre input methodologies (if any) do you consider most appropriate for us to consider the use of a more 'principle-based' specification?

The Court of Appeal recognised "… there is a continuum between complete certainty at one end and complete flexibility at the other"[15].

The Court of Appeal also recognised "… Parliament did not accord the Commission absolute flexibility, nor did it require absolute certainty in the regulatory regime".[16]

The High Court Merit Appeal decision sets out that the "IMs as far as is reasonably practical, set out relevant matters in sufficient detail so that each affected supplier is reasonably able to estimate the material effects of the methodology on the supplier" but "there will necessarily be uncertainty for regulated suppliers as to the impact on them of IMs and Part 4 regulation more generally. Some uncertainty is inevitable".[17]

2degrees considers the extent to which it is "reasonably practical" or practicable to set out in the IMs sufficient detail, or prescription, to be able to estimate the impact of the IMs will vary on a case-by-case basis.

In simple terms, a prescriptive approach should be applied to elements of the IMs which are not time dependent e.g. the version of CAPM that should be applied does not depend on whether the Commission is undertaking the first regulatory price determination or a subsequent price reset.

There may be other elements of the IMs where it is appropriate for the Commission to have more discretion and flexibility and, therefore, apply a 'principle-based' specification. An example would be the Quality Dimensions IM. The appropriate service quality guarantees and targets can be reasonably expected to vary (improve) between price resets. It would not be desirable to lock these elements of service quality into the Quality Dimensions IM, so a more principles-based approach is likely to be more appropriate.

Q21 Are there other approaches to allocating costs between regulated FFLAS services and other services that could be used? Are there features of suppliers or services that require particular consideration (e.g., business structure, presence of other forms of economic regulation, accounting systems etc.)?

2degrees notes Telecom's (now Chorus) previous submission on cost allocation rules for IMs under Part 4 of the Commerce Act is relevant.

In this submission, Telecom outlined its views clearly on how the cost allocation rules should be specified in order to avoid or mitigate the risk costs would be allocated inefficiently and/or inappropriately between regulated and unregulated businesses.[18]

Telecom's views are entirely consistent with the Commission's commentary that "S 166(2)(b) may also be implicated where costs are allocated between FFLAS and unregulated services

[15] Commerce Commission v Vector Ltd [2012] NZCA 220, [2012] 2 NZLR 525 at [60].
[16] Commerce Commission v Vector Limited [2012] NZCA 220 at [60].
[17] Commerce Commission, New regulatory framework for fibre: Invitation to comment on our proposed approach, 9 November 2018, at [214].
[18] Telecom "Submission on the Commerce Commission's Draft Reasons and Proposed Regulation of Input Methodologies under Part 4 of the Commerce Act 1986", 9 August 2010.

as the allocation may impact competition, including the incentives for access competition. Over-allocating 'not directly attributable' costs to FFLAS also risks creating negative outcomes, including higher prices for FFLAS end-users (i.e. they don't share the benefits from efficiency gains, 162(c)) and a potential lessening of competition in competitive (or potentially competitive) markets (s166(2)(b))".

Q22 What views do you have on whether an input methodology for allocating costs between different FFLAS services should be set for information disclosure and/or price-quality regulation?

The Cost Allocation IM should be applied for both Information Disclosure and price-quality regulation, where applicable.

The Commission has offered no basis for suggesting the Cost Allocation IM, or any other IM, should only be used for Information Disclosure purposes.

Allocation of costs between different fibre services will be important in relation to promotion of competition (please refer to our response to Q4).

We also note the role of IMs in relation to Information Disclosure versus price-quality regulation is an issue that was dealt with when the Part 4 price regulation and IMs were established. We are unaware of any reasons a different approach would be warranted under Part 6 of the Telecommunications Act.

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?

While 2degrees did not directly participate in the Part 4 IMs development and review, or the UCLL/UBA FPP approach, we consider it was appropriate for the Commission to use the Part 4 WACC IM (with mid-point WACC) for the copper price determinations and consider it will be appropriate to do so again for the fibre WACC IM. The Commission has provided limited views about the other Part 4 IMs. The new regulatory framework consultation made some reference to the relevance of the Cost Allocation IM and the high-level approach in the Regulated Asset Base (**RAB**) IM but has not commented on the relevance of the other Part 4 IMs.

We are interested in understanding the Commission's views on the extent to which other Part 4 IMs can either be transposed or used as a starting point for determining the fibre IMs.

Q25 What are your views on CEPA's advice on the approach to setting the quality dimensions input methodology?

