FIBRE INPUT METHODOLOGIES: FURTHER CONSULTATION DRAFT (INITIAL VALUE OF FINANCIAL LOSS ASSET) – REASONS PAPER

Submission to the Commerce Commission

PUBLIC VERSION

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Executive summary

1. The Commerce Commission (he Commission) should be explicit about the definition of *"financial loss"*. The allocation methodology to determine financial losses needs to be consistent with the definition.

2. An avoidable cost allocation methodology (ACAM) is consistent with orthodox definitions and measures of losses. An approach such as Accounting-Based Allocation Approach (ABAA) would overstate financial losses and result in wealth transfers (higher fibre prices) from end-consumers to Chorus.

3. The determination of financial losses should only include financial losses incurred by Chorus for the provision of UFB services that it is contracted with the Crown to provide i.e. it should be limited to the losses incurred by the part of its FFLAS business that will be subject to Price-Quality (PQ) regulation.

4. For the purposes of determining financial losses, we consider that the onus should be on Chorus' to demonstrate:

   (i) what part of its joint and common costs, if any, it would not have occurred absent providing UFB services as part of the UFB initiative; and

   (ii) the opportunity cost of the pre-2011 assets and how they would otherwise have been deployed if they weren't used to provide UFB services as part of the UFB initiative.

5. The matter of double-recovered of costs through copper and fibre pricing remains unresolved. The Commission's position on determination of financial losses (adoption of ABAA) and double-recovery from copper and fibre (not addressed) will 'lock-in' excessive profits into Chorus' fibre prices. If the Commission considers the TERA approach to resolving this issue won't work it should determine what would be a better approach.

INTRODUCTION

6. Vocus welcomes the opportunity to submit in response to the *"Fibre Input Methodologies: Further consultation draft (initial value of financial loss asset) – reasons paper"*, 13 August 2020.

7. If you would like any further information or have any queries about this submission, please contact:

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PQ VERSUS ID-ONLY FFLAS

8. For the avoidance of doubt, and consistent with the draft Fibre Input Methodologies Determination 2020 definitions, the financial loss asset needs to exclude any financial losses Chorus may have voluntarily incurred, including in relation to any decision to roll-out fibre outside of the UFB areas it is contracted with the Government to supply.

9. This accords with the distinction the Commission will need to make (including through cost allocation) between Chorus' Price-Quality (PQ) FFLAS business and its Information-Disclosure (ID)-only FFLAS business.

THE COMMISSION SHOULD BE EXPLICIT ABOUT THE DEFINITION OF *"FINANCIAL LOSS"*

10. We agree with 2degrees that the starting point for the consideration of the value of the financial loss asset should be what is meant by a financial loss.[1]

11. The Commission remains silent on how it interprets the term "*financial loss"* even though it is seeking *"feedback on … our approach to the proposed legal interpretation of s 177 …"*. The treatment of pre-2011 assets and the appropriate cost allocation methodology hinges on the definition of financial loss.

12. We consider that application of an Accounting-Based Allocation Approach (ABAA) would be incompatible with any reasonable and orthodox definition of financial loss and therefore is not an option available to the Commission. This could render the consultation paper's discussion on section 162 considerations largely irrelevant.

[1] 2degrees, Submission on Fibre input methodologies – Draft decision, 30 January 2020.

FINANCIAL LOSS IS AN INCREMENTAL OF AVOIDABLE COST CONCEPT

13. The Commission should determine financial losses (if any) on an incremental or avoidable cost basis. This is an economic and orthodox approach to financial loss determination, consistent with the previous Telecommunications Service Obligation (TSO) net cost determination requirements (and effectively a reversal of the Avoidable Cost Allocation Methodology (ACAM) arrangements that were previously in place under Part 4 Commerce Act).[2] There is nothing in the latest consultation paper that would cause us to depart from this view.

