ENABLE NETWORKS LIMITED AND ULTRAFAST FIBRE LIMITED

FIRST CROSS-SUBMISSION ON NZCC FIBRE REGULATION EMERGING VIEWS: TECHNICAL PAPER

31 JULY 2019

1. Introduction

1.1 This first cross-submission is made by Enable Networks Limited (**Enable**) and Ultrafast Fibre Limited (**Ultrafast Fibre**) (collectively referred to in this submission as **LFC**s) in response to submissions made in response to the Commerce Commission's *Fibre regulation emerging views: Technical Paper* dated 21 May 2019 (**EVP**) on issues other than the cost of capital (including asset stranding) which will be covered in our second cross-submission.

1.2 We focus in this cross-submission on a number of key issues raised in submissions. On issues we have not responded to, we refer to and rely on our submissions on the EVP dated 16 July 2019.

1.3 The general theme of submissions of the major retail service providers is that we should be subjected to a greater degree of regulation than suggested in the EVP. We ask the Commission to bear in mind that the additional measures advocated will increase our compliance burden and drive increased cost into our business, reducing the competitiveness of our FFLAS services relative to these submitters' competing broadband access services.

1.4 While it is in their commercial interests to put us into a regulatory straight-jacket, it would not be consistent with the s 162 purpose of promoting outcomes which are consistent with outcomes produced in workably competitive markets.

2. Interaction between s 162 and s 166 of the Telecommunications Act 2001

2.1 The Commission's Emerging View is that s 162 and s 166 "*contain complementary rather than competing objectives*"[1] but "*it is possible there may be situations where the best blend of the objectives in s 166 would be achieved by making a decision that may promote outcomes in s 162* ***to a lesser extent****, but that enhances competition in one or more telecommunications services markets*"[2] (own emphasis).

2.2 Professor Yarrow questions where the two purposes are complementary, noting that there is "*an inherent tension between the s 166(2)(b) and s 162 purpose statements*".[3]

2.3 We agree. As set out in our Submission, the Act does not allow the Commission to apply s 162 "to a lesser extent" by giving precedence to s 166 (2)(b).

2.4 As Chorus submits, if there is a conflict between s 162 and s 166, "*the purpose statement in s 162 prevails*"[4], because "*s 162 applies to all of Part 6, including how s 166(2) itself should be interpreted*".[5]

2.5 We also agree with Chorus that there is no basis for the Commission to depart from the outcomes that would occur in a workably competitive market, as required by s 162 "*to give a 'leg up' to rival networks*".[6]

3. The relevance of the UFB GPS to the exercise of the Commission's discretion under Part 6

3.1 We agree with Chorus that the Commission must have regard to the 2011 UFB Government Policy Statement under s 19A of the Act.[7]

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[1] NZCC *Fibre regulation emerging views: Technical Paper*, 21 May 2019 (**EVP**) [61]

[2] NZCC, *New regulatory framework for fibre: Invitation to comment on our proposed approach,* 9 November 2018 [5.45], referred to at EVP [72]

[3] George Yarrow, *Questions relating to the regulation of fibre fixed line access services (FFLAS) in New Zealand, Report for Chorus* (**Yarrow**)

[4] Chorus, *Submission in response to the Commerce Commission's fibre regulation emerging views*, 16 July 2019 [56] (**Chorus**)

[5] Chorus [58]

[6] Chorus [48]

3.2 The Commission's Emerging View is that the 2011 GPS is not relevant because since it was issued "*the UFB network has been substantially constructed*".[8] This is factually incorrect, as the fibres from the fibre flexibility point to the premises are not provided until a customer connection is ordered.

3.3 Moreover, now that a substantial part of the network investment has been sunk, the GPS has greater relevance than ever in relation to the Commission's Part 6 determinations.

