



**TSLRIC price review  
determination for the  
Unbundled Copper Local Loop  
and Unbundled Bitstream  
Access services**

***Model Reference Paper***

**Commerce Commission**

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## Summary

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## 0 Introduction

This section provides background information on the project and describes the structure of the document.

### 0.1 Background

Unbundled Copper Local Loop (UCLL) and Unbundled Bitstream Access (UBA) are services that allow alternative operators' access to the local loop infrastructure of Chorus.

The Telecommunications Act 2001 (the Act) requires the Commerce Commission (the Commission) to determine a price for the UCLL and UBA services. In the first instance the Commission is required to benchmark prices against comparable countries under the 'initial pricing principle' (IPP). If an access seeker or Chorus Limited is not satisfied with the price (either the UCLL or UBA) determined under the IPP, the Act provides that the party can ask the Commission to calculate a price for that service in accordance with the 'final pricing principle' (FPP), which is Total Service Long Run Incremental Cost (TSLRIC) for UCLL and UBA.

The Commission reviewed the benchmarked UCLL price on 3 December 2012 and determined the UBA benchmarked price on 5 November 2013. However, the Commission has received FPP requests both for UCLL and UBA: the UCLL FPP requests were received in February 2013, the UBA FPP requests were received in January 2014. Therefore, the Commission needs to determine a price for the UCLL and UBA services in accordance with the FPP.

TERA Consultants (TERA) has been engaged by the Commission to assist in determining a price for the UCLL and UBA services in accordance with the FPP which is TSLRIC.

A consultation paper on conceptual issues of UCLL cost modelling was issued by the Commission in December 2013. A further consultation paper focusing on UBA<sup>1</sup> was also issued in early February 2014. Responses from interested parties were received in February 2014.

The Commission issued a paper which set out its preliminary views on its proposed regulatory framework for the UCLL and UBA TSLRIC cost modelling exercises and its preliminary views on a number of fundamental assumptions for the development of a

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<sup>1</sup> Commerce Commission, Determining a TSLRIC price for Chorus' unbundled bitstream access service under the final pricing principle, (7 February 2014)

TSLRIC cost model for the UCLL and UBA services<sup>2</sup>. Having reviewed the Commission paper, TERA has provided its views on some key methodological choices related to the calculation of TSLRIC in the document “Modern Equivalent Assets and relevant scenarios”.

The Commission sought the view of interested parties on all topics and has reviewed the submissions and the cross-submissions sent by all the interested parties.

Based on these consultations, and on the papers previously published, the Commission has made a number of decisions regarding the modelling and the pricing of the different regulated services. These decisions define the criteria for developing the access network cost model, the core network cost model (see §1.1 for the scope of each model) and the OPEX model, which are used to set UCLL and UBA prices. This document is therefore describing the criteria that have been followed.

A draft version of this document was published in December 2014. The Commission sought the views of interested parties on several documents and models including the present document and has reviewed the submissions and the cross-submissions sent by all the interested parties.

A second draft version of this document was published in July 2015. The Commission sought the views of interested parties on several documents and models including the present document and has reviewed the submissions and the cross-submissions sent by all the interested parties.

The earlier versions of this Model Reference Paper have been updated to produce the current final version.

The modelling approach is described in the model specification document which refers to this document in order to describe how the different criteria have impacted the modelling. The details of the model are provided in the model documentation. Information regarding non-recurring charges relating to UCLL and UBA is in the non-recurring charges methodology document.

## 0.2 Structure of this document

This document details the criteria followed when building the cost models. This Model Reference Paper has the following structure:

- **Section 1** – General considerations on the modelling (see §1): it details general criteria that are common to the access network and to the core network cost models;

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<sup>2</sup> Commerce Commission, Consultation paper outlining our proposed view on regulatory framework and modelling approach for UBA and UCLL services, (9 July 2014)

- **Section 2** – Access network to be modelled for UCLL (see §2): it details the criteria to be followed for the modelling of the access network cost model;
- **Section 3** – Core network to be modelled for UBA (see §3): it details the criteria to be followed for the modelling of the core network cost model;
- **Section 4** – Types of costs and cost allocation (see §4): it defines the types of costs that should be included in the cost models and how they should be allocated;
- **Section 5** – Regulatory period (see §5): it defines the regulatory period; and
- **Section 6** – Checking the model (see §6): it details the different steps that should be followed to ensure the best overall quality.

## 1 General considerations on the modelling

### 1.1 Access and core network cost models

The core network consists mainly of active assets, whereas the access network consists essentially of passive assets.

The costs of the core network are generally variable with the number of active lines or the traffic whereas the costs of the access network are variable with the number of lines.

The costs of the core and access networks, as traditionally defined, would give the costs of the traffic and the line-sensitive parts of the network respectively. As a consequence, core and access networks are modelled separately.

**Criterion 1:** Access and core networks should be modelled separately.

The access network cost model should therefore include the modelling of the local loop and the different physical links that are part of the core network such as the sub-loop backhaul and the links between the different exchanges. These are included in the access network cost model as they share the same infrastructure. There are thus some economies of scope that should be captured.

**Criterion 2:** The scope of the access model is the local loop, from the External Termination Point (ETP) (excluded) to the Main Distribution Frame (MDF). The physical links that are part of the core network are modelled in the access network and should feed the core network cost model.

### 1.2 TSLRIC

TSLRIC is a forward-looking cost-based methodology that is required by the Act to be used by the Commission when conducting pricing review determinations for the UCLL and UBA services.

**Criterion 3:** The TSLRIC methodology should be used to price the different regulated services.



### 1.3 Replacement costs

As the TSLRIC FPP refers to forward-looking costs, current costs will be the appropriate cost basis. One way to estimate current costs is to calculate the replacement cost of each asset. The replacement cost can be higher or lower than the historic cost.

General purpose properties such as office buildings are typically valued on an open market valuation basis (either for existing or alternative use).

**Criterion 4:** Replacement costs in the model should correspond to the costs of buying new equipment in the base year.

For properties in general, the building costs should be valued in accordance with the market price and the public valuation in each geographical area

### 1.4 International parts

The international parts of the access network and of the core network should be disregarded as they are not included in the scope of the services that are priced.

**Criterion 5:** International part should be disregarded.

### 1.5 Red zones in Christchurch area

The Canterbury Earthquake Recovery Authority (CERA) has confirmed that there is no demand for telecommunications services within the Residential Red Zone Area within the regulatory period. Further, they note the extent of the Residential Red Zone Area may change with time.

There are about 8,000 properties within the Residential Red Zone that are either vacant or will shortly be vacated (based on data from Corelogic NZ Limited). Once these properties have been vacated, any remaining buildings will be demolished.

The land is unlikely to have significant building undertaken within the regulatory period. Consequently, the UCLL and UBA demand within the Residential Red Zone Area is deemed to be zero for the purposes of our modelling.

**Criterion 6:** The red zones in the Christchurch area should be disregarded.

## 2 Access network to be modelled for UCLL

### 2.1 MEA definition

The Commission has consulted the industry on the definition of the Modern Equivalent Asset (MEA) of the UCLL.

The definition of the MEA that has been provided by the Commission is to provide the UCLL service in the most cost-efficient way across the lifetime of the service<sup>3</sup>. This is subject to considerations on the ability to unbundle from the Commission which are given weight.

**Criterion 7:** The MEA of the UCLL is the cost-efficient way of providing the UCLL service.

The MEA of the UCLL should be based on the most modern technology in use, i.e. a fibre access network. However, as it would not necessarily be cost-efficient to roll-out a wired network in the whole country, the MEA of the UCLL should also be based on a fixed wireless access (FWA) network. This is subject to speed considerations which are given weight. In areas which are unlikely to be unbundled, FWA enables the provisioning of voice and broadband services and can reduce the cost of the network compared to a wired network.

FWA is deployed in exchange areas unlikely to be unbundle and is based on Rural Broadband Initiative (RBI) (cumulative criteria).

The model also features a full point-to-point fibre network without FWA.

**Criterion 8:** The MEA of the UCLL is based on a mix between a point-to-point fibre network and a FWA network.

The UCLL service is a copper based service. The cost of the MEA should thus be adjusted. As described during the consultation on the MEA, there are three possible adjustments:

1. Speed based adjustment

This adjustment reflects the speed difference between a MEA network and a copper network.

2. Customer willingness based adjustment

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<sup>3</sup> The following factors have been considered when selecting the MEA: Technological performance; Cost; Operator strategy; and Subscriber and retail price.

This adjustment reflects the customer willingness to pay an extra fee in order to have a fibre connection instead of a copper connection.

**3. Cost-based adjustment:**

This adjustment reflects the difference between the cost of the MEA network and the cost of a copper network.

Having consulted the industry, the Commission has retained a cost-based adjustment.

**Criterion 9:** The cost of the MEA should be adjusted to reflect the cost difference between the MEA network and the copper network.

As a consequence, if the fibre + FWA network is the cheapest network, then the price of UCLL is based on the cost of the fibre + FWA network. If the copper network is the cheapest network, then the cost of the MEA network should be adjusted by the cost difference between the fibre + FWA network and the copper network. The price of the UCLL would therefore be based on the cost of the copper network.

## 2.2 Network to be modelled

In order to implement this cost-based adjustment, the Commission has identified two scenarios:

- A nationwide copper network; and
- A nationwide coverage achieved by a mix between a fibre network and a FWA network (this latter scenario also allows us to model a nationwide fibre network).

The adjusted cost of the MEA network is therefore the cost-efficient network (cheapest) selected between the two roll-out scenarios. The selection should be made based on UCLL costs at the national level and not per exchange.

**Criterion 10:** In order to compute the cost-adjustment, a copper access network and a fibre + FWA network should be modelled. The adjusted cost of the MEA network is the cheapest network selected at the national level between the two scenarios identified.