14. The approach the Commission has taken when considering whether there has been anti-competitive conduct/predatory pricing/cross-subsidisation – for example, the investigation into Telecom's residential telephony pricing in Wellington – provides useful precedent the Commission can and should draw on.[3]

15. The test the Commission used in this investigation was whether Telecom was offering residential telephony prices at a loss. The Commission considered various potential different cost measures to identify any potential losses, noting for example:

> *"Baumol et al provide an analysis of the arbitrary nature of 'full cost allocation' and argue that despite the courts moving in the direction of the marginal and incremental analysis that economics suggests, regulators seem vulnerable to an adoption of a fully allocated cost approach."*

16. Consistent with the commentary of fully allocated cost methodologies (FACM) the Commission adopted an Average Incremental Cost (AIC) approach, noting for example:

> "AIC … appears the proper figure to compare with incremental revenues to determine if the predator's price is remunerative."
>
> "On the basis of the cost information provided by Telecom, there is no apparent pricing below AIC in Lower Hutt, and it cannot be concluded that cross-subsidisation is occurring."

17. We also note that while Telecom objected to adoption of an AIC approach, for this investigation, it did so on the basis that it considered the Commission should have used a Marginal Cost approach. Both approaches are inconsistent with FACM, including ABAA.

18. Various definitions in the Telecommunications Act provide useful guidance that financial loss is an incremental or avoidable cost concept

19. Financial loss is conceptually and definitionally similar to *"actual costs saved"*, *"avoided cost saved"* and *"net cost"* which are defined in the Telecommunications Act. The *"net cost"* definition is clear, when measuring the financial losses from providing TSO services to commercially non-viable customers, the costs must be *"unavoidable"* and *"incremental"*. If the Commission considers there is a distinction between *"net cost"* and *"financial loss"* such that one is an incremental method and the other is not, it would be useful to understand the distinction the Commission is making.

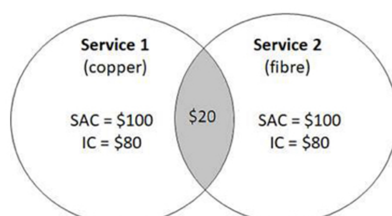
[2] Vocus, Draft Fibre Input Methodologies Determination, Submission to Commerce Commission, 28 January 2020.
[3] https://comcom.govt.nz/news-and-media/media-releases/archive/telecomsaturn-report-part-1

20. The definition of Total Service Long Run Incremental Cost (TSLRIC), an incremental cost methodology, in the Telecommunications Act also provides useful guidance. The TSLRIC/incremental cost definition states that it includes costs *"that are directly attributable to, or reasonably identifiable as incremental to, the service, taking into account the service provider's provision of other telecommunications services"*.

THE COMMISSION'S STYLISED EXAMPLE

21. The Commission uses the following stylised example of incremental, shared, and stand-alone costs.[4] The example illustrates that if Chorus' recovers $80 from its fibre business during the transition period it will not incur a financial loss:

Figure 1: Example of incremental, shared, and standalone costs



22. The Commission objection is that *"The incremental cost approach that has been proposed by RSPs would see all common and joint costs carried by a declining number of copper service connections. As a result, a growing number of FFLAS connections during the pre-implementation period would contribute nothing to meeting the costs of shared assets which are employed in the supply of FFLAS"*.

23. The Commission's objection reflects a simplification in stylised example, whereby shared costs are assumed to be invariant to whether one or two services are provided. The allocation of shared costs under an incremental cost approach depends on what is avoidable/genuinely unavoidable. This is illustrated by the following, more sophisticated, stylised example the Commission provided on cost allocation in the High Court IMs Merit Appeal case:[5]

[4] We note the same example was used by the Commerce Commission in relation to its Part 4 Input Methodologies decision.
[5] WELLINGTON INTERNATIONAL AIRPORT LTD & ORS v COMMERCE COMMISSION [2013] NZHC [11 December 2013], from paragraph [1829].

Electricity lines and fibre (broadband)

Services provided separately

Service	Total asset base	Poles	Other assets
Electricity lines	100	25	75
Fibre	100	25	75

Services provided together

Service	Total asset base	Poles	Other assets
Electricity lines	180	30	75
Fibre			75

By leveraging off the existing ELS [ie an EDB] infrastructure, poles for the fibre business can be provided for only an additional $5M, such that the shared (accounting) cost of the poles is only $30M.

Leveraging the existing ELS's infrastructure is therefore more efficient than building a new network. The efficiency gain (or "economic common cost") is $20M (ie. $50M - $30M), such that the total asset base required to provide the services together is only $180M (rather than $200M).