3.4 According to Vector "*we don't believe it can have been the intention of parliament to undermine the fundamental premises of UFB by allowing the full recovery of previous UFB losses. Specifically, the construction and uptake risk was to fit squarely with the successful bidder*…"[9]

3.5 Trustpower submits in similar vein:

(a) "*build risk in the early years of the government's Ultra-fast Broadband (UFB) was assumed by regulated suppliers and they faced the consequences if the build took longer or cost more than anticipated. There was no expectation that future regulation would, say, compensate them if these adverse consequences came to pass*";[10] and

(b) "*regulated suppliers committed to invest in 2011 and so whether compensation for risks has a detrimental impact on investment incentives doesn't appear a relevant consideration, given that the commitments have already been made*".[11]

3.6 To the contrary, the 2011 GPS provided exactly that expectation to potential UFB investors, that future regulation would recognise the initial investment risks. The 2011 GPS specifically stated the objective that any price regulation "***that may occur in the future*** *recognises that revenues, over the life of the assets, are sufficient to cover efficient operating costs and a normal return on, and recovery of, capital invested*"[12] (own emphasis).

3.7 As Professor Yarrow notes "*one strategy of good regulation is to seek to reduce [regulatory] uncertainty by basing decisions on stable sets of 'principles' made known to market participants, who can then in any given economic context, anticipate the likely outcome of the decision. This can be called 'contingent predictability': regulators have flexibility to respond to changing economic contexts, but, knowing both the current context (the 'contingencies') and the principles at work, businesses can develop reasonably accurate expectations of the decision itself*".[13]

3.8 The 2011 GPS is an example of this. According to Professor Yarrow "*Chorus and other FFLAS providers have already made substantial and now sunk investments in their networks, but they have done so under contractual arrangements that made no specific provision for FCM. The Government Policy Statement …did, however, give investors grounds for confidence on the matter and the Statement is notable for its emphasis on taking a 'whole life-cycle' perspective…"*[14]

3.9 Professor Yarrow concludes that the Commission should "*go back to the start of the first period and rely on the FCM principle (NPV = 0) from that earlier point onwards. The argument for doing so is that it is consistent with the principle the Commission has committed to apply in the future…A decision on initial RABs that would amount to NPV < 0 would I think serve to reduce the*

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[7] Chorus [64]

[8] EVP [91]

[9] Vector, *Submission to Commerce Commission on the Fibre Regulation Emerging Views Paper* 16 July 2019 p4 (**Vecto**r)

[10] Trustpower, *Submission: Fibre Regulation Emerging* Views 16 July 2019 [3.4.4] (**Trustpower**)

[11] Trustpower [3.4.11]

[12] *Statement to the Commerce Commission Concerning Incentives for Businesses to Invest in Ultra-fast Broadband Infrastructure*, New Zealand Gazette No 155, 13 October 2011, 4440 (**2011 GPS**)

[13] Yarrow p6

[14] Yarrow p22

credibility to a commitment to NPV = 0 looking forward, and hence to be negative for regulatory certainty and investment in later periods."[15]

3.10 UFB investors make the same point. According to TelstraSuper, "*investors …took on substantial risks to invest in fibre ahead of demand and New Zealanders now have the benefit of a network that will deliver substantial socio-economic benefits for decades to come. The risk was specifically acknowledged by Government (e.g. section 18(2A) and policy statements) back at the outset of the fibre rollout".*[16]

3.11 L1 Capital submits that "*a rate of return that does not acknowledge risks taken by early investors in fibre networks means that the NZ government has effectively reneged on commitments made to the capital markets at the time of the UFB investment. Importantly, it has chosen to renege at a time when investment is already significantly sunk in the network. This will have a chilling effect on any new infrastructure PPP project undertaken by the government in the future by raising sovereign risk.*"[17]

3.12 Black Crane Capital submit that the Commission's view on historic costs "*is short sighted and must be resisted*" because "*companies must be able to earn a fair return on capital, for both prospective and also historic investments. The latter is just as important as the former; if historic investment is treated unfairly, the investment community will lose confidence in the NZCC creating an environment where they can earn an adequate return on future infrastructure investment".*[18]

3.13 According to Oxera "*the relevant cost of capital in this assessment is the cost of capital that prevailed at the start of the fibre investment programme. Due to the higher systematic risks of fibre that prevailed at the start of the fibre investment programme, the appropriate asset beta for fibre services in 2011 would be higher than the asset beta estimated today*".[19]