### 2.2.1 Scope of the access network

The access network should start at the external termination point (ETP) and stop at the distribution frame (MDF or ODF). The ETP is however not part of the access network as its cost is recovered through a different service (it is considered in non-recurring charges).

**Criterion 11:** The access network starts at the ETP and stops at the distribution frame.

## 2.2.2 Copper access network

The first roll-out scenario to be modelled is a copper access network. It should be a nationwide network with the restrictions as described in §1.

Assets within the copper access network include:

- The lead-in cable (cable from the copper cable termination to the ETP, including lateral), the ETP being excluded;
- The distribution cable, including joints;
- The feeder cable, including joints when the line is not cabinetised;
- The trenching including ducts, manholes and poles; and
- The Main Distribution Frame (MDF).

## 2.2.3 Fibre access network and FWA

The second roll-out scenario should be a mix of a fibre access network and a FWA network. This mix should provide nationwide coverage with the restrictions as described in §1.

### 2.2.3.1 Fibre access network

Like the copper access network which is a point-to-point (PTP) network, the fibre access network should be a fibre to the home (FTTH) PTP fibre network.

|   |
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| <b>Criterion 12:</b> The fibre network should be a PTP network. |
|---|

The fibre access network coverage should be complementary to the FWA network, meaning that there is no duplication between the fibre access network and the FWA network in the sense of any end-user being served by both.

The fibre access network should provide a direct connection between the exchange and the customers. As a consequence, unlike the MDF as described in §2.6.1.6, the copper active or passive cabinets should not be used as a constraint for connecting the end-users to the exchanges.

### 2.2.3.2 FWA network

The general approach to model FWA is that it should only be deployed at the edge of the network where FTTH deployment is very expensive and not economically viable, and where unbundling is unlikely to occur, FWA being a step change.

To assess the costs related to different types of FWA coverage, several scenarios should be tested:

- FWA covering the full areas where unbundling is unlikely to occur,

- FWA covering long lines in areas where unbundling is unlikely to occur and covered by RBI,
- FWA covering long lines in areas where unbundling is unlikely to occur and covered by RBI or extrapolated when not covered by RBI,
- Absence of FWA.

As a starting point, the position of the FWA sites can pragmatically be based on the RBI FWA sites that reside within the areas unlikely to be unbundled. It is reasonable to assume that the best available sites that provide the best possible have been used for the RBI.

**Criterion 13:** RBI sites should be considered as a relevant proxy to assess the cost of FWA.

The FWA sites will be connected to the rest of the network via fibre from the nearest exchange.

Where this fibre cable passes premises on its way to the FWA site, these premises will be assumed to be connected to the FTTH-network and modelled accordingly. As a consequence, microwave backhaul is not considered since it does not enable to connect customers along the backhaul and is as a consequence less economic. Also, except in the scenario where FWA covering the full areas where unbundling is unlikely to occur, since FWA is at the edge of the FTTH network, the length of incremental fibre to connect FWA sites is small and makes fibre backhaul even cheaper than microwave.

This approach will modify the coverage of FWA sites.

**Criterion 14:** The FWA sites should be connected to the nearest exchange. Customers located on the way from the FWA sites to the exchanges should be connected by the FTTH-network.

The technology used by the FWA network should be based on the most advanced, in use technology as it would offer a higher throughput to end-users and a better coverage for a lower cost. The FWA deployment should therefore be based on Long Term Evolution (LTE) technology.

**Criterion 15:** The FWA should use LTE technology.

The modelling of the coverage of the FWA network is based on the RBI FWA coverage. Customers which are assumed to be connected to the FWA network are being allocated a throughput based on their copper network length: the capacity

provided to each FWA user is based ADSL 2+ quality of service, then on distance between user and active node (non-RBI active cabinet or MDF).

Line speeds are capped at 1.9Mbps, which is based on the level of throughput modelled for UBA. Low speed lines are allocated a minimum of 150kbps.

RBI sites are then filled to their capacity, starting from users farthest from the MDF, i.e. most remote users, to users that are closest to the MDF.

**Criterion 16:** The FWA coverage should be inferred from the distance to active node (active cabinet or MDF) in the copper network and ADSL 2+ throughput.

## 2.3 Non-TSO areas

The areas outside the TSO (Telecommunications Service Obligations) areas are a proxy for areas where the deployment of a network would be inefficient to invest in without a capital contribution. As deploying a network outside the TSO-area is considered uneconomic, Chorus would not have extended its network outside the TSO-area unless it received capital contributions when doing so.

For a hypothetical efficient operator, it is assumed that the boundary between economical and uneconomical network deployment is also the TSO-area.

It is therefore reasonable to assume that a hypothetical efficient operator would only deploy a network where economic, unless required to do otherwise. As a consequence, the hypothetical efficient operator would only deploy FWA within the TSO areas.

Accordingly, it is recommended to restrict the coverage of the access network to the TSO-area which represents 93.89% of the total number of dwellings in New Zealand.

**Criterion 17:** The capital cost of the access network should be computed over the TSO-areas, including the cost of connections outside the TSO-area for the part of those connections that is within the TSO-area. It is assumed that the capital contributions cover exactly the cost of the non-TSO areas. The operating costs of the access network should however be computed over a nationwide network.

## 2.4 Mapping the local loop to services

Different services use the local loop either entirely or only part of it.

When the line is not cabinetised, the local loop is made of three parts:

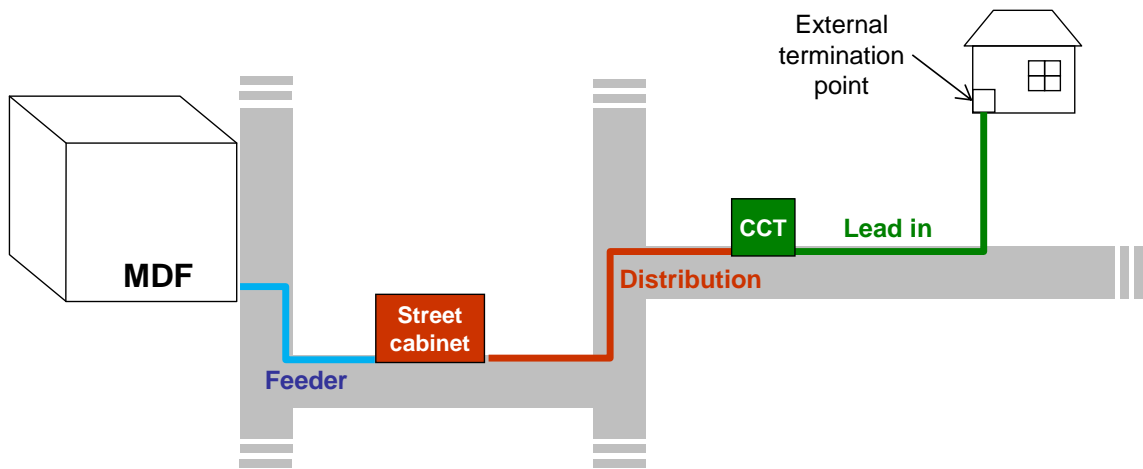
- the lead-in (including the lateral for modelling);

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- the distribution; and
- the feeder.

The sub-loop is only the lead-in and the distribution.

**Figure 1 - Architecture of the local access copper network**



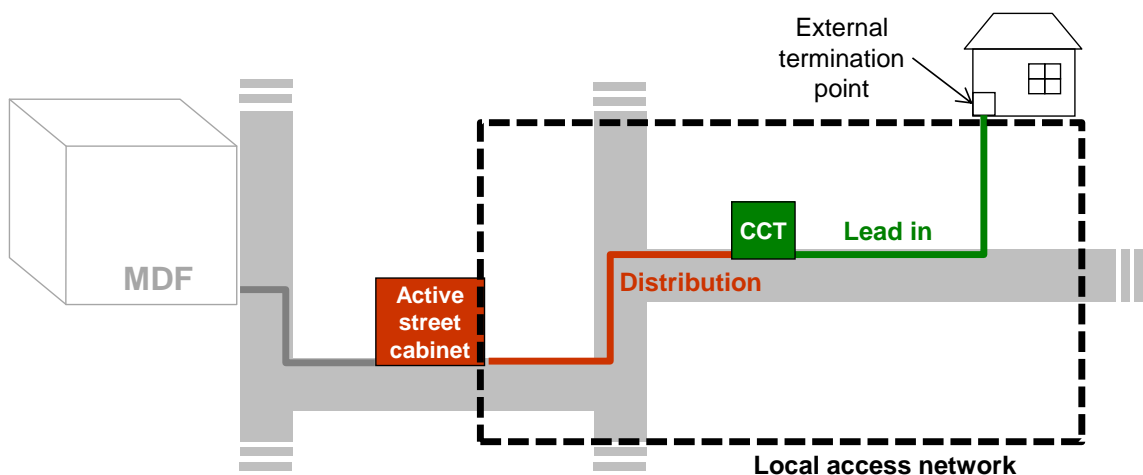
Source: TERA Consultants

When the line is cabinetised, the local loop is made of two parts:

- the lead-in; and
- the distribution.

The “feeder” in this case, i.e. the link between the active cabinet and the exchange, is the assets which would be used to provide the sub-loop backhaul (SLUBH) service if purchased by an access seeker. For convenience therefore the term “sub-loop backhaul” and contraction “(SLUBH)” are used to refer to the feeder assets.

**Figure 2 - Architecture of the local access network when the street cabinet is active**



Source: TERA Consultants

There are however some relationships between the different services.

The relationship between the unbundling of the local loop (ULL), the sub-loop unbundling (SLU) and the unbundling of the copper local loop (UCLL) is given by the following formula:



$$ULL = SLU * \frac{\# \text{ active lines at the cabinet}}{\text{Total \# active lines}} + UCLL * \frac{\# \text{ active lines at the exchange}}{\text{Total \# active line}}$$

The relationship between UCLL, SLU and the sub-loop backhaul (SLUBH) prices is given by the following formula:

$$UCLL = SLU + SLUBH$$

The model should derive the cost of the ULL and the cost of the SLUBH and deduce the cost of the SLU and the cost of the UCLL by verifying the two previous equations simultaneously.