...

Applying accounting based allocation approach (ABAA)

Shared accounting costs ($30M) are allocated to each service using asset allocators (causal relationship or proxy allocator).

For example, if poles are allocated evenly between the two services using PPE (property, plant and equipment) categories in the financial accounts:

Service	Total asset base	Poles	Other assets
Electricity lines	90	15	75
Fibre	90	15	75

...

Applying avoidable cost allocation methodology (ACAM)

...

Under ACAM ... stand-alone cost is allocated to the ELS ($100M) and incremental or "avoidable" cost is allocated to fibre ($80M).

...

While ACAM allocates the full economic common cost (or "efficiency gain") to the ELS, in the worked example it allocates shared (accounting costs between the two services as follows:

Service	Total asset base	Poles	Other assets
Electricity lines	100	25	75
Fibre	80	5	75

Accordingly, it is not correct that under ACAM all "shared costs" (as defined by the Commission) are necessarily allocated to the regulated service.

We note the following conclusions from this more sophisticated example: *"Under ACAM ... stand-alone cost is allocated to the ELS ($100M) and incremental or "avoidable" cost is allocated to fibre ($80M)"* and *"it is not correct that under ACAM all "shared costs" (as defined by the Commission) are necessarily allocated to the regulated service"* [emphasis added]. The High Court decision confirmed this analysis noting *"the shared accounting cost of $30 million is greater than the economic common costs of $20 million"*.[6]

24. An incremental cost approach would only exclude costs the supplier would incur regardless of whether it supplied the particular service in question (UFB).

25. If the Commission adopts an ABAA approach which, say, allocates half the common costs to the fibre business financial losses will be overstated e.g. if Chorus' earns $85 from the fibre business it will increase its profits by $5m, but the Commission determination will be that it has made a financial loss of $5m. The use of ABAA would effectively impose a tax on fibre users (a $10m tax or wealth transfer from users to Chorus, on the basis of the Authority's stylised example).

26. The further the application of ABAA departs from an incremental cost approach the higher the effective tax on fibre users, and the larger the wealth transfer from users to Chorus. The Commission has every reason to be concerned *"Chorus has strong incentives to allocate as high a volume and value as possible to pre-2011 assets"*. Application of ABAA will help assist Chorus to do precisely this.

IMPLICATIONS OF AN INCREMENTAL COST APPROACH TO TREATMENT OF SHARED COMMON COSTS, AND PRE-2011 ASSETS

27. As illustrated by the stylised examples above, an incremental cost approach does not necessarily mean no shared costs or pre-2011 assets can be included in the *financial*

[6] WELLINGTON INTERNATIONAL AIRPORT LTD & ORS v COMMERCE COMMISSION [2013] NZHC [11 December 2013], from paragraph [1830].

loss determination, but would appropriately limit their allocation and would mean costs could not be allocated using a fully allocated cost allocation methodology (FACM), including ABAA.

28. For example, if the provision of UFB services during the 2011 – 2022 period necessitated larger corporate overheads then the increase (compared to a counterfactual where Chorus did not provide UFB services) could be attributed and allocated to UFB services for the purpose of determining financial losses. This is reflected in the allocation of $5m of shared poles to the fibre business in the above example.

29. The Commission has noted our submission that *"Investments made prior to [2011] were made (by definition) regardless of whether Chorus undertook UFB roll-out and therefore do not impact on the financial losses (if any) it incurred"*. After considering the Commission's consultation, we would add a rider that where pre-2011 assets are redeployed, AND have an alternative use and opportunity cost if they weren't used to provide UFB services, these could potentially be attributed and allocated to UFB services for the purpose of determining financial losses.

30. An example might be a copper asset Chorus would not otherwise need and could resell. The sale value (not the book value) would reflect the opportunity cost of the asset and would be the only value that could be directly attributed to the financial loss calculation. Pre-2011 assets could only contribute to UFB financial losses in very limited circumstances. The Commission's approach would likely result in over-allocation of pre-2011 assets because it does not intend to *"determine the opportunity cost"*. The Commission asserts its approach *"is in our view nonetheless likely to be consistent with this"* without explaining how or why it would be consistent.