3.14 As we set out in our submission, s 19A imposes a mandatory obligation on the Commission to have regard to the 2011 GPS in making its Part 6 decisions. This means the Commission would err in law if, as TelstraSuper submit, it were "*to average investor returns downwards with the benefit of hindsight*".[20]

4. Pricing principles

4.1 Retail service providers advocate for pricing principles to be specified by the Commission:

(a) 2degrees: "*there would be substantial benefit in adopting Pricing Principles for fibre*";[21]

(b) Spark: "*pricing methodologies are key for Information Disclosure that will apply equally to Chorus and LFCs…an effective ID regime would establish pricing principles in the IMs and require LFCs to report against those principles,*"[22] …"*s 166, and the purposes of ID requires the Commission to take action to influence efficient pricing for entities subject to ID only*";[23]

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[15] Yarrow p23

[16] TelstraSuper, *Feedback on Emerging Views Paper* p1 (**TelstraSuper**)

[17] L1 Capital, 16 July 2019 p21 (**L1**)

[18] Black Crane Capital, *Submission on Fibre Input methodologies: Emerging Views* Paper 15 July 2019 p1 (**Black Crane**)

[19] Oxera, *Compensation for asymmetric type 2 risks*, 15 July 2019 (**Oxera (1))**

[20] TelstraSuper p1

[21] 2degrees, *Submission on Commerce Commission Fibre Regulation Emerging Views Paper* 16 July 2019 p6 (**2degrees**)

[22] Spark, *Fibre regulation emerging views: technical paper submission* 16 July 2019 [30] (**Spark**)

[23] Spark [31]

(c) Vocus: "*if the Commission confirms its position and does not address economic Pricing Principles and rules for allocating costs between different FFLAS services, as part of implementation of the first price-quality determination, we request the Commission undertake this work immediately after the first price-quality determination has been finalised*";[24]

(d) Trustpower: LFCs should be subject to pricing principles because unlike Chorus they will not be subject to price caps.[25]

4.2 Trustpower relies on Link Economics' report that it is unlikely that existing competitive constraints from copper services "*will be sustained over the medium to long-term as bandwidth requirements extend beyond the limitations for the copper network. Application of pricing principles to the LFCs will help ensure the interests of consumers are protected*".[26]

4.3 Link Economics suggests a model based on the pricing principles defined by the Electricity Authority and disclosure obligations set out in the Electricity Distribution Information Disclosure Determination as "*an example of how a light-handed oversight regime can be implemented*".[27]

4.4 However, these pricing principles are non-binding, and the light handed monitoring regime for electricity distributors is implemented through information disclosure requirements, not the IMs. This is consistent with Part 6, which does not include pricing methodologies in the s 176 matters to be covered by input methodologies, but does include them in the s 188(2) information which may be required for information disclosures.

4.5 It is clear from submissions that the key driver for advocating pricing principles is to create a "back door" unbundling IM:

(a) 2degrees: "*the Cost Allocation IM and/or pricing principles should determine how the price of layer 1 and layer 2 services are determined*";[28]

(b) Spark: "*access seekers looking to make long term investments in order to roll out unbundled fibre networks and the viability of these networks will be determined in part by the pricing of layer 1 and layer 2 services.*"[29]

(c) Vodafone "*this IM should detail how costs are allocated between layer 1 and layer 2 on a granular basis*";[30]

(d) Vector: "*the Commission should specifically develop pricing principles addressing the price squeeze risk that applies in relation to key input services (in particular unbundled fibre services) and Chorus' layer 2 prices*";[31]

(e) Vocus: "*it should be recognised the matter of cost allocation and pricing for different FFLAS services is a live issue, with Vodafone and Vocus already facing issues with Chorus' proposed pricing for unbundled fibre*";[32]

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[24] Vocus, *Fibre regulation emerging views submission* 16 July 2019 [63] (**Vocus**)

[25] Trustpower [3.4.14], [3.4.16]