**Criterion 18:** The access network cost model should derive the cost of the UCLL and SLU based on the cost of the ULL and the cost of the SLUBH.

## 2.5 Demand

When assessing the demand that should be taken into account in the access network cost model, the key questions that need to be considered are:

- Should the Chorus Ultra-Fast Broadband (UFB) demand be included in the demand assumptions for UCLL?
- Should the Hybrid fibre-coaxial (HFC) demand be included in the demand assumptions for UCLL?
- Should the Local Fibre Company (LFC) demand be included in the assumptions for UCLL?
- Should a constant demand or a projected demand be used for UCLL?

These questions are addressed hereafter:

### 2.5.1 Should the Chorus UFB demand be included in the demand assumptions for UCLL?

The demand assumption should include both the current Chorus UFB demand and the demand for the service it is replacing (UCLL) because copper customers are expected to migrate to the MEA network given the fact that capabilities of FTTH are greater.

In summary, Chorus UFB is replacing copper (while HFC is not replacing copper but is competing against copper) and therefore, the aggregated demand of the two should be considered for UCLL.

**Criterion 19:** The Chorus UFB demand should be included in the UCLL demand.

### 2.5.2 Should the HFC demand be included in the demand assumptions for UCLL?

The European Commission justifies not including HFC demand in their impact assessment note as follows:

*“In other words, stability would be reached by calculating the access costs of an NGA network and thus counteracting the volume effect (due to decreasing demand) which has been leading to higher unit costs. Such volume effects would see copper prices rising as customers switch to NGA products, because the same cost base of copper would be distributed between a smaller number of lines. In the proposed methodology, the model includes both copper and NGA lines, and therefore only traffic volume moving to other infrastructures (e.g. cable, mobile and alternative operators’ fibre) would entail an inflation of unit costs”.*

*“Next generation loops have at least the same potential as copper loops to be replicated since fibre constitutes the competitive response to alternative infrastructures such as mobile and cable. Most likely, fibre has more potential for competition as it is capable of delivering greater functionalities, to further expand the demand and to lower entry barriers (especially if regulated access to the civil engineering is ensured). Some alternative operators are already deploying their own fibre networks and new business models are emerging (such as co-investment)”.*<sup>4</sup>

This means that for the European Commission, HFC (“cable”) is a competitive platform and therefore HFC demand can reasonably be assumed not to be on the MEA network.

The demand assumption should not include services that are in competition with the FTTH/FWA, which includes HFC. The incumbent will have to compete with HFC and therefore, it will not be able to capture demand from HFC, because HFC is able to provide ultrafast broadband.

Accordingly, it is recommended not to include HFC demand in the UCLL demand.

|   |
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| <b>Criterion 20:</b> The HFC demand should not be included in the UCLL demand |
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### 2.5.3 Should the LFC demand be included in the assumptions for UCLL?

Not including demand from LFC would increase unit costs in this area and would encourage inefficient entry. LFC UFB is replacing copper (while HFC is not replacing copper but is competing against copper) and therefore, the aggregated demand of the two should be considered for UCLL. The LFCs, being recipients of the same UFB

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<sup>5</sup> Commerce Commission, Standard Terms Determination For Chorus’ Unbundled Bitstream Access Service, 30 November 2011

government funding as Chorus, are replacing copper in their areas. The LFCs are therefore not alternative fibre providers in the European Commission's use of that term.

Accordingly, it is recommended to include LFC demand in the TSLRIC model for UCLL.

**Criterion 21:** The LFC demand should be included in the UCLL demand

#### 2.5.4 Should a constant demand or a projected demand be used for UCLL?

The starting point for estimating the demand for the regulatory period is the actual demand, i.e. Chorus' current copper demand (broadband, leased lines, telephony) and the demand already migrated to FTTH-network, i.e. the demand on the LFC networks and demand on Chorus' FTTH-network as explained in §2.5.1.

The reason to project demand is that a constant demand assumption would slightly underestimate the number of fixed lines, as the number of dwellings will increase over time. The forecasts should be based on the number of buildings and population. However, it is expected that this would be a relatively small increase.

The UCLL demand assumption in the model, i.e. 100% demand, is a sufficient efficiency benchmark:

- The existence of several parallel infrastructures in the local loop lowers economies of scale and is not necessarily efficient because of the existence of significant fixed costs. As a consequence, migration to the new platform should be as fast as possible, which means that the 100% demand assumption sends the right economic signal in terms of efficiency;
- Including forecasts is likely to have a relatively minor effect.

Accordingly, it is recommended to use constant demand for UCLL.

**Criterion 22:** The UCLL demand should be constant over the regulatory period

## 2.6 Optimisation in the TSLRIC model

### 2.6.1 Optimisation of the nodes of the network

There are generally speaking four degrees of optimisation:

- no optimisation;
- scorched node;
- modified scorched node; and
- scorched earth.

These four degrees of optimisation are presented hereafter.

### *2.6.1.1 No optimisation*

This is the approach where the number, location, topology and function of exchanges and cabinets in Chorus' actual network are retained in the analysis. This approach means that potentially inefficient network designs will be reflected in the model, thus compensating the access provider for investments a hypothetical efficient operator will not make. However, these inefficient designs are often the result of restrictions faced when the network was deployed and reflects the fact that the actual network was deployed and expanded over time. Generally, it is often difficult to argue that the access provider did not deploy an efficient network – all things considered.

In a TSLRIC context however, some degree of optimisation is almost always applied by regulators around the world and no optimisation is therefore not common practice.

### *2.6.1.2 Scorched node optimisation*

In this approach, the number, locations and functions of the network nodes are left as they are, but where the access network is optimised with respect to the efficient routing and dimensioning of the local access network between the nodes and end-users' premises. This method provides a trade-off between efficient and 'real world'/historic investment considerations.

Scorched node optimisation is widely used by regulators.

### *2.6.1.3 Modified scorched node optimisation*

This optimisation is a variant of the scorched node approach.

Under this approach, there is a greater degree of flexibility in the level of network scorching that occurs. The materiality of the difference between scorched node optimisation and modified scorched node optimisation depends on the degree of modifications the regulator applies to the scorched node optimisation, but it tends to be relatively immaterial.

This means modelling an "modified scorched node network" which is constrained by the existing number of nodes (exchanges and cabinets) and their existing locations and follows the road network. The boundaries of the exchange can be optimised.

### *2.6.1.4 Scorched earth optimisation*

This is the approach where the network is fully optimised. This approach allows complete redesign of the network, without considering any past investment and existing node locations/numbers. It removes all of the inefficiencies that may have arisen due to the historical development of the network. However, this approach may not reflect a number of 'real world' issues such as the sunk, irreversible nature of some of the investments that the regulated operator has made, such as the number and the location of local exchanges. Furthermore, it requires the entire network deployment to

be re-designed, which can be very complicated and require a great deal of assumptions to be applied and design rules to be developed.

Scorched earth optimisation is generally not used by regulatory authorities in a TSLRIC context.

#### *2.6.1.5 Optimisation for the copper network modelling*

The Commission has advised us that the scorched earth approach should in principle be the starting point for the network optimisation, as this is consistent with the Commission's regulatory framework. However the Commission has also acknowledged that scorching the location of nodes (MDFs or cabinets) would amount to shifting the boundary between the access and the core networks, which is unlikely to materially affect the total network costs. Also, identifying a right location for a node (MDF or cabinet) – e. g. which street? – and the right size of the node (MDF/cabinet sizes vary a lot from an area to another) is not something that can be modelled since it requires having knowledge of local constraints in each city/village. Trying to model it would generate a high risk of creating an unrealistic network (this is why scorched earth is rarely used by NRAs). Given the constraints of the scorched earth approach, we recommend a modified scorched node approach taking only the locations of Chorus' exchanges and cabinets as fixed while optimising all other aspects of the network.

Exchange boundaries defined by Chorus should be optimized according to the direct paths from premises to exchanges (via the road network), i.e. premises will be connected to their closest exchange.

**Criterion 23:** A modified scorched node network based on Chorus' copper network with optimised node boundaries should be modelled.

Other minor modifications will apply in the following situations:

- When the different coverage areas provided by the operators are not rigorously contiguous and they create holes in the coverage of the country;
- When needed to ensure the connectivity of the whole road network;
- When needed to ensure the connectivity of the road network within each coverage area;
- When a cabinet is located in the coverage area of a different exchange than the one it is linked to;
- When an exchange is located outside of its coverage area;
- When several exchanges are located in the same coverage area;
- When there is no exchange in some coverage areas; and
- When a coverage area is split in several non-adjacent parts.

### *2.6.1.6 Modelling of the fibre network*

The UFB fibre network being deployed is not providing a nationwide coverage.

Furthermore there is no technical argument from a network point of view against using the current copper nodes and their coverage area as the nodes and their coverage area for a nationwide fibre roll-out.

Consequently, it is recommended to use the location of the MDF nodes of the current copper network as the location of the Optical Distribution Frames (ODF) of the fibre network.

ODF boundaries should be optimized according to the direct paths from premises to exchanges, i.e. premises should be connected to their closest exchange.

**Criterion 24:** The location of the MDF nodes of the current copper network should be used as the location of the ODF nodes. Exchange boundaries should be optimized.

### **2.6.2 Optimisation of the network**

Having defined the nodes of the network to be modelled, the network itself should be optimised.

There are generally speaking three degrees of network optimisation:

- no optimisation;
- a cost-based optimisation; and
- a cable-length-based optimisation.

