Submission on Commerce Commission Fibre Regulation Emerging Views Paper

16 July 2019

1 Executive summary

2degrees welcomes the invitation to submit in relation to the Commerce Commission's (the Commission's) Emerging Views Paper (EVP) on the development of fibre Input Methodologies (IMs) under the new Part 6 of the Telecommunications Act (the Act).

As a full-service telecommunications provider, 2degrees will purchase Fibre Fixed Line Access Services (FFLAS) under this new regulatory framework for both UFB services and as key fibre input services to fixed and wireless networks. This will include inputs for Fixed Wireless Access (FWA) services and future 5G services. [1]

In addition to fixed line investments, 2degrees are currently planning substantial future investments in a 5G network upgrade. In its recent Mobile Market Study Preliminary Findings report the Commission highlighted the importance of continued wholesale competition brought by 2degrees in wireless markets.[2] It will be important to ensure the new Part 6 regulatory framework, which is heavily focussed on regulation of Chorus wholesale fibre inputs, does not harm competition from competitive wireless alternatives, for example by favouring particular technologies or access services such as retail fixed broadband services. To do so would be inconsistent with the purpose of the Act, which is to promote competition for the long-term benefit of *all* telecommunications end-users (not just consumers of retail fixed broadband services).

2degrees reiterates its view that the Commission has made a positive start to the development of the new fibre regulatory regime.

2degrees is **largely in agreement with the Commission in relation to its interpretation of its legal framework,** although we think the competition objective has greater relevance than the EVP suggests. 2degrees agree the statutory objective of section 166(2)(b) doesn't subjugate one form of competition (retail competition) over other forms (infrastructure-based competition). The arguments in favour of retail competition reflect the vested interests of parties who do not want to face infrastructure-based competition (Chorus) and whose business model is retail-only in telecommunications (Trustpower). The Commission will need to evaluate the extent to which section 166(2)(b) is relevant to each of its decisions on the IMs.

2degrees support adoption of the Part 4 economic principles as proposed by the Commission (real financial capital maintenance (FCM), allocation of risk, and asymmetric consequences of over and under-investment) but also consider pricing principles (which we see as relating to competition) to be especially important in telecommunications as compared to regulated Part 4 services. Pricing principles have been adopted for Airports and Gas Pipeline services under Part 4 of the Commerce Act (Part 4 Commerce Act). We consider there would be substantial benefits from adopting them for fibre as well. As such, we consider **the Commission's emerging view on Pricing Principles should be revisited.** If pricing principles are not

[1] In the form of Dark Fibre Access Services (DFAS) and Intra Candidate Backhaul Services (ICABS). Alongside fibre input services, 2degrees will also purchase copper ADSL and VDSL services outside the new Part 6 of the Act for customers not able to receive fibre services.
[2] Commerce Commission, Mobile Market Study – Preliminary Findings, 16 May 2019.

adopted for the first regulatory period, it will be important to ensure they are considered before the second regulatory period. Under Part 6 the Commission is able to introduce new IMs at any time, so a decision not to introduce Pricing Principles before the first price-quality determination does not exclude their introduction in the future.

Part 4 Commerce Act provides useful precedent. 2degrees appreciates the Commission providing details of the extent to which it is relying on Part 4 Commerce Act precedent, including the table comparisons in the Summary Paper. 2degrees support adopting much of the Part 4 precedent, for example, in relation to the adoption of pricing principles and the Commission's position that the Part 4 WACC IM (as reflected in the copper pricing FPP determination) and mid-point WACC (as reflected in Part 4 Airports, and the copper pricing FPP determination) should be adopted.

However, there are also key differences in telecommunications (including with the new regulatory framework of the Act and the UFB rollout) that require deviation from Part 4 precedent. 2degrees has identified key potential areas of weakness in implementation of the new framework, including:

- **Determination of the scope of regulated services, including costs and assets:**

  We do not support LFCs determining which of the services they offer are regulated and which assets are employed, or partly employed, in the provision of those services. The Commission should be clear about what is and is not included as part of FFLAS. We note despite it being clarified to legislators that the new Part 6 of the Act does include ICABS, Chorus' are seeking these to be excluded.

- **Information asymmetries and limited oversight of Chorus given time pressures**

  One of the challenges the Commission will need to address is obtaining reliable information for price-setting. The Commission will face significant challenges in determining Chorus' reasonable current and projected costs (and Maximum Allowable Revenue) for its FFLAS business given the limited timeframe for the determinations and immaturity of the new fibre regulatory framework (for example, the Commission doesn't have the history of Asset Management Plan (AMP) capex and opex forecasts that it has in electricity). It is notable that the Commission has been able to substantially curtail Network Tasman and The Lines Company's respective capex allowance on the basis of *"a history of over-forecasting in their past AMPs"*. In the absence of such information the Commission will need substitute safeguards such as Independent Verification, caps on expenditure allowances and limiting the extent to which it relies on supplier provided information.

  If the Commission relies on Chorus' supplier proposal as part of the price-quality determination, it should consider adopting a '**re-opener'** that would allow the price-quality path to be adjusted if Chorus' actual capex and/or opex is below the levels in its proposals and allowed for in the price path.

  2degrees also remains of the view that **the Commission should adopt more prescriptive (and restrictive) Cost Allocation and RAB IM rules** given the impact Chorus can have on competition.

- **Financial losses should be calculated on an incremental cost basis [Q21]**

  The Commission's emerging view that Chorus' financial losses from UFB services should be calculated on an ABAA fully allocated cost basis, rather than an ACAM incremental or avoidable cost basis, would result in excessive profits being capitalised in Chorus' RAB and failure to meet the Part 6 purpose (s162(d)). Each dollar of common cost capitalised in the RAB equates to a monopoly profit allowance with no benefit to consumers from the higher prices. It is also inconsistent with how a supplier in a workably competitive market would operate – assessing the merit of new investment or services on the basis of whether the additional revenue would exceed incremental costs and thereby increase overall profits.