[26] Link Economics, *Report on the Commerce Commission's Emerging Views on Fibre Regulation* 15 July 2019 p4 (**Link Economics**)

[27] Above

[28] 2degrees p7

[29] Spark [27a]

[30] Vodafone, *Submission on Fibre Regulation Emerging Views* 16 July 2019, p14 (**Vodafone**)

[31] Vector [12]

[32] Vocus [62]

(f) Link Economics: "*A pricing methodology disclosure could also address in the future the relativity between the pricing of unbundled products, dark fibre, and layer 2 services. This may aid in ensuring against foreclosure of competition for layer 2 products using unbundled services*".[33]

4.6 As we have previously submitted in cross-submissions on the Commission's new regulatory framework for fibre consultation, it would not be appropriate for the Commission to set pricing principles under Part 6 for unbundled fibre services when the regulatory requirements relating to those services are defined in Part 4AA of the Act, and will remain in place after the Part 6 regime comes into effect.

4.7 In addition, as we submitted, "*there is no lack of clarity about the equivalence obligations that apply to price under Part 4AA. Section 156AB is clear that the price charged by the service provider must be the same as the price charged to the service provider's own business operations*".[34] LFCs obtained expert advice on the application of their equivalence obligations in relation to pricing under Part 4AA, and set their unbundled layer 1 prices accordingly.

4.8 In the context of a rapidly changing market, existing regulatory obligations on fibre providers under Part 4AA of the Act, and increasing competition from alternative technologies, a Part 6 pricing principle is unnecessary. We also note that, apart from the focus on fibre unbundled prices, no clear pricing principle has been articulated by submitters.

5. Cost allocation

5.1 In its submission, Spark addresses the cost allocation IM and states, in relation to allocations between FFLAS and other services, that "*the proposed approach leaves significant discretion with Chorus and LFCs over significant allocations of shared assets and costs. Shared costs are likely to comprise over 50% of all costs*".[35]

5.2 Making a similar point Trustpower states, "*more detailed rules could be developed by Chorus in consultation with RSPs for approval and amendment by the Commission*".[36]

5.3 In response, we note that shared assets/costs across FFLAS and non-FFLAS services are not material for LFCs, who are solely FFLAS providers.

5.4 A principle based approach to the IM will ensure that it is flexible enough to accommodate all fibre providers, and durable enough to be able to be applied both historically and in the future. Durability is important in ensuring the IMs achieve their purpose of providing regulatory certainty.

5.5 A provider-led approach is the most practical way of implementing the cost allocation IM, as the information required to derive the allocators and asset/cost components will be unique to each FFLAS provider. Disclosure of allocation methods and outcomes will assist the Commission in its oversight role, and provide transparency for other parties.

6. Depreciation on Crown Funded Assets

6.1 Vector submits that "*Chorus should not be entitled to claim depreciation on government funded assets and Chorus should not be entitled to depreciation on those assets after the implementation date*".[37]

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[33] Link Economics p5

[34] Enable and Ultrafast Fibre, *Cross-submission on the new regulatory framework for fibre*, 31 January 2019 [3.4]

[35] Spark [34]

[36] Trustpower [3.6.2], [3.6.3]

[37] Vector [34]

6.2 This view fails to recognise that the Crown funding was a loan to be repaid, not a grant. As the Crown funding was a financing arrangement only, LFCs took on all the risk of constructing and managing the assets, interfacing with RSPs, and connecting end-users.

6.3 Spark submits "*It's unclear to us why depreciation (and indexation) of a Crown funded asset would be included in past losses or for the purposes of the ongoing BBM. Depreciation should occur on assets funded by Chorus as, to the degree there is a mismatch in timing of the return of capital, Chorus will receive a benefit from an investment it has not made*".[38]

6.4 Spark further states that "*we think that the asset should come in at the time the funding is repaid, and that anything more than that is a smoothing issue. Nonetheless, if the Commission does want to recognise depreciation on an asset that Chorus has not funded for other reasons, then it should do this in an NPV = 0 way".*[39]