These three degrees of optimisation are presented hereafter:

#### *2.6.2.1 No optimisation*

This is the approach where the inventory of the network modelled is Chorus' actual inventory. Similarly as in §2.6.1.1, this approach means that potentially inefficient network designs will be reflected in the model, thus compensating the access provider for investments a hypothetical efficient operator will not make. However, these inefficient designs are often the result of restrictions faced when the network was deployed and reflect the fact that the actual network was deployed and expanded over time. Generally, it is often difficult to argue that the access provider did not deploy an efficient network at the time – all things considered.

In a TSLRIC context however, some degree of optimisation is almost always applied by regulators around the world and no optimisation is therefore not common practice.

### *2.6.2.2 Cost-based optimisation*

This is the approach where the cost of the network is optimised. This approach means the cost of the network is computed for each possible set of engineering rules identified. The set of engineering rules that gives the lowest cost is the one that is kept. This approach is in line with the MEA definition. However, it has several drawbacks:

- this approach would lead to a level of efficiency not achievable by even the most efficient operator, especially as it may not be able to take into account quality constraints;
- this approach is not in line with how an actual operator is rolling out a network; and
- finally, a practical consideration is that it is not possible to model all possible network configurations.

Cost-based optimisation is generally not used by regulatory authorities in a TSLRIC context.

### *2.6.2.3 Length-based optimisation*

This is the approach where the length of the cables is optimised. This approach means that for each line, the length is following the shortest path between the customers' premises and the nodes of the network (via the road network).

This approach has many advantages:

- it approach ensures the best quality of service possible to the customers as the length of the lines has been minimised, all other things being equal;
- it also approach optimises, to a certain degree, the costs as the cost of the network is driven by the length of cables and trenches;
- it approach is in line with how an operator is traditionally planning its network.

Length-based optimisation is widely used by regulators.

Cable length-based optimisation was tested in New Zealand against infrastructure (pole/trench) length-based optimisation and proved to be more efficient from a cost point of view because of the share of cable costs compared to infrastructure costs.

### *2.6.2.4 Optimisation of the copper network modelling*

A length-based optimisation is recommended for the modelled copper network.

|  |
|--|
| <p><b>Criterion 25: For the copper network</b>, the cable length-based optimisation approach should be followed for the modelling of the copper network.</p> |
|--|

The optimisation of the length of each line should be done in two steps:

- Optimisation of the length of the line between:
  - The customers' premises and the active cabinet for lines connected to an active cabinet;
  - The customers' premises and the passive cabinet for lines connected to a passive cabinet; and
  - The customers' premises and the exchange for lines connected directly to an exchange.
- Optimisation of the length of the line between the cabinet (active or passive) and the exchange

#### *2.6.2.5 Optimisation of the fibre network modelling*

For the same reasons, a length-based optimisation is also recommended for the modelled fibre network.

**Criterion 26: For the fibre network**, the length-based optimisation approach should be followed for the modelling of the fibre network.

The optimisation of the length of each line is done by directly optimising the path from the customers' premises to the exchange, i.e. without considering the copper cabinets.

## **2.7 Access modelling approach**

### **2.7.1 Demand assessment**

The access increments include all services that use the access network. The relevant measure of demand for these services, defined as end user demand, is the current level of demand, as explained in §2.5.

**Criterion 27:** The starting point when building the bottom-up model is the level of demand in New Zealand for all the services.

### **2.7.2 Network design**

Engineering principles will inform the dimensioning process for direct network cost categories. These engineering rules should be provided by Chorus as a starting point e.g. the number of pairs per dwelling is derived from the engineering rules provided by Chorus.

When no engineering rule is available (e.g. the MEA is a point-to-point fibre network with FWA which is different from what Chorus deploys), data provided by industry best



practices should be used (data from either alternative operators in New Zealand or data from other countries).

Other cost categories will be required to provide functionality to direct network cost categories. These are referred to as indirect network cost categories.

**Criterion 28:** The engineering rules as provided by Chorus are the starting point of the modelling, except if very different from standard practice elsewhere or they would not apply to a HEO.

### 2.7.3 Network costing

In the access network cost model, both unit costs of equipment and the operating and indirect costs associated with the different types of equipment are included. Using this information, the total investment costs for the network can be estimated. However, the model also needs to calculate annual costs, so the investment costs will need to be annualised to generate an annual figure for the capital expenditure involved with using each asset.

Operating costs and corporate overheads should be calculated in accordance with §4.3 and §1.

**Criterion 29:** The access network cost model should derive a total investment and an annualised cost.

**Criterion 30:** Operating costs, corporate overheads and indirect costs should be included when relevant.

### 2.7.4 Services costing

The final step in the process will be to calculate the costs for various products under scrutiny. Based on the hypothetical network that has been built, the model needs to calculate the costs attributable to each of the various services.

This means that all of the different cost categories (direct network costs, indirect network costs, operating costs and overheads) will be aggregated when calculating the costs of the products.

### 3 Core network to be modelled for UBA

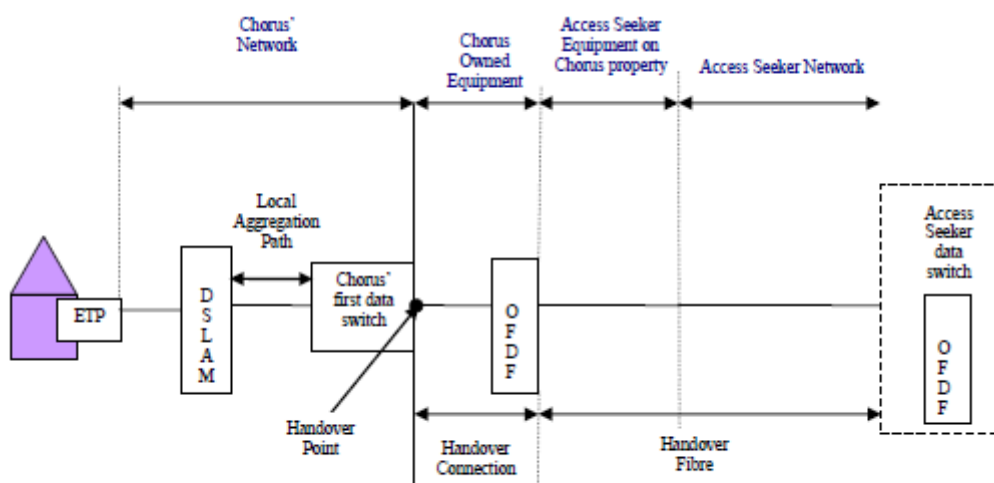
#### 3.1 Scope of core model

The aim of the core network cost model is to derive a price for the different variants of the UBA service.

The UBA service is defined as follows by the STD<sup>5</sup>:

*“The UBA service is a DSL enabled service (and its associated functions, including the associated functions of Chorus’ operational support systems) that enables access to, and interconnection with, that part of Chorus fixed PDN that connects the End User’s building (or, where relevant, the building distribution frames) to Chorus first data switch (or equivalent facility) other than a DSLAM.”*

**Figure 3: Different types of costs in an operator’s costs**



Source: STD for Chorus’ unbundled bitstream access service

##### 3.1.1 Assets to be modelled

The UBA service is therefore a combination of:

- Chorus’ copper local loop which connects the end user to an exchange or an active cabinet (to a point where a DSLAM is located); and
- Chorus’ core network restricted to the part located between the DSLAM and the first data switch, the handover point being excluded from the UBA service as this part of the handover connection, which is paid separately. It is noted that handover points were designated when UBA was first regulated and that these

<sup>5</sup> Commerce Commission, Standard Terms Determination For Chorus’ Unbundled Bitstream Access Service, 30 November 2011

corresponded to the switches in the network at a point in time (2007). Since 2007, subsequent switches have been deployed and have become new first data switches, but the UBA handover points have remained the same. However, given the fact that the TSLRIC model reflects a new network built bottom-up, such legacy specificities are not considered.

The access network cost model contains the dimensioning of all passive links as explained in §1.1. The core network cost model should therefore contain the dimensioning of all active assets. The assets to be included in the core network cost model are:

- DSLAM;
- Switches; and
- Site assets, including power equipment, air-conditioning equipment and other assets such as security, furniture etc.

**Criterion 31:** The core network should start at the DSLAM (located either at the exchange or in the active cabinet) and stop at the first data switch (FDS).

### 3.1.2 Economies of scope

As the aim of the core network is to derive a price for UBA variants, the modelling of Chorus' core network beyond the first data switch is not required. However:

- The handover points should be included in the modelling. The handover points are the point of interconnection with access seekers. As ports on the first data switch are dedicated for this type of interconnection, these ports plus a share of the cost of the first data switch should be allocated to interconnection; and
- The inter-exchange links not included in the local aggregation path (e.g. inter-FDS links) should be modelled to capture the economies of scope as they share the same trench as the access network.

**Criterion 32:** The handover points and the inter-exchange links should be modelled.

### 3.1.3 RBI program

Chorus has received some subsidies as part of the RBI program in order to roll-out DSLAM infrastructure in rural areas. A hypothetical efficient operator building a network in these rural areas would also receive a government subsidy that would cover the cost of the backhaul that supports RBI DSLAMs. Otherwise, it would not deploy any network.

The cost of the DSLAMs deployed as a direct result of the RBI program should therefore not be recovered through UBA.

**Criterion 33:** The cost of the DSLAM deployed as a direct result of the RBI program should not be recovered by Chorus through UBA.

## 3.2 MEA definition

The Commission has consulted the industry on the definition of the MEA for UBA. The definition of the MEA for the UBA that has been retained by Commission is a Next Generation Network (NGN) layer 2 Ethernet core network to support broadband provided over a copper/FTTN underlying access network architecture.

**Criterion 34:** The MEA for UBA is a NGN Ethernet core network to support broadband provided over a copper/FTTN underlying access network architecture.