- **Double recovery for copper-fibre needs to be addressed**

  We welcome that the Commission recognises double-recovery is an issue, but would like it to investigate how it can best prevent or mitigate double-recovery between Chorus' copper and fibre services. Not addressing this would weaken the limits on Chorus' ability to extract excessive profits and result in failure to meet the Part 6 purpose (section 162(d)). We acknowledge this issue is more challenging than for LFCs' electricity and fibre services, or utilities that provide both electricity and gas network services (or gas distribution and transmission services), however it cannot be ignored.

The Quality IM is a new requirement for the Commission. 2degrees considers the quality metrics in the Network Infrastructure Project Agreements (NIPAs) and wholesale service agreements (WSAs) to be generally satisfactory. We support the Commission's adoption of CEPA level 3 for the Quality IM, given the need for flexibility in the IM (to allow for technology/quality changes over time). However, we are increasingly concerned about the actual service standards that will apply come the date when the new regulatory framework comes into place.

We would be concerned if the Commission adopted Chorus' suggestion of not setting targets for quality regulation (as part of the price-quality path) for the first regulatory period as a transitional measure. We consider the quality requirements under the UFB agreements should be used to help set the Quality IM as well as the quality measures and standards set under PQR and ID determinations for the first regulatory period. We would support transitional measures for the first regulatory period to ensure quality requirements currently in place in the UFB agreements 'carry over' to the new regulatory framework.

Need for a longer consultation period for the draft IMs

In relation to the next stage of development of the new Part 6 fibre regime, 2degrees continues to seek a **longer consultation period for the draft IMs** than is currently scheduled. The short legislative timeframe the Commission has available for dealing with complex and detailed issues, such as development of the fibre IMs, and the first price-quality determination, increases the risk that they will favour Chorus, at the expense of the smaller and less well-resourced RSPs and end-users, if not managed carefully.

The draft decision consultation, which will include a draft Reasons Paper (or Papers) and IMs, will be much more substantive than the EVP yet the Commission has currently scheduled a shorter period for this consultation. We consider six weeks could be suitable for individual IMs

or a subset of IMs, if a staggered consultation is adopted, but not for the omnibus consultation on the entire set of IMs the Commission is planning at this stage.

We reiterate our previous submission that if the Commission consults on an omnibus draft *"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"*.[3]

As well as allowing more time for submissions, the Commission should consider providing different due dates for different IMs to help manage the volume of material that will need to be reviewed. While the Commission has decided against a staggered release of the draft IMs, there is no reason it couldn't stagger the due dates for the submissions on the different components of the IMs.

To the extent the Part 4 Commerce Act and copper pricing determinations set precedent which can be applied to Part 6, this will help reduce the time pressure the Commission and stakeholders inevitably face. For example, only limited work should be needed for application of the Part 4 electricity WACC IM, and use of mid-point WACC from the copper pricing determination. The Transpower Capex IM is the largest single Part 4 IM so we expect time savings to the extent the Commission adopts a similar approach for the Part 6 Capex IM.

[3] 2degrees, Submission in response to the Commerce Commission's proposed approach on the new regulatory framework for fibre, December 2018.

2 Legal Framework

2degrees is largely in agreement with the Commission in relation to its interpretation of its legal framework although we think the competition objective has greater relevance than the EVP suggests [Q3 & Q4].

We understand matters relating to cost allocation and Related Party Transactions came under a lot of attention during the Part 4 IMs statutory review, due to competition-specific considerations. We expect issues with the impact on competition to be substantially more material in relation to the provision of fibre services and telecommunications more generally, than for services regulated under Part 4 Commerce Act.

2degrees agree with the Commission that the statutory objective (section 166(2)(b)) doesn't subjugate one form of competition (retail competition) over other forms (infrastructure-based competition). The arguments in favour of retail competition reflect the vested interests of parties who does not want to face infrastructure-based competition (Chorus/LFCs) and whose business model is retail-only in telecommunications (Trustpower). Under the Act the Commission will need to evaluate the extent to which section 166(2)(b) is relevant to each of its decisions on the IMs.

We interpret the Commission *"assumption that in practice the section 166 objectives would generally be met for most of our decisions if they promoted the section 162 outcomes"*[4] as meaning the Commission expects most of the decisions it has to make in relation to the IMs won't impact on the promotion of competition. We do not agree with this, and, regardless, consider the Commission needs to be careful about such assumptions, which could have unintended consequences that damage competition.

2degrees agrees with the Commission that the power to set IMs extends beyond IMs required for information disclosure (ID) or price-quality regulation (PQR), and that *"subject to the mandatory obligations in s 166 (and any other mandatory obligations in the Act), [the Commission] can determine any IMs where doing so would fit within the purpose in s 174. This would include IMs to support the matters in subparts 7 to 10 of Part 6 and not only IMs directly related to PQR and ID regulation"*.[5] [Q3]

We also agree that section 178(2) enables the Commission to determine additional IMs at any time after the implementation date of 1 January 2022.[6] This is something 2degrees advocated for when the legislation was being introduced.

[4] Commerce Commission, Fibre regulation emerging views: Technical Paper, 21 May 2019, para 69.
[5] Commerce Commission, Fibre regulation emerging views: Technical Paper, 21 May 2019, para 99.
[6] Commerce Commission, Fibre regulation emerging views: Technical Paper, 21 May 2019, para 100.

3 Economic Principles

The Commission has decided to maintain the same economic principles as it has under Part 4 of the Commerce Act: real financial capital maintenance (FCM), allocation of risk, and asymmetric consequences of over and under-investment. While we support adoption of these principles, there were a number of competition, pricing and policy principles submitters proposed, but the Commission rejected.

In relation to the pricing principles, which we see as relating to competition, there is an element of 'kicking to touch' for a later date. In our view, if these are not adopted for the first regulatory period, it will be important to ensure they are revisited after the Commission has made its first pricing determination.