It will be important to ensure the Quality Dimensions IM, and service quality standards set at price reset, prevent or limit Chorus' ability to continue to cut or cap its costs and increase profitability by operating a low quality of service, and for ensuring supply of FFLAS is of a quality that reflects end-user demands.

We agree that the Commission will need to "… consider whether a wider range of quality measures may be appropriate in the context of Part 6 than [are] currently appl[ied] in price-quality paths under Part 4 of the Commerce Act".

We note the Commission is currently considering whether the Part 4 quality standards should be extended to include "other dimensions of quality"[19] and "the link between price and quality".[20] This could have implications for Part 6 fibre quality standards and for the Part 6 Quality Dimensions IM.

It will also be appropriate to take account of the risk that "any given dimension we set may not be wholly controllable by the wholesale fibre provider" and, similarly, the "chance that under the retail service quality provisions some aspects of quality are more easily controlled by the wholesaler, rather than the retailer".[21]

It was a good first step for the development of the Quality Dimensions IM to seek external expert advice, including on international precedent. We consider the CEPA report is useful and frames well the trade-off between certainty and flexibility, both in terms of the Quality Dimensions IM and the IMs more generally.

We agree with CEPA that it is useful to distinguish between "quality dimensions", "quality metrics" and "quality standards". Quality metrics and quality standards should be treated as subsets of quality dimensions.

We anticipate the Quality Dimensions IM will be able to get down to the level of quality metrics (what CEPA label 'level 3'). If the IM goes to this level the Commission would need flexibility to expand the metrics at each price reset.

Quality standards (what CEPA label 'level 4') are something that is likely to change over-time (with each reset) and would therefore not be appropriate to set in the IM. Our view is consistent with CEPA's observation "A fast-moving market may result in rapid changes to the metrics and standards against which services should be measured".

2degrees is open to the suggestion the Commission use an industry forum (the Telecommunications Carriers' Forum) so that it can draw on technical knowledge and expertise to advise on appropriate standards/metrics for particular quality dimensions.

Under Part 4 precedent, Transpower is required to propose service quality standards for each price reset. We discuss this below in response to Q27. Transpower's (voluntary) adoption of a Consumer Advisory Panel and formal consultation on its proposals is relevant to the efficacy of this approach. At this stage it is unclear whether Chorus would be willing to commit to adopting the same approach.

[19] Commerce Commission, Issues Paper, Default price-quality paths for electricity distribution businesses from 1 April 2020, 15 November 2018, paragraph 3.39.
[20] Commerce Commission, Issues Paper, Default price-quality paths for electricity distribution businesses from 1 April 2020, 15 November 2018, paragraph 3.40.
[21] Commerce Commission, New regulatory framework for fibre: Invitation to comment on our proposed approach, 9 November 2018, paragraph 7.110.

Q26 What specific factors of the telecommunications environment do you think are relevant to setting input methodologies for quality dimensions?

The increased importance of competition to, and the fast-changing nature of, the telecommunications environment are key factors that will be relevant to setting IMs for quality dimensions.

The setting of an appropriate Quality Dimensions IM impacts both the ability of FFLAS providers to effectively compete with each other and other competitive service offerings. In addition, CEPA rightly identifies fast changing end-user requirements as a factor especially relevant to the telecommunications environment, and one which is important to setting the Quality Dimensions IM: the Quality Dimensions IM must ensure FFLAS services are of a quality that remains relevant and fit-for-purpose across the duration of the regulation. As set out in our response to Q14 and Q25, for this reason we consider a more principles-based, rather than prescriptive ('level 4') approach, is more appropriate for the Quality Dimensions IM. This provides flexibility to vary (improve) the appropriate service quality targets between price resets to reflect changes in end-user demands and technological developments.

Q27 What views do you have on the approach or processes that should be adopted for setting price-quality paths? For example:

Our expectation is that the approach to Individual Price-Quality Path (**IPP**) regulation for Transpower will form the basis for the starting point on price-quality regulation for Chorus' fibre services, given Part 6 has been modelled on the Part 4 provisions relating to Transpower.

The new fibre framework consultation states "[w]e propose adopting a broadly similar approach to the setting of price-quality paths as for customised price-quality paths and individual price-quality paths under the Commerce Act". We are interested to understand where the Commission considers the Customised Price-Quality Path (**CPP**) precedent may be more applicable than the IPP precedent.

Q27a Should a supplier be required to present a price-quality path proposal? What role would the Commission have in evaluating the proposal?