## 3.3 Demand

When assessing the demand that should be taken into account in the core network cost model, the key questions that need to be considered are:

- Should the LFC demand be included in the demand assumptions for UBA?
- Should the RBI FWA demand be included in the demand assumptions for UBA?
- Should the HFC demand be included in the demand assumptions for UBA?
- Should unbundled lines be included in the demand assumption for UBA?
- Should a constant demand or a projected demand be used for UBA?
- Should the traffic per customer grow over time?

These questions are addressed hereafter:

### 3.3.1 Should the LFC demand be included in the demand assumptions for UBA?

LFC demand is not usually considered in UBA modelling. This is because the LFC platform is different than the platform used for UBA and therefore its demand cannot be reasonably included in the core network for the UBA service.

It is therefore recommended that, consistent with common international practice, LFC demand should be excluded from the demand for UBA.

**Criterion 35:** The LFC demand should not be taken into account in the demand assumption for UBA.

### 3.3.1 Should the FWA RBI demand be included in the demand assumptions for UBA?

For the same reason as for LFC, it is therefore recommended that FWA RBI demand should be excluded from the demand for UBA.

**Criterion 36:** The FWA RBI demand should not be taken into account in the demand assumption for UBA.

### 3.3.2 Should the HFC demand be included in the demand assumptions for UBA?

HFC demand is not usually considered in UBA modelling. This is because HFC is a competing platform and therefore its demand cannot be reasonably included in the core network for the UBA service.

It is therefore recommended that, consistent with common international practice, HFC demand should be excluded from the demand for UBA.

**Criterion 37:** The HFC demand should not be taken into account in the demand assumption for UBA.

### 3.3.3 Should the unbundled lines demand be included in the demand assumptions for UBA?

Demand for unbundled lines is not usually considered in UBA modelling. This is because unbundled lines use a competing platform (the core network of access seekers) and therefore its demand cannot be reasonably included in the core network for the UBA service.

It is therefore recommended that, consistent with common international practice, unbundled lines demand should be excluded from the demand for UBA.

**Criterion 38:** The unbundled lines demand should not be taken into account in the demand assumption for UBA.

### 3.3.4 Should a constant demand or a projected demand be used for UCLL?

For pricing the UBA service, a FTTN network is being modelled.

The approach followed by regulatory authorities is generally to use the actual and forecasted demand of the incumbent in its core network.

As a consequence, the demand for UBA set by regulatory authorities is the actual and forecasted demand.

Chorus' actual demand for UBA may decrease over the regulatory period. So, assuming constant demand may be inappropriate if a new operator deploys copper today for UBA and has to compete with FTTH, HFC and unbundling.

The implication is that the actual demand for UBA is decreasing as FTTH is being developed, which may lead to UBA costs increases.

Assuming a declining demand profile is likely to lead to cost increases because of the smaller quantity base over which the fixed costs would have to be spread. Therefore, if prices are smoothed, the prices based on a declining demand profile are likely to be higher compared to prices based on costs with a constant demand profile.

An approach to include declining demand as a result of greater competition, will lead to an increase in prices – which is counter-intuitive. It is expected that as competition increases, prices will decline.

In this regard, Professor Vogelsang also advised that:

*“TSLRIC is conceptually based on an expanding market, where additional capacity is being installed. Since a large portion of the copper-related costs are sunk and some overcapacities develop, true forward-looking costs will therefore be much lower than TSLRIC as traditionally calculated by regulators. Also in this stage of the market an operator in a competitive environment would wish to take advantage of wholesale demand to defend its position against competing technologies. But if TSLRIC were still measured based on the old technology this would lead to price increases because of the smaller quantity base over which then fixed costs would have to be spread. Summing up, in the face of long-term declining demand relying on the TSLRIC standard for the old technology would induce unnecessary over-capacities and allocative inefficiencies in copper networks”<sup>6</sup>*

In the July consultation, the Commission stated that if migration away from Chorus' actual network to alternative networks is included within the model, this again will not reflect an efficient outcome.

- Declining utilisation of the network would imply a higher cost to end-users and could attract build decisions where that is not efficient; and
- It is noted that the declining utilisation could lead to a cost spiral – increasing costs would likely accelerate migration away from the network, leading to further cost increases to end-users that remain on the network.

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<sup>6</sup> Ingo Vogelsang “The effects of the UCLL contribution to the UBA aggregate on competition for the long-term benefit of end-users in New Zealand telecommunications markets” 2 July 2014, paragraph [10].

Accordingly, it is recommended to use constant demand for UBA.

**Criterion 39:** The UBA demand should be constant.

### 3.3.5 Should the traffic per customer grow over time?

Average throughput per customer grows all over the world with the development of services requiring greater and greater of data. For example, the average size of a web page was circa 180 kilo bytes (KB) in 2005 and is circa 1,600 KB in 2014.<sup>7</sup> Also, Cisco provides regular update of traffic grows in different regions of the world which show the exponential increase in traffic<sup>8</sup>. As a consequence, the traffic per customer should be assumed to increase for UBA over time.

**Criterion 40:** The UBA traffic per customer should increase over time.

## 3.4 Services to be modelled

Given the limited scope of the core network being modelled (see §3.1) as it is fit to derive the price of the UBA services, the model should include solely the services that share assets with the UBA services.

### 3.4.1 Broadband services

#### 3.4.1.1 Regulated broadband services

The model should include all the regulated broadband services provided using either ADSL or VDSL.

**Criterion 41:** The model should include all the regulated broadband services.

#### 3.4.1.2 Non-regulated broadband services

DSLAMs are dimensioned according to the number of active customers. With a single DSLAM, ADSL, VDSL and SHDSL customers can be served. All these services should therefore be included in the network cost model.

**Criterion 42:** The model should include all the non-regulated broadband services.

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<sup>7</sup> <http://www.websiteoptimization.com/speed/tweak/average-web-page/>

<sup>8</sup> <http://www.cisco.com/c/en/us/solutions/service-provider/visual-networking-index-vni/index.html>

### 3.4.2 Remaining services

#### 3.4.2.1 SLUBH

This link is shared between the bitstream services and other services such as leased line services or legacy services.

The model should therefore capture the relevant economies of scope of the SLUBH.

**Criterion 43:** The model should capture the economies of scope of the SLUBH.

#### 3.4.2.2 First data switch

The first data switch is dimensioned based on the number of DSLAMs that should be connected to it and based on the number of handover points it should offer. The handover connection service should therefore be included in the core network cost model.

**Criterion 44:** The core network model should include the handover connection service to dimension the FDS and capture the relevant economies of scope.

## 3.5 Technologies to be modelled

### 3.5.1 Switching technology

The core network that should be modelled is an Ethernet network as it is the most cost-efficient way to deliver the UBA service.

**Criterion 45:** The core network model should be an Ethernet network.

### 3.5.2 Transmission technology

#### 3.5.2.1 No SDH

The Synchronous Digital Hierarchy (SDH) transmission technology is a legacy technology that does not reflect the MEA choice. Any existing SDH links in Chorus' network will therefore be disregarded and replaced by Ethernet links.

#### 3.5.2.2 Use of microwaves for remote sites

On remote sites with no easy access, microwave links can be used. However, microwave links are less future proof than fibre. Also, programs to replace microwaves



by fibre links have been observed. As a consequence, it is proposed to exclude microwave links.

**Criterion BU 46:** The model should not include Chorus' existing microwaves links.

### *3.5.2.3 Use of submarine cables*

Where microwaves cannot be used, submarine cables should be used to connect islands to the main land. The existing links should be used.

**Criterion BU 47:** The model should include Chorus' existing submarine links.

### *3.5.2.4 Use of DWDM*

Improvements in laser technology have increased the capacity of optical fibre. Dense wavelength division multiplexing (DWDM) allows the combination of a number of wavelengths on a fibre so the capacity of a single fibre is increased even more.

From a top-down perspective, an all-IP network might well incorporate a considerable amount of DWDM equipment. However, it is most likely that this has occurred due to historical reasons of limited fibre availability within existing trenches and ducts. Choosing between digging up the streets to install additional fibre optic cables or installing DWDM equipment at relevant node locations, the latter option will probably prove to be more cost effective in most circumstances.

Nevertheless, from a bottom-up/replacement cost perspective, the number of fibres in each cable/duct/trench becomes a variable and thus no longer acts as a constraint for the network design. Furthermore, the cost of rolling out more fibre cables (or cables with more fibres) is more cost-efficient than installing DWDM.

There is however one case where the use of DWDM could be necessary in the cost model, which is for long distances. In this case, even a new operator building a new network would require DWDM.

**Criterion BU 48:** The models should include only DWDM links for long distance links.

## **3.6 Optimisation in the TSLRIC model**

An optimally structured network taking only the locations of Chorus' exchanges as fixed while optimising all other aspects of the network is recommended.

- Under this approach, there is a great degree of flexibility in the level of network optimisation that occurs. The materiality of the difference between this approach and the scorched node optimisation depends on the degree of optimisation the regulator applies, but it tends to be relatively immaterial.
- This means modelling an “optimally structured network” which is constrained by the existing number of nodes (exchanges and cabinets) and their existing locations and follows the road network.

The choice of this approach also minimises the potential issue of double recovery between UCLL and UBA as node locations is more likely to be the same if the same optimisation is chosen.

**Criterion 49:** An optimally structured network based on Chorus’ copper network with optimised exchange boundaries should be modelled.

However the optimisations that should be made are different than those made in the access network cost model.

This approach means making optimisations in the following situations:

- Number of assets should be assessed based on the demand;
- Space required should reflect the number of assets modelled and not the actual surface of Chorus’ buildings;
- Power usage should reflect the assets modelled, i.e. the power consumption of the modern assets given the number of assets modelled;
- The air-conditioning requirement should also reflect the assets being modelled.

## 3.7 Core modelling approach

### 3.7.1 Demand assessment

The core increments include all services that use the core network. The relevant measure of demand for these services, defined as end-user demand (internal and external), is the current level of demand.