We expect competition and pricing principles to be more important in telecommunications than for Part 4 Commerce Act regulated services. Part 4 Commerce Act and the Electricity Industry Act provide precedent for inclusion of pricing principles in the IMs. The Electricity Authority wasn't required to adopt pricing principles but determined it should do so for electricity distribution. It went a step further for electricity transmission, mandating guidelines and requiring Transpower to seek approval for its transmission pricing methodology.

While Pricing Principles are mandatory under Part 4 Commerce Act and discretionary under Part 6 Telecommunications Act, we consider there would be substantial benefit in adopting Pricing Principles for fibre.

We are unclear why the Commission has adopted a different approach in telecommunications to that of Part 4 regulated services. The Commission has raised concerns about the application of a subsidy-free (incremental cost) pricing principle, but it had no such concerns introducing them for airports and gas. While the Part 4 IMs required the Commission to develop Pricing Principles IMs, if a subsidy-free principle was problematic the Commission didn't need to include it in the IMs. The Commission and Electricity Authority have determined subsidy-free pricing is appropriate for airports, electricity and gas. It is a standard pricing principle (albeit with variations in the wording) for network pricing.

For the avoidance of doubt, the EVP is mistaken in the suggestion that while 2degrees considers the objective of promoting competition is a key differentiating factor between the Part 4 IMs and the Part 6 IMs, it did not support a competition principle and is neutral in regard to the need for pricing principles.[7] As stated in 2degrees' submission *"….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"*.

We support adoption of pricing principles but recognise there are overlaps between pricing principles and rules for cost allocation amongst different FFLAS services.

[7] Commerce Commission, Fibre regulation emerging views: Technical Paper, 21 May 2019, paras 130 &133.4.

4 Extent to which Part 4 Commerce Act provides relevant precedent

2degrees appreciates the Commission providing details of the extent to which it is relying on Part 4 Commerce Act precedent. The table comparisons in the Summary Paper are useful.

It is relatively non-contentious that Part 4 provides relevant precedent. This has been acknowledged by both RSPs and Chorus.

The similarity between the Part 4 Commerce Act and Part 6 Telecommunications Act provisions also mean there are learnings from the High Court Part 4 IMs Merit Appeal decision which provide relevant precedent.

We do note, however, that there are some areas where Part 4 precedent has not been followed but where this is not noted in the EVP (for example in relation to pricing principle precedent).[8]

2degrees has the following initial views on the extent to which the Commission should rely on Part 4 precedent:

- **Pricing Principles: [Q7]**

  The Part 4 IMs contain pricing principles, including a principle requiring pricing between incremental and stand-alone costs (subsidy-free pricing). The Electricity Authority has also adopted pricing principles for electricity distribution which provide relevant precedent.

  2degrees considers that the IMs should address pricing between different regulated FFLAS services. Just as the Commission determined separate TSLRIC prices for each of UBA and UCLL (and didn't leave it to Chorus to unbundle an aggregate price for both services), the Cost Allocation IM and/or pricing principles should determine how the price of layer 1 and layer 2 services are determined.

- **Cost allocation (including for RAB) IM: [Q16]**

  2degrees supports the Commission adopting the approach in the Airports Cost Allocation IM of providing for an ABAA cost allocation methodology between regulated FFLAS services and other services, and not providing for ACAM (only suitable for calculating financial losses) or OVABAA.

  It is notable and relevant that there is no equivalent of section 52T(3) Commerce Act in the Telecommunications Act.[9] The section 166(2)(b) Telecommunications Act provisions to promote competition are also relevant. These legislative differences support (i)

[8] The electricity IMs do not include pricing principles because these are within the jurisdiction of the Electricity Authority. However, the Electricity Authority pricing principles provide relevant precedent and are very similar to the Pricing Principles IMs. Most of the deviations reflect changes the Electricity Authority recently made to the electricity distribution pricing principles.

[9] The Commission makes the same observation: *"Under Part 4 of the Commerce Act, IMs must not unduly deter investment by a supplier of regulated goods or services in the provision of other goods or services. The OVABAA cost allocation option was introduced into the electricity and gas Part 4 IMs to help achieve this outcome. There is no equivalent requirement in Part 6."* Commerce Commission, Fibre regulation emerging views: Technical Paper, 21 May 2019, para 306.

exclusion of ACAM and OVABAA for the cost allocation (which would allow all common costs to be allocated to the regulated business);[10] and (ii) adopting a more prescriptive approach to cost allocation, which the Commission is presently shying away from.

- **Double-recovery of shared and common costs:**

  The Commission's approach has been to exclude double-recovery of shared and common costs where a regulated supplier provides both electricity and gas network services (e.g. Vector), and/or gas distribution and transmission services (e.g. FirstGas). This is directly relevant to treatment of LFCs' electricity distribution and fibre services, as is recognised in the Commission's proposals. It is also directly relevant to Chorus' copper and fibre services. We consider the Commission should explore further how it can manage the issue of double-recovery between Chorus' copper and fibre services.

- **Determination of financial losses:**

  The High Court Part 4 IMs decision provides relevant precedent in relation to its concerns that *"The more common costs that are allocated to regulated services, the higher the prices for regulated services will be"*[11] and that "*An initial RAB value would … be fundamentally flawed … if it failed to limit suppliers' ability to extract excessive profits over time"*.[12,13] The previous requirement under the Telecommunications Act to calculate the net losses of providing TSO services to commercially non-viable customers on an incremental cost basis is also directly relevant.

- **WACC IM: [Q24 & 31]**

  There are no relevant industry specific or legislative differences which would warrant variation in relation to WACC methodology. This is reflected in adoption of the Part 4 WACC IMs for determining the TSLRIC price for copper services.

- **WACC percentile:**

  The methodological approach the Commission took to determining WACC percentiles under Part 4 provides relevant precedent. While the Commission adopted 67th percentile for electricity and gas, this reflected industry-specific circumstances. The Commission's adoption of mid-point for airports and copper services provides the most directly relevant precedent for fibre.