We note Transpower is required to present a price-quality path proposal under the IPP regulation, and other regulated suppliers (Electricity Distribution Businesses and Gas Pipeline Businesses) are only required to present a proposal if they apply for a CPP.

The Part 4 Capex IM, in combination with s53ZD notices, require Transpower to submit a proposal for the operating and base capital expenditure allowances and quality standards to apply for the regulatory period. Transpower's voluntary adoption of a Consumer Advisory Panel and formal consultation on its proposals is relevant to the efficacy of this approach.

Transpower is required to submit its proposal 16 months prior to the start of the regulatory period (11 months prior to the Commerce Commission making a final price determination).

Given the Commission proposes to make a final price determination for fibre 12 months after the determination of the IMs the proposal process may not be feasible for the first regulatory period, or it may mean the proposal has to be limited in scope.

We are interested to understand the Commissions' views on requirements for the supplier (Chorus) to present a proposal, based on its experience under both Part 4 of the Commerce Act and the Telecommunications Act.

Whether or not there is a requirement for the supplier to present a proposal depends on whether the supplier is likely to engage with the process in good-faith. The experience in telecommunications, given the approach Chorus has adopted in the past, has not been encouraging and does not fill us with confidence. For example:

- In relation to Chorus' submission of a TSLRIC calculation for copper services, the Commission concluded Chorus hadn't presented it with an appropriate TSLRIC-model that could be used to set the prices of the UCLL and UBA services.[22]
- In the case of the TSO, Telecom [now Chorus] managed to more than double the estimate it had provided under Information Disclosure. The Telecom [Chorus] TSO net cost estimate was originally $167m (2000/2001), when it was used for information disclosure only, then jumped to $408m (2001/02), after the Telecommunications Act enabled Chorus to recover a share of the net costs from its competitors. These estimates are both substantially higher than the Commission's determinations of the network cost of the TSO: $65.57m (2001/02), $56.75m (2002/03), and $69.72m (2008/09, draft) in the final year the Commission calculated the cost.

Q27b What historical or forecast information should be required and where should this information be sourced from? Should the information be subject to customer consultation and/or independent scrutiny or other verification?

The inclusion of both customer consultation and independent verification would be consistent with Part 4 precedent.

We note the Part 4 CPP process requirements include both customer consultation requirements and an Independent Verifier agreed by both the regulated supplier and the Commission. We would welcome customer engagement, including with RSPs.

The Part 4 IPP arrangements for Transpower's 2020 price reset now also include an Independent Verifier, and Transpower's voluntary addition of a consultation process and a Consumer Advisory Panel. This helps enhance the credibility of the material subsequently proposed to the Commission.

Q27c Is there a role for a forecast total expenditure (totex) approach instead of requiring building blocks to be set with reference to capital and operating expenditure?

We note the Commission's observation that "[a] number of overseas regulators, including Ofgem and more recently the Australian Energy Markets Commission (AEMC), have moved

[22] Commerce Commission, Further draft pricing review determination for Chorus' unbundled copper local loop service, 2 July 2015, paragraph 1917.

to a 'totex' approach for setting revenue allowances for regulated utilities. This has been partly motivated by concerns around the asymmetric treatment of capital expenditure and operating expenditure".[23]

While the Commission considered the option of forecasting operating expenditure and capital expenditure together (a "totex" model) for DPP3, it indicated a preference against this approach on the basis that:

- "A move to a full totex approach would be a significant change in regulatory approach for EDBs".[24] This explanation is not necessarily applicable under Part 6 where a new regulatory regime is being developed.

- "According to advice prepared by Frontier Economics for the AEMC, the transition to a totex framework would require significant development work and would likely take two to three years". [25] We assume this advice would also apply to application under Part 6 in which case the Commission may not be able to develop a totex approach within the legislative timeframe for the Implementation Date.

Q28 Do you have any views on additional incentive mechanisms (such as IRIS) that would be beneficial to consider including? (Note that the scope to include any additional mechanisms may be limited, given the time constraints we are under.)

This question may come down to time constraints and the extent to which the Commission can leverage off existing Part 4 precedent. IRIS, for example, was initially applied only to Transpower, before being extended to other regulated suppliers.

[23] Commerce Commission, Issues Paper, Default price-quality paths for electricity distribution businesses from 1 April 2020, 15 November 2018, paragraph E24.
[24] Commerce Commission, Issues Paper, Default price-quality paths for electricity distribution businesses from 1 April 2020, 15 November 2018, paragraph E25.
[25] Commerce Commission, Issues Paper, Default price-quality paths for electricity distribution businesses from 1 April 2020, 15 November 2018, paragraph E25.