**Criterion 50:** The starting point when building the core TSLRIC model is the level of demand in New Zealand for all the services using the core network of the incumbent in accordance with §3.3.

### 3.7.2 Network design

Engineering principles will inform the dimensioning process for direct network cost categories. E.g. the number of ports per line card is derived from the engineering rules provided by Chorus.

Other cost categories will be required to provide functionality for direct network cost categories. These are referred to as indirect network cost categories.

**Criterion 51:** The engineering rules as provided by Chorus are the starting point of the modelling.

### 3.7.3 Network costing

In the core network cost model, both unit costs of equipment and the operating and indirect costs associated with the different types of equipment are included. Using this information, the total investment costs for the network can be estimated. However, the model also needs to calculate annual costs, so the investment costs will need to be annualised to generate an annual figure for the capital expenditure involved with using each asset.

Operating costs and corporate overheads should be calculated in accordance with §0 and §1.

Operating costs, corporate overheads and indirect costs will however be carried out in the core network cost model.

**Criterion 52:** The core network cost model should derive a total investment and an annualised cost.

**Criterion 53:** Operating costs, corporate overheads and indirect costs should be included when relevant.

### 3.7.4 Services costing

The final step in the process will be to calculate the costs for various products under scrutiny. Based on the hypothetical network that has been built, the model needs to calculate the costs attributable to each of the various services.

This means that all of the different cost categories (direct network costs, indirect network costs, operating costs and overheads) will be aggregated when calculating the costs of the products.

TSLRIC price review determination for the Unbundled Copper Local Loop and Unbundled  
Bitstream Access services  
Model Reference Paper

The costing of the different services will be carried out in the core network cost model.

**Criterion 54:** The different services under scrutiny will include all the different cost categories.

## 4 Types of costs and cost allocation

There are two dimensions in categorising costs when considering fixed telecommunications networks:

- The first dimension categorises costs depending on how assets contribute in producing certain services (e.g. directly or indirectly).
- The second dimension deals with whether costs refer to investments to acquire physical assets (Capital expenditure, or CAPEX) or are the result of normal business operations (Operational expenditure, or OPEX). This raises the question of how to identify CAPEX and OPEX costs.

**Figure 4: Different types of costs for a telecom network and examples**

|                | CAPEX       | OPEX                                     |
|----------------|-------------|--|
| Direct costs   | DSLAM...    | Electricity consumption of the DSLAMs... |
| Indirect costs | Trenches... | Staff managing the trenches...           |
| Overheads      | IT...       | CEO wage...                              |

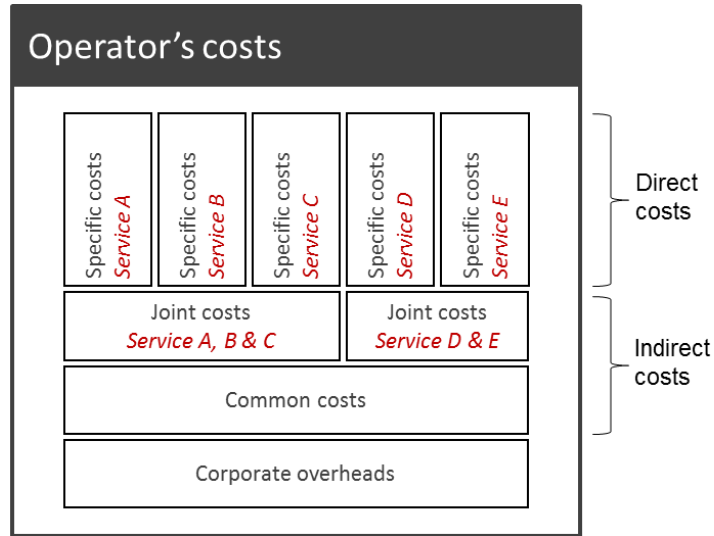
*Source: TERA Consultants*

### 4.1 Direct, Indirect costs and Corporate Overheads

In a telecommunications network, assets are usually not used exclusively for one set of services but are instead shared between a group of services or even among an entire portfolio of services produced by an operator (e.g. trenches in the fixed network).

Costs can thus be categorised into four main groups: direct costs, joint costs, network common costs and corporate overheads.

**Figure 5: Different types of costs in an operator's costs**



Source: TERA Consultants

The definition of each group of cost is given below.

- **Direct costs:** these costs are directly related to the production of a given service. They would cease to exist if the service was to be terminated. They are therefore directly attributable costs that have an unambiguous causal relationship with the *considered service*.
- **Joint costs:** these costs cannot be specifically allocated to one service; they are incurred when producing a given set of services. They are indirectly attributable costs that have an unambiguous cause-effect relationship with the *considered group of services*.
- **Network common costs:** these costs are incurred when producing all services. As in joint costs above, network common costs are indirectly attributable. They have an unambiguous causal relationship with *all services*.
- **Corporate overheads (also known as “non-network common costs”):** Overhead costs are costs that are incurred to operate a telecommunications company but that are not directly incurred to provide a core and access network. Examples include human resources, legal, and planning departments. These costs cannot be allocated in a non-arbitrary way. They are shared by the entire portfolio of services.

As a general rule, it can be considered that when an operator produces several services, it is less expensive to jointly produce these services than to produce them separately: the total cost of producing several services is lower than the sum of the stand-alone costs. Joint and common costs, therefore, consist of economies of scope achieved by an operator.

When trying to assess the cost of a service, its joint and common network costs raise the question of how to allocate them among the different services produced by the operator. Joint and common costs are prevalent in telecommunications networks. Several network elements are not specific to a given service but are required to provide a set of services. The allocation of network costs between different services is a key issue for network costing because telecommunications networks support and share many services (voice services, broadband, IPTV, leased lines, etc.).

Joint and common cost allocation is a complex and critical task as different methods can lead to different unit costs for a given service. The following sections will present various cost allocation approaches for indirect costs and the special case of corporate overheads.

#### 4.1.1 Allocation of joint and network common costs allocation

Different allocation keys can be envisaged for the allocation of indirect costs. The choice of the allocation can lead to very different unit costs for a given service.

In cost modelling, two types of cost allocation families are generally considered: proportional rules cost allocation families (technical allocation) or game-theory rules cost allocation families (economical allocation):

- **Proportional rules** (technical allocation): capacity based allocation, Moriarty, and residual benefit.
- **Game-theory rules** (economic allocation): Shapley-Shubik, nucleolus.

Each allocation rule has its advantages and drawbacks. The capacity based allocation rule and the Shapley-Shubik rule are the rules that are generally considered and used by regulatory authorities for allocating joint and common network costs. These two approaches have the advantage of being more easily implementable in a bottom-up model. They are presented hereafter:

- **The capacity based allocation rule** allocates common and joint costs to the services based on the network capacity required by each service. This rule is the one traditionally used by regulatory authorities as it follows the cost drivers (networks are dimensioned to support a given capacity such as a given number of customers or a given amount of traffic). This rule tends to allocate a large share of indirect costs to services that load the network a lot (data, Internet or Video on Demand), but leads to low unit costs for services that load the network (voice services) less. As the traditional rule, the capacity based allocation rule should be implemented in the model. This allocation rule means that for each asset the capacity has to be identified and then assessed:
  - The table below identifies the capacity of the different assets that are producing network common or joints costs:

**Table 1 – Capacity of the different assets**

| Asset         | Capacity driver                           |
|---------------|---|
| Trenches      | Ducts                                     |
| Ducts         | Surface of the cables inside of the ducts |
| Copper cables | Copper pairs                              |
| Fibre cables  | Fibres                                    |
| DSLAM         | Active customers                          |
| Switch        | Ports                                     |
| SFP           | UBA traffic                               |

*Source: TERA Consultants*

- For each of these assets, the capacity has to be derived. There are three possible approaches:
  - The capacity is computed bottom-up e.g. the number of ducts located in each trench is assessed bottom-up based on the number of dwellings and the engineering rules;
  - The capacity is provided by Chorus as part of the data collection e.g. the number of ADSL, VDSL and SHDSL customers connected to each site is provided by Chorus; and
  - The capacity is based on external data (benchmark, hypothesis or TERA's expertise). This approach should be used only in the case where the two other approaches cannot be applied.
  
- **The Shapley-Shubik allocation rule<sup>9</sup>** consists of setting the cost of a service equal to the average of the incremental costs of the service after reviewing every possible order of arrival of the increment (see example below). Such a rule may be worth considering because it gives different insights to the traditional rule. For example, with the capacity based allocation rule, voice services are often allocated a very small share of common network costs because they use much less capacity compared to other services. Therefore,

<sup>9</sup> The Shapley-Shubik rule has also been considered by some NRAs such as ARCEP in France (decision 2008-0896) or ComReg in Ireland (decision D03/08).



voice services may bear very low costs, which could contrast with the value of the voice services as perceived by market players and consumers. In such a case, the Shapley-Shubik allocation rule may provide a more appropriate outcome. This allocation rule however presents two difficulties:

- First of all, it is necessary to define the relevant increments. There can be different ways to define the increments. In general, in order to simplify the approach, broad increments are generally considered such as: voice service increment, broadband increment, IPTV increment and leased lines and data services increment. With such broad increments, traditional allocation approaches can still be needed to calculate costs of smaller services (for example, for call origination within the voice increment).
- Second of all, this rule requires running the cost model several times (for example, six times if there are three increments and 24 times if there are four increments). This is also why it is preferable to define broad increments.