- **Independent Verification and consumer engagement:**

  Part 4 Commerce Act provides relevant precedent in relation to transmission IPPs and electricity distribution customised price-quality paths (CPPs). This includes the further initiatives to develop and evolve these requirements reflected in the draft Transpower IPP determination for 2020-2025. Independent Verification will be an essential component of

[10] We are aware there are some practical issues with application of OVABAA, under the Part 4 Cost Allocation IMs.
[11] WELLINGTON INTERNATIONAL AIRPORT LTD & ORS v COMMERCE COMMISSION [2013] NZHC [11 December 2013], from para [1804].
[12] WELLINGTON INTERNATIONAL AIRPORT LTD & ORS v COMMERCE COMMISSION [2013] NZHC [11 December 2013], para [770].
[13] While the High Court supported the Commission's views against ACAM for financial separation purposes (where the regulated business would be treated as the stand-alone business), the same analysis would support ACAM for calculating financial losses with the UFB business treated as the avoidable business.

the first price-quality determination if the Commission relies on a Chorus' supplier proposal or other Chorus provided information (such as expenditure forecasts in Chorus' AMP).

- **Quality Dimensions IM:**

  The Commission proposes to expand Information Disclosure requirements to obtain the information it needs to set new service quality standards for the next (2025) electricity price-quality resets. The Commission could adopt the same approach for fibre where it doesn't have adequate information for potential service quality standards.

- **Capex IM: [Q53, 54 & 55]**

  We agree with the Commission that *"While the IMs in Part 4 were designed for different sectors … there are lessons relevant to the fibre sector on how to assess and approve capex proposals"*.[14]

  There have been no submissions which provide relevant evidence the Commission should adopt a different approach to that under the Transpower Capex IM. The critical role of the Capex IM is to ensure gold-plating does not occur and investment reflects the needs of network-users. We also consider customer consultation and Independent Verification are vital components that have emerged as Part 4 Commerce Act regulation evolved.

- **Penalties and fines:**

  The Commission is proposing to amend the Part 4 IMs *"… to make it clear that fines and penalties do not qualify as opex"*[15] for price-quality regulation purposes. The Commission noted it would be *"a perverse outcome" "If these costs were … passed through to consumers"* and *"pecuniary penalties and fines are intended to penalise distributors (or other parties) for conduct contravening standards that apply to them. There is no policy reason for these costs to be shared with consumers"*.[16] We agree. The same should apply in relation to fibre services regulated under Part 6 Telecommunications Act.

[14] Commerce Commission, Fibre regulation emerging views: Technical Paper, 21 May 2019, para 770.
[15] Commerce Commission, Default price-quality paths for electricity distribution businesses from 1 April 2020 – Draft decision, Reasons paper, 29 May 2019, para A61.
[16] Commerce Commission, Default price-quality paths for electricity distribution businesses from 1 April 2020 – Draft decision, Reasons paper, 29 May 2019, para A60.

5 Potential areas of weakness in implementation

2degrees is concerned the proposed design of key elements of the new IMs are unduly loose and would enable or result in excessive profits.

Key elements we are concerned with at this stage include:

- The determination of the scope of regulated services, including costs and assets;
- The significant information asymmetries and limited oversight of Chorus, particularly given time pressures;
- Not determining financial losses on an incremental cost basis; and
- Double recovery from fibre and copper.

We provide more details on each of these concerns in turn.

Determination of the scope of regulated services, including costs and assets

2degrees does not support the suggestion that *"Chorus and the other LFCs will need to determine which of the services they offer are regulated, and which assets are employed, wholly or partly, in the provision of those services"*.[17] We consider the Commission should provide regulatory direction about what costs and assets qualify for inclusion in the regulated fibre business.

Chorus is currently claiming FFLAS does not include ICABS, despite MBIE clarifying to legislators that the new Part 6 would include ICABS. For example, legislators were advised "*DFAS and ICABS are both fibre fixed line access services and will be subject to regulatory oversight under the new Part* 6".[18]

The issue of what is and isn't part of the regulated service has been contentious in electricity in relation to technological development and emerging technologies. For example, with debate about whether household LED lights, Electric Vehicle (EV) chargers etc should or can be included in the RAB. We understand electricity retailers raised concern that regulated suppliers would be able to inflate their regulated costs and inflate their regulated business profits/enable subsidisation of other competitive market activities. The Commission has had to publish guidance on how EDBs should be accounting for costs and revenues on such issues and deemed it necessary to undertake an information gathering process to investigate how emerging technology investments are accounted for by EDBs.

We expect analogous issues could arise in relation to what Chorus attempts to include in its RAB and regulated costs if it isn't given clear and prescriptive direction.

[17] Commerce Commission, Fibre regulation emerging views: Technical Paper, 21 May 2019, para 187.
[18] See: Telecommunications (New Regulatory Framework) Amendment Bill, Departmental Report to the Economic Development, Science and Innovation Committee, 20 April 2018, at Appendix 2 page 20.

Information asymmetries and limited oversight of Chorus given time pressures

One of the challenges the Commission needs to address is obtaining reliable information for price-setting. The Commission will face significant challenges in determining Chorus' reasonable current and projected costs (and Maximum Allowable Revenue), for its FFLAS business, given the limited timeframe for the determinations and immaturity of the new fibre regulatory framework. The Commission doesn't have the history of Asset Management Plan (AMP) capex and opex forecasts that it has in electricity. The Commission will need substitute safeguards such as Independent Verification, caps on expenditure allowances and limiting the extent to which it relies on supplier provided information.

Chorus' suggestions that time-pressure to develop a supplier proposal should be managed through less granular or prescriptive information requirements, applying less scrutiny to proposed expenditure, etc, are entirely self-serving and would be contrary to the Part 6 purpose to promote the long-term interests of end-users and, more specifically, limiting Chorus' ability to extract excessive profits.