31. If a copper network asset that was redeployed did not have any other alternative use or resale value, then the loss (if any) that could be attributed to it is a loss incurred in relation to the provision of copper network services and not to the UFB service.

32. Chorus suggests *"the acquisition of pre-2011 assets by Chorus was itself undertaken as a condition, and pursuant to, the UFB initiative"*. It is unclear how assets that were commissioned by Chorus for provision of other services and before the Government had made decisions on the UFB tender could be incurred as a condition of the UFB initiative. Chorus skirts around this issue by commenting that pre-2011 assets are covered by the definition of fibre assets. There is no question the definition of fibre assets may include pre-2011 assets (section 177(1)(a)(ii) makes this explicit), but that is a separate question to whether they impact Chorus' financial losses (if any).

33. We reiterate our view that *"The burden of proof should be on Chorus to demonstrate financial losses: The High Court made clear the onus was on regulated suppliers to demonstrate the Part 4 RAB IM would not allow them to recover their costs of supply. The same burden of proof should apply to any financial loss determination. The onus should be on Chorus to demonstrate it has incurred genuine losses. It is clear from*

submissions there are substantial doubts about the extent to which Chorus has incurred any financial losses".[7]

34. The onus should be on Chorus' to demonstrate:

    (i) what part of its joint and common costs, if any, it would not have occurred absent providing UFB services as part of the UFB initiative; and

    (ii) the opportunity cost of the pre-2011 assets and how they would otherwise have been deployed if they weren't used to provide UFB services as part of the UFB initiative.

THE COMMISSION HAS NOT ENGAGED WITH OUR SUBSTANTIVE SUBMISSION POINTS ON FINANCIAL LOSS DETERMINATION

35. While the Commission has provided new rationale for adopting an ABAA approach for the financial loss determination, we still do not consider a sound basis has been provided for adopting anything other than an incremental cost allocation approach to the determination of financial losses (if any).[8]

36. While we have not submitted as extensively as some other stakeholders on this topic, we remain unclear why our submission points have been rejected and therefore cannot fully comment on the merit of the Commission's position.

37. We previously commented the High Court's concern about adopting a cost allocation methodology that results in over-allocation of common costs, and higher regulated prices to the long-term detriment of consumers, supports an incremental approach for calculation of financial losses.[9] There is nothing in the Commission's consultation papers that suggests this reasoning is unsound.

38. The Commission has not commented on our concern an ABAA approach *"would result in overstatement of financial losses and excessive profits. The excessive profits would be a pure windfall gain for Chorus and NOT a reward for innovation or efficiency gains. It would be a straight wealth transfer from consumers to Chorus with no compensating benefit to consumers"*.[10] The Commission noted *"submissions raised serious concerns that the inclusion of pre-2011 assets could allow regulated providers to extract excessive profits or make returns exceeding normal returns"* without commenting on the validity of these concerns.

39. Consistent with the discussion above, on the definition of financial loss, we have noted that the previous TSO net cost determination requirements to adopt an incremental cost basis provides *"an economic and orthodox"* precedent for loss calculation.[11]

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[7] Vocus, Fibre regulation emerging views, Cross-submission to Commerce Commission, 31st July 2019.
[8] Vocus, Draft Fibre Input Methodologies Determination, Cross-submission to Commerce Commission, 17 February 2020.
[9] Vocus, Draft Fibre Input Methodologies Determination, Submission to Commerce Commission, 28 January 2020.
[10] Vocus, Fibre regulation emerging views, Cross-submission to Commerce Commission, 31st July 2019.
[11] Vocus, Draft Fibre Input Methodologies Determination, Submission to Commerce Commission, 28 January 2020.

40. We have also noted *"Chorus' views on OVABAA … support adoption of an incremental cost approach to calculation of financial losses"*. [12] Various of our submissions cited Chorus' submissions that explained financial losses are defined on an incremental basis e.g. *"It is efficient … if the regulated business is able to recover at least the incremental costs …"*, *"… under ABAA, the costs that would be allocated could exceed incremental cost because this is an accounting method, rather than an economic method …"*.