6.5 We agree that, where the investment was supported by Crown funding, there are timing and smoothing issues to be considered in assessing the recovery of the investment in the FFLAS assets. This can be achieved in a NPV neutral way through different approaches, given the Crown funding is a loan, and has been (or is to be) repaid. We agree with Chorus that the approach proposed in the EVP (to include depreciation in the BBM, and adjust the return on capital building block for Crown funding) is preferable because it is smoother and straight forward to implement.[40]

6.6 Irrespective of the recovery profile, the costs to be recovered must include the full cost of the investment (through the depreciation component) and a return on that investment. The return on investment component is to be derived through the cost of capital allowance on the value of the investment, net of the Crown funding, for the period that the funding was provided. As the LFCs' share of the funding increases (and the Crown's share reduces), the cost of capital allowance adjusts. This appropriately recognises the role of Crown funding in the UFB initiative, and ensures LFCs recover a return only on the value of the investment they funded.

7. Quality IMs for ID regulation

7.1 In our submission we recommended that quality dimensions for PQR should not be inconsistent with TCF and WSA/NIPA standards and reporting obligations, and that to impose new requirements would likely undermine the well-established TCF self-regulatory process.[41]

7.2 A number of submitters support an industry lead approach to quality dimensions:

(a) Spark: "*The setting of [quality] dimensions and measures is largely a technical consideration relating to the identification of quality that is important to access seekers and end users. Accordingly, this is something that could be via a technical workshop or the TCF, i.e. such as the TCF based approach successfully taken during the development of UBA regulated services*";[42]

(b) 2degrees: "*NIPA and WSA quality requirements should be used to inform Part 6 quality regulations. 2degrees considers that the quality requirements of UFB arrangements have generally worked well to date;*"[43]

(c) Vodafone: "*It is important that the level of detail provided in WSAs is retained. These agreements have been carefully negotiated by industry with CIP oversight to suit the level of prescription required for the industry*;"[44]

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[38] Spark [56]

[39] Spark [57], [58]

[40] Chorus [99]

[41] Enable and Ultrafast Fibre, *Submission on NZCC Fibre Regulation Emerging Views* 16 July 2019 [9.10] – [9.12]

[42] Spark [67]

[43] 2degrees p19

7.3 For the reasons outlined in our submission, we remain of the view that, as with Part 4, no quality IM is required for ID.

7.4 For PQR, the new fibre SLAs discussed at paragraph 9.6 of our submission, should be the basis of quality dimensions. We think Vodafone's proposal to link the quality regime to the WSA obligations should be seriously considered by the Commission.

7.5 Those obligations, together with the obligations in the TCF Fibre Installation and Customer Transfer Codes (which are not affected by Part 6), will ensure adequate oversight of the quality of FFLAS.

8. Timing

8.1 We agree with 2degrees that a longer consultation period is required for the draft IMs than is currently scheduled, and that "*the proposed six weeks to make written submissions and two weeks for cross submissions is wholly inadequate*".[45]

8.2 Vocus has also urged the Commission to provide a longer consultation period for the draft IMs.[46]

8.3 There will be a considerable volume of material to review and respond to, including in addition to the Draft Decision, the Draft IM Determinations. As these Determinations are more technical documents that the Draft Decision, they require careful and detailed review, including:

(a) ensuring they give effect to the policy intent in the Draft Decision;

(b) identifying errors, inconsistencies or omissions; and

(c) drafting proposed amendments to support submissions.

8.4 This is a time consuming task. Accordingly we submit that the deadline for submissions on the Draft Determinations is extended beyond the Christmas break to the end of January. A two week cross submission period on the Draft Determinations can be provided for in early February without significant disruption to the Commission's timetable, given the submissions and cross submissions on the Draft Decision will be completed earlier.

8.5 In addition we request that an additional technical drafting consultation period is scheduled prior to the final determinations being published. This has proven useful for Part 4, and it helps catch any inadvertent errors or inconsistencies in the determination drafting, which helps to minimise regulatory cost and complexity.

END

[44] Vodafone p26

[45] 2degrees p3

[46] Vocus [24]