**Figure 6: Shapley-Shubik allocation in the case of a network supporting two services (voice and data)**

- Let us consider a network supporting voice and data. The standalone cost of voice is 75 and 80 for data. The total cost of the network is 100.
- For this 2-service Network, 2 sequential scenarios are possible:

| Scenario 1                 | Scenario 2                 |
|----------------------------|----------------------------|
| 1st investment<br>VOICE 75 | 1st investment<br>DATA 80  |
| 2nd investment<br>DATA 25  | 2nd investment<br>VOICE 20 |

- The cost allocation is then completed as follows (47.5% to voice, 52.5% to data):

|            | Voice  | Data   | Total |
|------------|--------|--------|-------|
| Scenario 1 | 75     | 25     | 100   |
| Scenario 2 | 20     | 80     | 100   |
| Sum        | 95     | 105    | 200   |
| %          | 47.5 % | 52.5 % | 100%  |

Source: TERA Consultants

Accordingly, the capacity based allocation rule should be used for the allocation of joint and common network costs.

**Criterion 55:** The capacity based rule for joint and common network costs should be implemented in the TSLRIC models.

#### 4.1.2 Allocation of corporate overheads

In addition to network costs, an operator faces non-network common costs such as the costs of maintaining a corporate office, which are incurred to support all functions and activities. Examples of these costs include costs associated with corporate headquarters, senior management and internal audit.

Identifying the impact of an increment on corporate overheads is a very complex task. These costs are potentially material and should be recovered if relevant<sup>10</sup>. According to BEREC, the method traditionally used by NRAs to allocate these costs is the Equal Proportion Mark-Up (EPMU) approach<sup>11</sup>:

*“In a regulatory environment it is accepted that all services should bear, in addition to their incremental cost, a reasonable proportion of the common costs. The preferred method of allocating common costs is Equal Proportionate Mark-Up (EPMU).”*


Under the EPMU approach, each service is allocated a share of the common costs in proportion to that service’s share of total attributable costs.

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<sup>10</sup> Article 6.2.3 of the Accounting Separation Regulation dated 2 August 2004 limits un-attributable cost to less than 10% of overall costs.

<sup>11</sup> ERG - Recommendation on how to implement the commission recommendation C(2005) 3480 – 2005.

**Table 2: Numerical example of the EPMU method (for illustrative purpose only)**

| Corporate overheads cost allocation in a 3-service network<br>(Voice, Internet, Leased Lines)   |                    |     |   |                     |                |
|---|--------------------|-----|---|---------------------|----------------|
| <ul style="list-style-type: none"> <li>Corporate overheads: NZD 100M</li> <li>Attributable costs (i.e. direct + indirect costs): <ul style="list-style-type: none"> <li>Voice NZD 320 M</li> <li>Data NZD 530 M</li> <li>Leased Lines NZD 80 M</li> </ul> </li> </ul> |                    |     |   |                     |                |
|   | Attributable costs |     |   | Corporate overheads |                |
| Voice   | NZD 320 M          | 34% |  | Voice               | NZD 34 M 34%   |
| Data  | NZD 530 M          | 57% |   | Data                | NZD 57 M 57%   |
| Leased Lines  | NZD 80 M           | 9%  |   | Leased Lines        | NZD 9 M 9%     |
|   |                    |     |   |                     | NZD 100 M 100% |

Source: TERA Consultants

While the EPMU approach is relatively simple to implement, the main drawback of this approach is that it does not take into account efficiency considerations.

“Ramsey-Boiteux” is an alternative to the EPMU approach. With this approach, the size of the mark-up on each service is inversely proportional to the price elasticity of demand for that service, as this minimises the consumption-distorting effect of raising prices above marginal cost<sup>12</sup>. This approach tends to maximise the welfare but is rarely implemented in practice due to the difficulty to calculate price elasticities.

The EPMU approach has traditionally been used in cost models developed in all European countries.

**Criterion 56:** Corporate overheads costs should be allocated on the basis of the modified EPMU approach.

<sup>12</sup> See Laffont and Tirole, 2001, Competition in Telecommunications, Cambridge: MIT Press, for more detailed on Ramsey-Boiteux pricing.

## 4.2 CAPEX assessment

CAPEX are costs incurred when a telecommunications operator invests in equipment and/or designs and implements the network infrastructure. The equipment includes, for example, the DSLAMs or the switches, whereas the costs for the design and implementation of the network infrastructure can be site acquisition and civil works.

In the network cost models, CAPEX are derived from the service demand through engineering principles (see sections §2.7).

### 4.2.1 Equipment prices

Equipment prices are likely to vary between operators for a number of reasons including differences in underlying network structure, specification, business focus, bargaining power and bargaining ability. Where significant differences exist between the cost estimates provided by different operators, clarification may be needed to ensure that the estimates refer to equipment with equivalent specifications.

Moreover, an incumbent could be expected to have stronger bargaining power than other operators. The models should take this into account.

**Criterion 57:** Prices used in the TSLRIC models should reflect those that an efficient operator with the bargaining power of a New Zealand operator with significant market power would face.

### 4.2.2 Base year

Initially, cost inputs in the model will be based on the latest available information (i.e. 2014 data). If data for one reason or another is not available for that specific year, an extrapolation should be made from relevant historic data to calculate the proper reference data for the base year.

**Criterion 58:** Initially, cost inputs should be based on the latest available information and subscription data will subsequently be updated to reflect 2014.

## 4.3 OPEX assessment

OPEX are costs incurred as a result of an operator performing its normal business operations. The OPEX to be taken into account for the cost model is network driven, i.e. the costs associated with the operation of the network, transmission, site rentals, operation and maintenance.

Several methods of operating cost assessment are possible, the choice of which depends on the goal of the modeller and the availability of data.

#### 4.3.1 Approach 1 - OPEX from the accounts

As is the norm of top-down modelling, OPEX costs are based on the operator's actual costs and can be obtained directly from the operator's accounting records.

This type of approach is not necessarily in line with TSLRIC cost models except if the operator's costs are efficiently incurred.

#### 4.3.2 Approach 2 - OPEX from the accounts with efficiency adjustments

As explained in the previous section, top-down modelling reflects the actual costs incurred by an operator, but it can also incorporate network inefficiencies.

To eliminate this problem, some efficiency adjustments can be set up. E.g., the operator costs for repairing the access network can be reduced to reflect a lower fault rate of a new entrant's more efficient network.

**Figure 7: Numerical example of top-down assessment with efficiency adjustments (for illustrative purpose only)**

|  |
|--|
| <p><u>Cost of faults:</u></p> <ul style="list-style-type: none"><li>• Faults OPEX (accounts – top-down): NZD 10M/year</li><li>• Operator figures: 15 faults/100 lines/year</li><li>• Efficient operator figures : 10 faults/100 lines/year</li></ul> <p><b>Efficiency gain: -33% (15 faults vs. 10 faults)</b></p> <p><b>Faults OPEX = NZD 10M x (1-33%) = NZD 6,7M/year</b></p> |
|--|

Source: TERA Consultants

#### 4.3.3 Approach 3 - Mark-up on CAPEX

This way of assessment involves defining a mark-up for each asset. This mark-up would be applied to the CAPEX.

#### 4.3.4 Approach 4 - Real bottom-up assessment based on time spent, power consumption

This approach consists in calculating the network's requirements (in energy, cooling, square meters) and to conduct a bottom-up assessment of OPEX (e.g. energy cost = kWh requirement for all networks elements x kWh price).

#### 4.3.5 Approach 5 - Benchmarking

This way of assessment involves collecting and analysing OPEX mark-ups used by regulators in other comparable countries.

#### 4.3.6 Conclusions

A top-down approach for the calculation of OPEX (approach 1) is not consistent with the principle of the bottom-up approach as inefficiencies and irrelevant cost may be included.

The benchmark approach (approach 5) is not country-specific and may lead to under-estimated / over-estimated OPEX in the context of New Zealand. As a consequence this approach should be used only in cases where operators' data is unavailable. Even where operator data is available, benchmarked data can be used as a cross-check of the resulting OPEX estimates.

Approaches 2, 3 and 4 tend to model the efficient costs of an operator.

Mark-up on CAPEX (approach 3) is not as precise as approaches 2 and 4 as setting the mark-up percentage is subjective and this figure is difficult to challenge.

As a consequence, operating costs should be calculated using approaches 2 and 4 depending on their feasibility (e.g. information availability):

- Energy, cooling and building costs should be calculated with a true bottom-up approach (approach 4) as required square meters and MWh can be derived from the bottom-up CAPEX model;
- Remaining OPEX categories should be calculated based on accounts with efficiency adjustments (approach 2).

**Criterion 59:** Operating costs should be calculated using OPEX from the accounts with efficiency adjustments, real bottom-up assessment should be performed for energy and square meters costs.

### 4.4 Depreciation

#### 4.4.1 Cost of capital

The cost of capital that should be used is a nominal post-tax weighted average cost of capital.

#### 4.4.2 Approach for modelling taxation

Most regulatory authorities use the tilted annuity (in the context of stable demand) approach to derive annual costs from the investment.

However, the tilted annuity formula does not allow the tax shield to be captured accurately. This is why the tax adjusted annuity should be used instead to derive the annual costs.

**Criterion 60:** A tax adjusted annuity should be used to derive the annual costs.

##### 4.4.2.1 Time to build

The time to build of the network is six months<sup>13</sup>.

**Criterion 61:** The annuity formula should reflect six months for the time to build.

##### 4.4.2.2 Tax depreciation rates

The first step of this approach is to define for each asset class a tax depreciation rate that reflects the tax shield.