Chorus lobbied for a very constrained timetable for implementation of the new fibre regime. It was well catered for by experts with Part 4/Part 4 Individual Price-Quality Path (IPP) experience to understand what is required for implementation of the regime. Chorus is now seeking a number of short-cuts and regulatory relief, including absence of service quality regulation,[19] on the basis that the timeframe for implementing the regime is limited (despite the Commission requesting and receiving the maximum possible extension to the implementation timeframe).

We consider the types of regulatory short-cuts proposed by Chorus would leave access seekers and end-users exposed to insufficient checks and scrutiny of current and projected costs for the first regulatory period. The risk is particularly pronounced as the Part 6 Telecommunications Act regime is new and there isn't a history of Asset Management Plan (AMP) disclosure that existed in electricity and gas when Part 4 was introduced.

It is clear from the recent default price-quality path (DPP) and IPP draft determinations that the Commission draws heavily on experience with how accurate supplier forecasts of opex and capex etc have been from past regulatory periods, including comparison of actual expenditure against allowed expenditure. This enabled, for example, the Commission to impose substantially tighter capex controls on Network Tasman and The Lines Company than other EDBs. The Commission noted the capex they forecast was justified by information presented in their AMPs, which was significantly rejected *"given a history of over-forecasting*

[19] We note that despite what Chorus wants, the Commission does not have discretion over whether price-quality regulation includes regulation of service quality. Both Part 6 of the Telecommunications Act and Part 4 of the Commerce Act require the Commission to regulate both price and service quality. Section 194(2)(c) of the Telecommunications Act specifies that *"A price-quality path must specify … the quality standards that must be met by a regulated fibre service provider"*. This is the same requirement as section 53M(1)(b) in Part 4 Commerce Act for which the Commission has noted *"We are required by the Act to set quality standards that must be met by regulated suppliers when setting price-quality paths"*: Commerce Commission, Default price-quality paths for electricity distribution businesses from 1 April 2020 – Draft decision, Reasons paper, 29 May 2019, para 7.13.

in their past AMPs" which meant the Commission did *"not have confidence that this expenditure will be delivered"* [emphasis added].[20]

The Commission will be at a substantial information disadvantage in determining Chorus' Maximum Allowable Revenue, compared to electricity and gas under Part 4 Commerce Act. There is a risk Chorus discloses immature and inflated AMP forecasts of opex and capex requirements and these don't get the attention they warrant in the first regulatory reset determination. This risk will be particularly heightened if Chorus adopts the same strategy for AMP forecasts that it did for TSO cost and copper TSLRIC estimates.

If the Commission relies on Chorus' supplier proposal, as part of the price-quality determination, it should consider adopting a 're-opener' that would allow the price-quality path to be adjusted if Chorus' actual capex and/or opex is below the levels in its proposals and allowed for in the price path. This could act as a proxy for the type of rules the Commission applies to scrutinise Electricity Distribution Businesses' (EDBs') past forecast performance.

2degrees also remains of the view that the Commission should adopt more prescriptive (and restrictive) Cost Allocation and RAB IM rules; particularly given the impact Chorus can have on competition.

Financial losses should be calculated on an incremental cost basis [Q21]

2degrees is concerned with the Commission's emerging view to include shared and common costs in the calculation of financial losses. Inclusion of these costs would capitalise excessive profits in Chorus' Regulated Asset Base (RAB), equating to a monopoly profit allowance with no benefit to consumers from the higher prices. We do not consider this is a sound approach and consider that the Commission should adopt an avoidable (ACAM) or incremental cost method consistent with orthodox, economic, definitions.

2degrees previously submitted *"The orthodox approach to assessing whether a service is being provided below cost is to assess costs on an avoidable or incremental cost approach, which excludes all shared and common costs (and assets)"*.[21] Our position is consistent with other submissions which advocated common costs be excluded from the calculation of financial losses. The Commission should reconsider these issues.

An approach which could be adopted would be to apply ACAM with the UFB business treated as the avoidable activity (the opposite to the way ACAM has been provided for in the Part 4 Cost Allocation IMs for financial separation purposes): What would Chorus' profits be, compared to their actual profits, if it did not provide UFB services?

The previous TSO net cost provisions in the Telecommunications Act for recovery of the losses Telecom incurred from the provision of the Kiwi Share Obligation also provide appropriate guidance on the approach the Commission should take to calculating financial losses:

[20] Commerce Commission, Default price-quality paths for electricity distribution businesses from 1 April 2020 – Draft decision, Reasons paper, 29 May 2019, para X49.
[21] 2degrees, Cross-submission in response to the Commerce Commission's proposed approach on the new regulatory framework for fibre, January 2019.

- Losses were defined as being *"unavoidable … incremental costs"* (section 5); and

- The Commission was required to take the range of direct and indirect revenues and associated benefits derived from providing the TSO services into account (section 84). This provision is consistent with Trustpower's comment *"The benefit that Chorus received from participating in the UFB project (including subsidised financing and avoiding the prospect of competitive overbuild in the UFB areas)[24] should also be taken into account"*.[22] In the context of fibre losses, this would include tax deductions for losses.

For the avoidance of doubt, 2degrees does not support the following proposals in relation to the allocation of costs that could be included in the past losses for the initial RAB:

- "*All shared costs (including operating costs, impairment and depreciation in accordance with section 177(1)(b)) that relate to the UFB initiative must be allocated using ABAA."*

- *"ABAA is to be applied using consistent, objective, measurable and timely cost allocators when calculating the past losses."* [23]

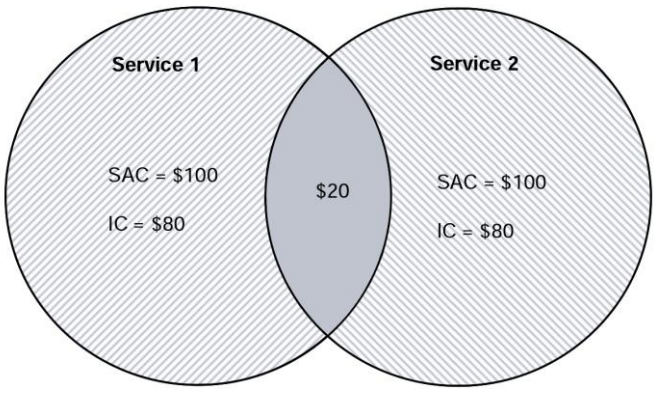
If financial losses are not calculated on an incremental or avoidable cost basis their level will be inflated and result in an excessive RAB. This would be contrary to the statutory objective to limit excessive profits.

