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TelcoFibre@comcom.govt.nz

Submission on *[Draft] Fibre Input Methodologies Determination 2020 and Fibre input methodologies draft decision - reasons paper*

Northpower Fibre Limited and Northpower LFC2 Limited

Public version



Thank you for the opportunity to provide feedback on the [Draft] Fibre Input Methodologies Determination 2020 and Fibre input methodologies: Draft decision - reasons paper (**Paper**).

As you know, Northpower Fibre Limited and Northpower LFC2 Limited (together, **Northpower Fibre**) are responsible for the construction and operation of the Ultrafast Broadband (**UFB**) network in the Whangarei and Kaipara districts. Its UFB area accounts for approximately 1.6% of the national UFB network with a potential 33,000 connections once build is complete.

Other than where we have put forward a different view in this submission, Northpower Fibre remains broadly supportive of the draft determination on the input methodologies (**IMs**). We have chosen to focus this submission on only the key areas of the Paper that are important to us in providing a superior cost effective service to end use customers.

Key areas of focus

1. Our submission focuses on the following key areas:
 - Quality – IM requirements
 - Asset base – IM requirements
 - Principle-based regulation – comments
 - Commissioned assets and construction costs
2. As an overarching comment, we reiterate that the burden of the obligation imposed by the IMs should be proportionate to the size of the business being regulated. We believe the benefit of having proportionate regulatory obligations will be reflected back in efficiency, innovation and product development and superior service provided to consumers.

Quality – IM requirements

3. We submit that the proposed mandatory and optional quality dimensions should be an exhaustive list to provide certainty. They should also be consistent with those metrics that providers are currently required to report on to avoid the need to invest in new systems to capture the data. They should not be excessive so as to provide the right balance between ensuring service quality and providing quality service to users.
4. We caution that “end user satisfaction” may be difficult to appropriately measure when it is connected with services provided by a retailer. As a result, this quality dimension may provide inaccurate results to the extent it is not within the control of the regulated providers. We also note that the customer service dimension is currently only measured at the point of a new connection as it best assesses the immediate connection experience. We do not at present measure customer satisfaction after “new connection” stage after which it can be affected by other factors.
5. We support the Commission’s decision that it may set different quality reporting requirements for different regulated providers to recognise the difference in size, scale and complexity of the providers.
6. We urge the Commission to use information it already obtains through the obligations that LFCs are already subject to before imposing further obligations (e.g. the EOI requirements, non-discrimination requirements etc.). If the Commission is able to gain satisfaction on quality through information already captured for other purposes, it will provide greater efficiency and avoid potentially duplicating requirements.

Asset base – IM requirements

7. The proposed information specified in Schedule A would result in material increases in data collection, collation and assurance workload. We are able to provide information about assets by network layer and asset class but we submit that information beyond this is excessive and would capture immaterial numbers, especially as it is described as the *minimum* level of specificity. In particular, the following information about assets would be in addition to our current data collection processes:
 - a. Geographic location of assets – address and building information would be an additional requirement. We would be able to provide information about the assets by network layer and asset class. Network layer 2 assets could be further identified by geographic location of the cabinets.
 - b. Shared with other parties – a detailed breakout by asset covering shared use would be an additional requirement, instead we could provide information about shared assets across the entire network.
 - c. Shared with other services – again, a detailed breakout of assets shared with other services would be an additional requirement. We don't currently collect and collate information about which assets are shared with other services.

Principle-based regulation – comments

8. As submitted in our submission on the Emerging Views paper, we support IMs which are principle-based rather than prescriptive. This will allow the IMs to remain stable, while specific implementation of those rules can evolve with the market as necessary.
9. Principle-based rules can allow businesses to use their own processes and systems to comply, rather than being mandated to change to a new process/system specifying how RAB assets are to be captured and recorded solely for regulatory compliance purposes. This minimises compliance costs, and avoids 'second-guessing' businesses' own internal decisions. It is proportionate for LFCs, which is a critical factor for Northpower Fibre.

Areas of support

10. We support:
 - a. the use of GAAP-based information including the cost allocation IM and asset valuation IM (this aligns with our desire for proportionality of regulation to business size);
 - b. the absence of a requirement to allocate costs between FFLAS services, which would be costly and unnecessary. We note and support the potential for pricing methodology disclosures to provide information about cost recovery instead;
 - c. Assets being included at cost, after including all assets associated with the provision of the regulated service. There is no justification for an *ex-post* prudency test for the historical build and this would be inconsistent with the legislation;
 - d. Depreciation in accordance with GAAP with provision for alternative approaches which better match expected revenue recovery profile;

- e. Tax payable approach;
- f. Flexibility within information disclosure regulation to set target revenues and returns to reflect LFC specific circumstances and risks.