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<sup>13</sup> Technically this reflects the time between the moment the investment is paid and the network is generating revenues

**Table 3 – Tax depreciation rate**

| Asset class                                  | Tax depreciation rate |
|--|-----------------------|
| Copper cables                                | 13%                   |
| Copper joints                                | 13%                   |
| Copper Distribution points                   | 13%                   |
| Fibre Distribution points                    | 13%                   |
| Fibre cables                                 | 13%                   |
| Fibre joints                                 | 13%                   |
| Ducts  | 4%                    |
| Trenches                                     | 4%                    |
| Poles  | 10%                   |
| Chambers/Manholes/Jointholes/Pits            | 4%                    |
| MDF/ODF                                      | 16%                   |
| Switches/routers                             | 20%                   |
| FWA base stations                            | 8%                    |
| FWA spectrum                                 | 20%                   |
| Submarine links<br>(cables/landing stations) | 8%                    |
| Microwave links                              | 12%                   |
| DWDM links                                   | 13%                   |
| DSLAM<br>(card/subrack/rack)                 | 16%                   |
| Switches/routers<br>(card/subrack/rack/SFP)  | 16%                   |
| Building/Land                                | 3%                    |
| Power equipment                              | 8%                    |
| Air-conditioning equipment                   | 16%                   |
| Site equipment (e.g.<br>security equipment)  | 20%                   |

*Source: Commerce Commission*



#### 4.4.2.3 Adjustment to pre-tax annuity

The prices that are derived in the model are pre-tax prices. It is therefore required to adjust the post-tax annuity in order to take into account the level of tax paid. This adjustment is based on the tax depreciation rate defined in the previous section using the following formula:

$$\text{Adjustment to Pre Tax annuity} = \frac{1 - \frac{\text{Corporate Tax Rate} * \text{Tax Depreciation Rate}}{\text{Tax Depreciation Rate} + \text{WACC}_{\text{Post-Tax nominal}}}}{1 - \text{Corporate Tax Rate}}$$

#### 4.4.2.4 Post-tax real WACC

The third step is to derive a post-tax real WACC based on the post-tax nominal WACC. This is achieved by using the following formula:

$$\text{Post Tax real WACC} = \frac{1 + \text{WACC}_{\text{Post-Tax nominal}}}{1 + \text{Price Trend}} - 1$$

#### 4.4.2.5 Annuity

The final step is to determine the annuity. It is obtained by computing the annuity of the total investment using:

- the interest rate as defined by the post-tax real WACC;
- the asset life; and
- the annuity, which is corrected by the adjustment to pre-tax annuity.

The formula used is therefore the following one:

$$\text{Annuity} = \text{Investment} * \text{PMT}(\text{Post Tax real WACC}, \text{Asset life}, -1) \\ * \text{Adjustment to Pre Tax Annuity}$$

## 5 Regulatory period

The price control period should be a five year period starting in December 2015. Individual prices for each year of the price control period should be calculated.

**Criterion 62:** The price control period is 5 years (December 2015 – November 2020 period).

**Criterion 63:** Different prices over the price control period for both UBA and UCLL services should be calculated.

## 6 Checking the model

As part of the quality process, the model has been checked thanks to multiple and systematic audits and robustness analyses detailed below.

### 6.1 Internal review

The model has been reviewed by both TERA and the Commission in order to ensure no modelling errors remain and to ensure that the relevant inputs and parameters are used.

### 6.2 Comparison with existing networks

The outputs of the model have been compared to existing networks in order to ensure the consistency of the modelling.

### 6.3 Sensitivity analyses

Sensitivity analyses have been carried out to ensure that the model reacts as expected when the inputs are changed and to test the sensitivity of the results to the variations of the inputs.

When the model was updated (following consultations), results of the modelling had been checked for consistency with former versions and with assumptions updates.

### 6.4 Benchmark with publicly available information

The inputs, especially the unit costs but also when relevant and possible engineering rules, should be benchmarked with publicly available information in order to ensure that the inputs used in the model are reasonable. These benchmarks can be based on local data or international data.

However, there is some data where an international benchmark is not fit for purpose as the data should rely on the local specificities.

### 6.5 Reconciliation with top-down models and with top-down data

The outputs of the modelling should be reconciled with the top-down data provided by the operators.

## 7 Appendix: list of the criteria

**Criterion 1: Access and core networks should be modelled separately.**

**Criterion 2: The scope of the access model is the local loop, from the External Termination Point (ETP) (excluded) to the Main Distribution Frame (MDF). The physical links that are part of the core network are modelled in the access network and should feed the core network cost model.**

**Criterion 3: The TSLRIC methodology should be used to price the different regulated services.**

**Criterion 4: Replacement costs in the model should correspond to the costs of buying new equipment in the base year.**

**Criterion 5: International part should be disregarded.**

**Criterion 6: The red zones in the Christchurch area should be disregarded.**

**Criterion 7: The MEA of the UCLL is the cost-efficient way of providing the UCLL service.**

**Criterion 8: The MEA of the UCLL is based on a mix between a point-to-point fibre network and a FWA network.**

**Criterion 9: The cost of the MEA should be adjusted to reflect the cost difference between the MEA network and the copper network.**

**Criterion 10: In order to compute the cost-adjustment, a copper access network and a fibre + FWA network should be modelled. The adjusted cost of the MEA network is the cheapest network selected at the national level between the two scenarios identified.**

**Criterion 11: The access network starts at the ETP and stops at the distribution frame.**

**Criterion 12: The fibre network should be a PTP network.**

**Criterion 13: RBI sites should be considered as a relevant proxy to assess the cost of FWA.**

**Criterion 14: The FWA sites should be connected to the nearest exchange. Customers located on the way from the FWA sites to the exchanges should be connected by the FTTH-network.**

**Criterion 15: The FWA should use LTE technology.**

**Criterion 16: The FWA coverage should be inferred from the distance to active node (active cabinet or MDF) in the copper network and ADSL 2+ throughput.**

**Criterion 17:** The capital cost of the access network should be computed over the TSO-areas, including the cost of connections outside the TSO-area for the part of those connections that is within the TSO-area. It is assumed that the capital contributions cover exactly the cost of the non-TSO areas. The operating costs of the access network should however be computed over a nationwide network.

**Criterion 18:** The access network cost model should derive the cost of the UCLL and SLU based on the cost of the ULL and the cost of the SLUBH.

**Criterion 19:** The Chorus UFB demand should be included in the UCLL demand.

**Criterion 20:** The HFC demand should not be included in the UCLL demand

**Criterion 21:** The LFC demand should be included in the UCLL demand

**Criterion 22:** The UCLL demand should be constant

**Criterion 23:** A modified scorched node network based on Chorus' copper network with optimised node boundaries should be modelled.

**Criterion 24:** The location of the MDF nodes of the current copper network should be used as the location of the ODF nodes. Exchange boundaries should be optimized.

**Criterion 25:** For the copper network, the cable length-based optimisation approach should be followed for the modelling of the copper network.

**Criterion 26:** For the fibre network, the length-based optimisation approach should be followed for the modelling of the fibre network.

**Criterion 27:** The starting point when building the bottom-up model is the level of demand in New Zealand for all the services.

**Criterion 28:** The engineering rules as provided by Chorus are the starting point of the modelling, except if very different from standard practice elsewhere or they would not apply to a HEO.

**Criterion 29:** The access network cost model should derive a total investment and an annualised cost.

**Criterion 30:** Operating costs, corporate overheads and indirect costs should be included when relevant.

**Criterion 31:** The core network should start at the DSLAM (located either at the exchange or in the active cabinet) and stop at the first data switch (FDS).

**Criterion 32:** The handover points and the inter-exchange links should be modelled.

**Criterion 33:** The cost of the DSLAM deployed as a direct result of the RBI program should not be recovered by Chorus through UBA.

**Criterion 34:** The MEA for UBA is a NGN Ethernet core network to support broadband provided over a copper/FTTN underlying access network architecture.

**Criterion 35:** The LFC demand should not be taken into account in the demand assumption for UBA.

**Criterion 36:** The FWA RBI demand should not be taken into account in the demand assumption for UBA.

**Criterion 37:** The HFC demand should not be taken into account in the demand assumption for UBA.

**Criterion 38:** The unbundled lines demand should not be taken into account in the demand assumption for UBA.

**Criterion 39:** The UBA demand should be constant.

**Criterion 40:** The UBA traffic per customer should increase over time.

**Criterion 41:** The model should include all the regulated broadband services.

**Criterion 42:** The model should include all the non-regulated broadband services.

**Criterion 43:** The model should capture the economies of scope of the SLUBH.

**Criterion 44:** The core network model should include the handover connection service to dimension the FDS and capture the relevant economies of scope.

**Criterion 45:** The core network model should be an Ethernet network.

**Criterion BU 46:** The model should not include Chorus' existing microwaves links.

**Criterion BU 47:** The model should include Chorus' existing submarine links.

**Criterion BU 48:** The models should include only DWDM links for long distance links.

**Criterion 49:** An optimally structured network based on Chorus' copper network with optimised exchange boundaries should be modelled.

**Criterion 50:** The starting point when building the core TSLRIC model is the level of demand in New Zealand for all the services using the core network of the incumbent in accordance with §3.3.

**Criterion 51:** The engineering rules as provided by Chorus are the starting point of the modelling.

**Criterion 52:** The core network cost model should derive a total investment and an annualised cost.

**Criterion 53:** Operating costs, corporate overheads and indirect costs should be included when relevant.

**Criterion 54: The different services under scrutiny will include all the different cost categories.**

**Criterion 55: The capacity based rule for joint and common network costs should be implemented in the TSLRIC models.**

**Criterion 56: Corporate overheads costs should be allocated on the basis of the modified EPMU approach.**

**Criterion 57: Prices used in the TSLRIC models should reflect those that an efficient operator with the bargaining power of a New Zealand operator with significant market power would face.**

**Criterion 58: Initially, cost inputs should be based on the latest available information and subscription data will subsequently be updated to reflect 2014.**

**Criterion 59: Operating costs should be calculated using OPEX from the accounts with efficiency adjustments, real bottom-up assessment should be performed for energy and square meters costs.**

**Criterion 60: A tax adjusted annuity should be used to derive the annual costs.**

**Criterion 61: The annuity formula should reflect six months for the time to build.**

**Criterion 62: The price control period is 5 years (December 2015 – November 2020 period).**

**Criterion 63: Different prices over the price control period for both UBA and UCLL services should be calculated.**