The Commission proposal that ABAA be applied (a fully allocated cost approach) would result in transfers from consumers to Chorus for no corresponding benefit.

Illustrating the impact of ABAA versus ACAM approaches [Q21]

The impact of ABAA versus ACAM is illustrated by the Commission's stylised example in relation to electricity distribution and gas pipeline services.[24]

Figure 3.1 Stand-Alone Costs, Incremental Costs, and Efficiency Gains from the Provision of Two Services



[22] Trustpower, Trustpower's Cross Submission on Fibre Input Methodologies – Process Paper, 1 February 2019.
[23] Commerce Commission, Fibre regulation emerging views: Technical Paper, 21 May 2019, para 343.
[24] Commerce Commission, Input Methodologies (Electricity Distribution and Gas Pipeline Services) Reasons Paper, December 2010, at Figure 3.1.

If Service 1 is Chorus' pre-existing services (and/or copper services) and Service 2 is Chorus' new UFB service, then whether or not Chorus' is making a financial loss on provision of UFB depends on whether it is receiving $80 of revenue from UFB services: $70 revenue = $10 loss, $80 revenue = $0 break-even (normal profit), and $90 revenue = $10 excessive profit. But if the Commission adopts the ABAA approach and, say, splits common costs equally between the two services, $80 of UFB revenue will be incorrectly treated as equivalent to a $10 loss (rather than break-even).

The emerging view rationale for adopting ABAA is unsound [Q21]

We do not consider the reasons provided against adoption of an incremental or avoidable cost approach to the financial loss calculation, including Vodafone's proposal that *"common costs should be attributed mainly to existing services and should not be included in the losses calculation",* to be valid.

We recognise the time pressures the Commission is working under mean this topic may not have yet received the attention it warrants. 2degrees does not consider the reasons provided in the EVP answer the matter:

- The issue the Commission raises with *"efficiency gains from sharing prior to the implementation date"*[25] is not relevant, particularly given that calculation of financial losses is a backward-looking exercise. Both Chorus and the Commission have noted *"that the calculation of past losses for the initial RAB is a backwards-looking exercise"*, and *"It relates to a transitional period"* so would not have any efficiency incentive impacts. We agree with Vodafone that *"There is no incentive component to actions taken in the past …"*.[26] The determination of financial losses simply determines whether Chorus extracts windfall gains (excessive profits).

  While the High Court commented *"… some degree of sharing of efficiency gains would occur in workably competitive markets, with implications for incentives to invest and innovate. The mandatory use of ACAM would not allow any such sharing"*[27] this is only the case where the regulated business is treated as the stand-alone business. If we take the Commission's stylised example above it is clear end-users would not get any sharing benefit from allocating shared and common costs to the UFB business for the purpose of calculating financial losses to be added to the RAB. All consumers would get is dis-benefits from higher RAB and FFLAS prices.

- The Commission's statement that an incremental or avoidable cost methodology *"would effectively remove many of the assets used to provide FFLAS"*[28] does not provide a rationale for inclusion or exclusion of common or shared costs. Businesses entering into new markets do not consider overhead cost allocations when developing new products

[25] Commerce Commission, Fibre regulation emerging views: Technical Paper, 21 May 2019, para 347.
[26] Vodafone, New regulatory framework for fibre: Submission on Commission's proposed approach, 21 December 2018, para 92.1.
[27] WELLINGTON INTERNATIONAL AIRPORT LTD & ORS v COMMERCE COMMISSION [2013] NZHC [11 December 2013], para [1876].
[28] Commerce Commission, Fibre regulation emerging views: Technical Paper, 21 May 2019, para 347.

and services but seek to ensure that the expected net present value of the business proposal is positive.[29]

- We do not agree with the Commission's claim that exclusion of common costs from the calculation of financial losses would be *"inconsistent with decisions for asset valuation to adopt a BBM in the EVP"*[30]. This is not a relevant consideration as calculation of financial losses from UFB and development of the building blocks (including RAB) for Chorus' FFLAS business are separate exercises. The reasons the Commission has provided for why it (i) limited the role of ACAM under Part 4 Commerce Act (previously a mandatory method); and (ii) rejected ACAM for cost allocation purposes for FFLAS are not applicable to a consideration of how to calculate financial losses, nor do they justify artificial inflation of the financial losses.[31] The Commission's arguments are based on treating the regulated business on a stand-alone cost basis and over-allocating costs to the regulated business. Application of ACAM to calculate financial losses would treat the UFB business as the incremental basis and avoid over-allocation of costs.

- The Commission claims *"[the ABAA method] can apply to both Chorus and the other LFCs".*[32] However, 2degrees notes that an avoidable or incremental cost methodology (or any other methodology) could equally apply to both Chorus and LFCS.

- The Commission claims *"[the ABAA method] is robust for use of fibre technology for non-UFB purposes including UFB initiated assets being used to provide other services and vice versa".*[33] 2degrees does not agree with this statement. The ABAA method would result in an artificial increase in the calculated financial losses about the actual financial losses (if any) Chorus incurred. An incremental or avoidable cost methodology is the only economically sound approach for calculating financial losses.