Areas of concern

11. The following draft decisions should be reconsidered:
 - a. Cost allocation IM:
 - i. We do not support the requirement to cap common costs at the avoidable cost for LFCs where common costs are not material. This test should not be required where common costs are not material;
 - b. Cost of capital IM:
 - i. The asset beta during the pre-implementation period should be increased to reflect the construction focus of the fibre providers during this period, and therefore the higher operating leverage and systematic risk. Although this issue is acknowledged in the draft decision, no adjustment has been made;
 - ii. The proposed asset beta for the post-implementation period is inadequate because it is based on data which includes companies with substantially lower risks (such as satellite and tower companies) and it ignores the additional risks faced by LFCs who are competing with Chorus in our service areas;
 - iii. The WACC estimate during the post-implementation period should not be based on annual estimates, rather the pre-implementation period is equivalent to a single regulatory period, consistent with the UFB contractual undertakings and the WACC parameters should be specified for that period of the financial loss asset;
 - iv. We are disappointed that there is no explicit allowance for LFCs for stranding risk of assets but note that under OID regulation there will be an opportunity for LFCs to address this risk when setting target returns and revenues. This is consistent with the paper decision to allow for ex ante provisions for stranding risk;
 - v. A vanilla WACC estimate is of less relevance than a post-tax estimate which is a measure which is better understood by our stakeholders. In addition, we submit that the WACC estimate should be published as a mid-point estimate along with the 25th and 75th percentile estimates, as it is for our electricity line businesses. This is consistent with the proposal to calculate a standard error and for LFCs to manage their target returns within an acceptable range, after taking into consideration the specific risks facing each business.

Commissioned assets and construction costs

Description of the issue

12. In our submission on the Emerging Views paper, we made the following comment:

*It is proposed that the initial RAB include all existing assets which are used to supply FFLAS. We note that, the majority of those assets are recorded in Northpower Fibre's financial reporting accounts, **but a small number are reported elsewhere**. It is our understanding that, when the initial RAB is established, all relevant assets will be included, regardless of their historical reporting.*

We expand further below on what these assets are, how they have been treated and how we submit they should be included in the RAB. Note that these issues relate only to Northpower Fibre Limited's UFB1 build and not to Northpower LFC2 Limited.

13. Construction costs were incurred by Northpower Limited as Northpower Fibre Limited's construction partner during the build of the UFB1 network. Whilst the commissioned assets have been recorded under GAAP as assets of Northpower Fibre Limited, certain additional costs incurred in constructing these commissioned assets remain in Northpower Limited as the contract meant that these could not be recognised in Northpower Fibre Limited under GAAP.
14. The definition of "value of commissioned asset" in 2.2.12 (1)(a)(i) of the draft determination states that the cost of the commissioned asset is based on the cost incurred under GAAP in constructing or acquiring the asset. While Northpower Fibre Limited's corporate structure remains as it is (with Crown Infrastructure Partners Limited's (CIP) shareholding preventing Northpower Fibre Limited from being treated as a group company), these construction costs cannot be recognised in Northpower Fibre Limited's RAB as this would be contrary to GAAP.
15. Northpower Limited is unable to recognise these costs as it is not itself subject to the FFLAS regulation. The costs were however incurred for the UFB initiative and therefore in relation to providing FFLAS services.
16. S177(1)(a)(i) of the Telecommunications (New Regulatory Framework) Amendment Act 2018 (Act) provides that the initial value of assets in the RAB is calculated by *taking the cost incurred by a regulated fibre service provider in constructing or acquiring the fibre asset*. The costs incurred by Northpower Limited are in relation to actual connections and additional investment in layer 2 services and infrastructure. But for the GAAP rules, they would have been incurred by and shown as assets of Northpower Fibre Limited.
17. The inability for Northpower Fibre Limited to include these additional construction costs in its RAB is contrary to the intent of the legislation.
18. We understand that the other LFCs have already changed their corporate structures since commencement of the UFB1 build by removing CIP's part-ownership and as such have been able to recognise the additional costs incurred by the construction partner in the accounts of the regulated provider. From a policy perspective, and given there is no mandatory requirement to change the existing corporate structure before the regulatory regime takes effect, Northpower Fibre Limited should be treated equitably in terms of the make-up of its RAB and costs not excluded because its shareholding structure has not changed.
19. Essentially, it is a question of timing as to when those costs would be able to be transferred intra-group as part of a corporate restructure/exiting of the CIP shareholding.

Potential solutions

20. Per S177 of the Act, Northpower Limited incurred the costs in constructing or acquiring the asset and for providing the regulated FFLAS service as part of the UFB initiative. As the Act regulates the service rather than the entity, these costs are ring-fenced with the regulated service being the provision of FFLAS by Northpower Fibre Limited. As such, Northpower Fibre Limited will look to include these costs in the operational expenditure component of the financial loss asset when constructing its RAB.
21. An alternative potential solution to address this issue and to allow Northpower Fibre Limited to include these construction costs in its RAB would be to amend the definition of "value of commissioned asset" in 2.2.12 (1)(a)(i) to expressly allow non-GAAP allowed



costs to be included in the value where a corporate structure might mean that under GAAP costs sit outside of the entity but the costs were incurred in constructing or acquiring the asset and are in relation to providing the regulated service.

22. There may be other more practical solutions that would be better and we would be happy to discuss any of these further with the Commission. Northpower Limited has retained robust records of this expenditure and is able to accurately quantify and describe its nature.

We thank you again for the opportunity to provide feedback, and look forward to further working with the Commission on these matters.

Please contact Darren Mason (darren.mason@northpowerfibre.co.nz) if you would like to discuss any aspect of this submission further.

Darren Mason
Chief Executive
Northpower Fibre Limited