41. Chorus' has been clear an incremental cost approach would ensure the service is able break-even and ABAA could make provision of the service appear *"uncommercial and unprofitable"* when it is not. What has Chorus was explaining is that an accounting loss under ABAA is not necessarily an actual financial loss and will overstate the size of the financial loss.

42. The following citation merits referencing in full. Chorus' comments can be reasonably read with *"unregulated services"* replaced with 'new services' or the 'UFB service':[13]

> *"Under economic principles in a WCM [workably competitive market], the allocation of costs to any service or group of services over the long term: … Has the lower bound of incremental or avoidable cost, and in competitive markets the provision of the service would cease if revenue was insufficient to recover incremental or avoidable cost …"*
>
> *"The amount of cost that is allocated to any service reflects the amount that can be recovered from that service, which in turn reflects the conditions in the market."*
>
> *"What's important, is that in a competitive market firms will make decisions as to whether or not to enter a market based on the incremental cost of that entry. It's accepted in regulatory economics literature that requiring a regulated business to recover an accounting allocation of cost from unregulated activities can create an artificial barrier to its participation in those activities."*
>
> *"The Commission's assumption that all unregulated services would be expected to make some contribution to common costs is not unreasonable. However, there is no basis for assuming that every service would be capable of generating a surplus over incremental cost consistent with an accounting-based allocation of shared costs. The accounting-based allocators the Commission requires will be based upon a measure of the physical use of the assets rather than the conditions in the relevant market. There will be occasions when the provision of an unregulated service is able to generate a surplus over incremental cost, but not a surplus that covers the accounting-based allocation. "In these circumstances, a fine tuning of the allocation would be required to make provision of the unregulated service financially viable and provide an incentive for provision – this is the purpose of OVABAA."*
>
> *"When considering Chorus' entry into related unregulated markets, there may be circumstances where Chorus could generate revenue in excess of incremental cost, but not enough to cover the full ABAA."*

43. Chorus' comments are consistent with Unison's comments on workably competitive market criteria that *"Businesses entering into new markets would not consider overhead*

[12] Vocus, Draft Fibre Input Methodologies Determination, Cross-submission to Commerce Commission, 17 February 2020.
[13] Chorus, Submission on Fibre input methodologies: Draft decision reasons paper dated 19 November 2019 and Draft fibre input methodologies determination 2020 dated 11 December 2019, 28 January 2020.

cost allocations when developing new products and services, but seek to ensure that the business proposition is the expected NPV>0".[14]

DOUBLE-RECOVERY OF COSTS THROUGH COPPER AND FIBRE PRICING REMAINS UNRESOLVED

44. We remain concerned the Commission's position on determination of financial losses (adoption of ABAA) and double-recovery from copper and fibre (not addressed) will 'lock-in' excessive profits into Chorus' fibre prices.

45. While the Commission has acknowledged double-recovery is a legitimate issue, it appears to have put the issue into the 'too hard basket', rejecting the approach proposed by TERA but not offering any alternative approach.

46. The consultation presents a *"pure incremental approach"* as a strawman option for dealing with double-recovery, which the Commission rejects on the basis it *"would see all common and joint costs carried by a declining number of copper service connections"* and *"As a result, a growing number of FFLAS connections during the pre-implementation period would contribute nothing"*.

47. For the avoidance of doubt, Vocus has advocated the Commission avoid or mitigate double-recovery by recognising: (i) the UCLL and UBA prices it set provided for recovery of certain costs, and sharing of common costs, which may also be used for fibre services; and (ii) the contribution provided for in the copper pricing determination to the recovery of these costs be accounted for in the FFLAS cost allocation and price determination.

48. The Commission observation that *"both copper and UFB demand were in the [TSLRIC] model"* and *"the costs of the modelled network, which includes costs of ducts, were shared across all copper and fibre demand"* reinforces that the way costs were shared needs to be taken into account to avoid double recovery. There is nothing in our position on this subject which is inconsistent with the Commission commentary on the how TSLRIC prices were modelled and determined.

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[14] Unison, UNISON SUBMISSION ON AMENDED DRAFT DECISION TO REMOVE ACAM AS A COST ALLOCATION OPTION FROM THE INPUT METHODOLOGIES, 13 October 2016, page 2.