- The Commission claims *"[the ABAA method] is consistent with the economic principle of Financial Capital Maintenance (FCM), including in terms of ensuring that Chorus receives a return on its investment in reused and common copper assets, particularly during the later years of the loss period when some of the assets will be increasingly, if not fully, used to provide UFB services"*.[34]

  For the Commission to rely on arguments that the use of ABAA for calculating financial losses *"is consistent with the economic principle of FCM"* it would need to demonstrate financial losses calculated on alternative incremental or avoidable cost basis would prevent Chorus from being fully compensated for past losses and earning at least a normal return. 2degrees cannot see a basis on which the Commission will be able to do so.

- The Commission claims that *"As the past losses will largely be calculated retrospectively, many of the reasons for using OVABAA or ACAM to create incentives to improve efficiency*

[29] See: Unison, UNISON SUBMISSION ON AMENDED DRAFT DECISION TO REMOVE ACAM AS A COST ALLOCATION OPTION FROM THE INPUT METHODOLOGIES, 13 October 2016, page 2.
[30] Commerce Commission, Fibre regulation emerging views: Technical Paper, 21 May 2019, para 347.
[31] WELLINGTON INTERNATIONAL AIRPORT LTD & ORS v COMMERCE COMMISSION [2013] NZHC [11 December 2013], from para [1876].
[32] Commerce Commission, Fibre regulation emerging views: Technical Paper, 21 May 2019, para 360.3.
[33] Commerce Commission, Fibre regulation emerging views: Technical Paper, 21 May 2019, para 360.4.
[34] Commerce Commission, Fibre regulation emerging views: Technical Paper, 21 May 2019, para 360.5.

or reduce unwanted cross-subsidisation do not apply".[35] In our view, an incremental or avoidable cost approach is the only economically valid approach to calculating financial losses, regardless of whether losses are being calculated in the past or future.

The burden of proof should be on Chorus to demonstrate the size of past financial losses [Q23]

2degrees does not support *"use of proxies"* or simplification of cost allocation to determine past financial losses.[36]

Chorus' own reporting decisions mean there isn't the same level of financial transparency about Chorus' fibre business' performance and profitability that there is for other operators. Chorus has made a decision to operate its financials on a consolidated basis: *"Chorus has determined that it operates in one segment providing nationwide fixed line access network infrastructure. The determination is based on the reports reviewed by the Chief Executive Officer in assessing performance, allocating resources and making strategic decisions"*.[37]

The situation is akin to that in which other regulated suppliers under Part 4 were in when they claimed the Commission's RAB IM would result in under-recovery of cost. The High Court in the Part 4 IM Merit Appeal decision was clear, the onus of proof should be on the regulated supplier to demonstrate the level of losses they need to be compensated for to earn a normal return. The High Court noted *"no regulated supplier – other than Vector whose evidence we did not find persuasive – provided factual evidence to suggest that the initial RAB values were such that over the lifetime of the assets the suppliers would in fact earn less than normal returns"*. The High Court noted *that "like the Commission we think that is of considerable significance"*.[38]

The High Court determined *"reasonable investor expectations should be met by … there being no evidence that suppliers would be unable to recover the costs of their past prudent and efficient investments"*.[39] The High Court also commented *"An initial RAB value would, in our view … be fundamentally flawed if it generated prices that were inconsistent with the achievement of the s 52A(1) purpose and outcomes, in particular if it failed to limit suppliers' ability to extract excessive profits over time"*.[40] We consider the High Court comments about the RAB hold equally for the value of financial losses that would be included in the fibre RABs.

The High Court commentary should be read in the context of the submissions and cross-submissions, which detailed why it should not be assumed Chorus has in fact incurred financial losses in provision of UFB services:

> *"… it is very hard to imagine that Chorus either expected to make a financial loss when it initially contracted to provide UFB services, or that it has actually made a loss, given what has actually*

[35] Commerce Commission, Fibre regulation emerging views: Technical Paper, 21 May 2019, para 360.6.
[36] Commerce Commission, Fibre regulation emerging views: Technical Paper, 21 May 2019, para 375.
[37] https://company.chorus.co.nz/file-download/download/public/1946
[38] WELLINGTON INTERNATIONAL AIRPORT LTD & ORS v COMMERCE COMMISSION [2013] NZHC [11 December 2013], para [589].
[39] WELLINGTON INTERNATIONAL AIRPORT LTD & ORS v COMMERCE COMMISSION [2013] NZHC [11 December 2013], para [769].
[40] WELLINGTON INTERNATIONAL AIRPORT LTD & ORS v COMMERCE COMMISSION [2013] NZHC [11 December 2013], para [770].

transpired in the meantime. The evidence of Chorus' outturn financial performance over this period provided by Vodafone appears to support this view. Vodafone has estimated that, post-structural separation, Chorus has earned an average return on equity of 24.4% - well in excess of any reasonable 'standard' measure of profit."[41]

"We know that Chorus has earned an excessive profit ever since the UFB build began. Its return on equity from 2011 to 2018 is 24.4% on average, allowing them to recover over $300m more than would have been possible using a return on equity determined by the Commission for regulated utilities."[42]

"In agreeing to participate in the UFB build Chorus must have had an ex-ante expectation of recovering its incremental costs. … Chorus must then have set prices in a way to recover its known incremental costs. Anything less would have been financially irresponsible. Many prices were set in negotiation with the Crown. Some products were set at a level to encourage uptake, while others such as the direct fibre access service (DFAS) remain very high. Chorus itself then set the price for some of the most popular products – such as the 100/20mbps product. It is inconceivable that they chose a price that would have resulted in a loss."[43]

"Nothing in submissions alters our view that it is unlikely any losses actually occurred since fibre was first deployed. We agree with Chorus' assertion that in aggregate, the initial UFB prices and terms were "competitively tendered and heavily negotiated, and as a result reflects competitive market outcomes". A competitive market outcome is sufficient for Chorus and the LFCs to recover their costs, anything less would have been financially irresponsible given the uncertainty about the future regulatory regime."[44]

Consistent with the High Court commentary, we agree with Spark that *"… the burden of proof should be squarely on Chorus to establish that it has suffered a financial loss during the initial period of the UFB build, and to provide compelling evidence of the quantitative extent of that loss. In the absence of that evidence, the assumed level of financial losses should be zero, i.e., there should be no presumption that losses exist. Indeed, there is very good reason to think that Chorus has suffered no financial detriment"*.[45]

Double recovery for copper-fibre needs to be addressed

The Commission proposes to introduce rules that would prevent double-recovery from the LFCs provision of electricity distribution and fibre services, but has not yet proposed rules to prevent double-recovery from Chorus' copper and fibre services.[46] The intention to only address double-recovery between LFC electricity distribution and fibre businesses, and not Chorus' copper and fibre businesses, is a concern and would weaken the limits on Chorus' ability to extract excessive profits and result in failure to meet the Part 6 purpose (section 162(d)).

[41] Spark, Cross-submission, New regulatory framework for fibre: proposed approach, 1 February 2019, para 41.
[42] Vodafone, New regulatory framework for fibre: Submission on Commission's proposed approach, 21 December 2018.
[43] Vodafone, New regulatory framework for fibre: Submission on Commission's proposed approach, 21 December 2018, paras 87 – 89.
[44] Vodafone, New regulatory framework for fibre: Cross-Submission on Commission's proposed approach, 1 February 2019, para 24.
[45] Spark, Cross-submission, New regulatory framework for fibre: proposed approach, 1 February 2019.
[46] The BBM framework that applies under Part 4 Commerce Act also specifically ensures, for example, regulated suppliers that operate both gas and electricity networks (or gas distribution and transmission) are precluded from recovering common and shared costs from both networks.

We appreciate this is only an emerging view and that the Commission has recognised it as a genuine issue, but we don't consider it can or should be ignored simply because it might be difficult to address. We expect the Commission to investigate how it can best prevent or mitigate double-recovery between Chorus' copper and fibre services. We acknowledge the issue is more challenging than for LFCs' electricity and fibre services, or utilities that provide both electricity and gas network services (or gas distribution and transmission services).

The operation of price control in relation to Chorus' copper and fibre networks is made more complicated, by the fact the copper and fibre price determinations will be made at different times and under different sets of rules (e.g. copper pricing was set on the basis of a TSLRIC methodology) but the same issues are relevant.

We note Chorus suggested *"some submitters incorrectly conflate the Commission's TSLRIC costing exercise with Chorus' actual costs and ask the Commission to undertake tasks that are inconsistent with the BBM approach under Part 6"*.[47] We are not aware of any submission which raised concerns about double-recovery on the basis of a conflation of TSLRIC and actual costs. Both use building blocks methodologies. The use of TSLRIC rather than actual cost does not remove risk of double-recovery, it just changes the way costs are determined.

[47] Chorus, New regulatory framework for fibre: cross-submission on Commission's proposed approach, 1 February 2019, para 3.2.

6 Quality IM

Scope and detail of Quality IM

2degrees supports the Commission's adoption of CEPA level 3 in relation to the Quality IM. It is important that quality regulation under Part 6 sets the right balance between certainty and flexibility particularly given expected changes and developments in technology over time.

However, we are concerned to ensure adequate service quality measures and standards sit under the Quality IM, and that considerable industry efforts to date (in the form of UFB agreements and work to improve processes, such as fibre installation), are not lost when we transition to the new regulatory regime and NIPA and WSA requirements expire.

NIPA and WSA quality requirements should be used to inform Part 6 quality regulations

2degrees considers that the quality requirements of UFB agreements have generally worked well to date. While some adjustments may be required, the requirements under the UFB agreements should be used to help inform the quality measures and standards under PQR and ID determinations, provided that the quality requirements apply to all FFLAS (which enable access to and interconnection with the fibre network).

If the Commission determines that a transitional measure is necessary for the first regulatory period, 2degrees would support carrying over of quality requirements currently in place to the new regulatory framework. By drawing on existing UFB agreements, the Commission would ensure a smoother transition into the first regulatory period, with quality measures and standards consistent with fibre providers' current BAU and reporting standards.

In addition, we note the UFB agreements will be particularly helpful to the Commission in the first regulatory period given that it does not have the benefit of historical Information Disclosure on which to base its determinations. To this extent, 2degrees also encourages the Commission to set broad information disclosure requirements for quality so that future regulatory determinations will be well informed.

Principle of controllability

2degrees supports the Commission applying a 'principle of controllability' in determining which aspects of quality should be set under RSQ versus Part 6, and supports Spark's suggestion that quality dimensions should cover Chorus' operating efficiency and approach.

7 Other matters

Clarification of 2degrees' views on Starting Price Adjustments IM

2degrees raised the possibility that the Commission could consider developing a Starting Price Adjustment (SPA) IM, as an example of an IM outside of the minimum prescribed set of IMs in Part 6. We didn't express a view one way or another about the merit of this option, but are aware there was a lot of debate about whether a SPA IM should be introduced under Part 4.

Under Part 4 the Commission ultimately concluded it wasn't able to introduce such an IM because the window for introduction of additional IMs, beyond the mandatory requirements, had lapsed. The Commission's rebasing is not applicable under Part 6 Telecommunications Act due to legislative differences[48] and the fact it is in the process of developing the IMs.

It is less than clear why Chorus considers that *"a starting price adjustment … isn't relevant in this regulatory context where we have a MAR and anchor services (and certain other services can be) specified"*.[49]

The Commerce Commission will need to make a number of decisions at each price reset, including setting of a revised MAR, determining whether to roll-over existing prices, determining whether there should be an immediate and full starting price adjustment, or whether there should be price smoothing over the regulatory and beyond, etc.

[48] Section 178(2) of the Telecommunications Act.
[49] Chorus, New regulatory framework for fibre: cross-submission on Commission's proposed approach, 1 February 2019, para 7.3.