



Fibre regulation emerging views: technical paper

Cross-submission | Commerce Commission

31 July 2019

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Executive summary

The submissions have usefully highlighted the key issues for the next phase of the IMs process.

Retail service providers are clear that, for their investments, they need confidence: in how access prices will be set over time so that they are cost reflective; and that the approach to cost allocation will not leave them exposed to Chorus and LFC incentives to distort competition.

Accordingly, the Commission should prioritise the setting of pricing methodologies and implement a cost allocation approach that minimises the potential for competitive harm. While the approach will inevitably be more granular than currently proposed, this level of granularity will be required in any case to support the regulatory flexibility the Commission is seeking to develop.

Past losses

Unsurprisingly, Chorus and submitters have substantially different views on how the Commission should assess past losses. Nonetheless, there is wide agreement that there should be no double or over recovery of costs. Chorus notes that unlike a reconciliation against Part 4, however, that the substantial sharing of assets between services, and differences in asset valuation methodologies across the models, mean that it is not possible to reconcile the BBM against the Part 2 cost model to remove double recovery.

We asked TERA Consultants to consider where double recovery might lie and how the Commission might reasonably control for potential double recovery in practice. TERA advise that:

- The coexistence of two models with different modelling approaches and principles means that there is a risk of double recovery across a range of dimensions, including allocations of capex and opex, efficiency considerations, and assumptions relating to the reuse of assets and asset lives. TERA recommend that, as the TSLRIC model is already in place, controls should be applied to the BBM to remove any double recovery; and
- This controlling for double recovery in the BBM can be practically done and the Commission should, as an initial first step, address the proposed level of prescription and granularity with which data is provided. TERA note that the Commission will need to do this in any case to ensure it has flexibility to respond to future changes and mitigate Chorus incentives to preserve information asymmetries. Finally, the Commission should require a double recovery cross check by, in short, comparing total costs allocated to regulated services through the BBM model to revenues across copper and fibre services.

We believe that TERA has identified a reasonable and practical means of controlling for double recovery and that the information requirements to do this are likely no more than would be required for cost allocation and to regulatory flexibility reasons in any case. As highlighted in submissions, past losses are potentially a significant cost for end users and access provider claims for past losses should be critically assessed.

Quality dimension

Access seeker submissions also highlight that quality dimensions are important for the provision of services to end users.

In terms of building on the approach set out in the technical paper, we believe the priorities for the Quality IM process should be to:

- **Identify where services descriptions, non-price terms and measures will sit in the framework.** Clarity and confidence in these non-price terms is important for access seeker provision of services to end users. At this stage, the practical service definitions and non-price terms are spread across several UFB arrangements which, as Vodafone observe, have an uncertain future. We believe the terms need to be brought together and provided for in the Part 6 framework. However, at this stage, it is unclear where this will occur;

- **Agree a change process for wholesale services arrangements.** UFB reference offers currently include a change process and we believe that, given the dynamic nature of the services, there should be a similar change process in new wholesale arrangements; and
- **Ensure that the 2022 arrangements are fit for purpose.** We appreciate the reluctance by some submitters to amend existing UFB reference offer performance requirements. However, we cannot be confident that the current measures will be fit for purpose through to 2025, and we anticipated reference offer metrics will need to be augmented for network performance measures currently provided through Crown arrangements and new unbundled services. Any review should use the existing arrangements as a starting point.

Introduction

1. Thank you for the opportunity to comment on submissions on the Commission's emerging views technical paper for implementing Part 6 of Act (**the technical paper**).
2. There are markedly different proposals in submissions. Chorus proposes regulatory settings that would narrow the range of FFLAS services attributed to the RAB, maximises costs allocated to FFLAS services, and guarantees returns.
3. Conversely, access seekers express concerns relating to Chorus and LFCs incentives to chill competition and the implications this could have for their investments and plans. We should expect Chorus and LFCs to also act on incentives they have been presented with. Accordingly, submissions reinforce the need to provide pricing methodologies and importance of the Commission making conscious and informed cost allocations choices.
4. The Commission has further indicated that cross-submissions on issues related to "Cost of Capital and Risk" (as outlined in Chapter 5 of the Emerging Views Technical Paper) are now expected by Friday 9 August 2019.
5. Therefore, in this submission we've focused on the key competition and implementation issues faced by the Commission. The key areas being:
 - a. The UFB Fibre Network that Part 6 is being applied to;
 - b. Framework issues raised by submitters;
 - c. The importance of pricing methodologies and cost allocation;
 - d. Controlling for double recovery when considering past losses; and
 - e. The priorities for setting quality dimensions of regulated services.
6. An expert report by TERA Consultants (**TERA**) is attached. We asked TERA to advise on how the Commission might consider double recovery issues between copper and fibre regulatory pricing and practical mechanisms for controlling for double recovery.

The UFB Fibre Network

7. Submissions highlight the benefit on the Commission setting out its view on the regulated Fibre Network and expected regulatory outcomes early in the process.
8. There are clear differences across submitters on what is being regulated and expected regulatory outcomes. For example, Chorus proposals narrow the scope of regulated activities and controls, maximising its ability to take fibre value outside the regulatory model. Conversely, access seekers seek wholesale open access Fibre Network services. These different views of the world lead to markedly different regulatory decisions and outcomes.
9. At the same time, Chorus and its investors point to share price movements around the time the technical paper was released as, amongst other things, demonstrating the potential shocks for investors if those decisions are not aligned with reasonable investor perceptions of risk and return. However, this does not tell us what the required WACC for UFB PPP investment. All we know is that market was reacting to new information.
10. There will inevitably be market movement as a regulatory process has uncertainty. In this case, the technical paper followed Part 2 decisions and earlier *New regulatory framework for fibre* consultation that drew on Part 2 decisions and High Court and overseas regulators' reservations

relating to the application of a WACC uplift.¹ Accordingly, the technical paper's proposed approach is within a reasonable range of potential outcomes and was not unexpected. It is unlikely to be possible for the Commission to mitigate all market impact of regulatory decisions as to do so would require perfect information relating to investor preferences and prioritisation of those preferences over the requirements of the Act.

11. Therefore, we believe the best way for the Commission to manage these risks is to develop a clear set of principles early in the process to guide individual IM decisions, and provide more certainty for interested parties.

Framework

Purpose statement

12. Chorus appears to argue that:

- a. The s162 and s166(2)(b) purposes conflict, and s162 should take priority [57]; and
- b. The UFB Government Policy Statement (**GPS**) should be given specific consideration in implementing the Part 6 framework [64].

13. We disagree. We support that the Commission's interpretation that they contain complementary rather than competing objectives (Commission paper at [46]).

14. Further, the 2011 GPS is not relevant in this context. The GPS was implemented as a specific instrument in the application of Part 2 and the context of the time. The GPS further specifies that it only relates to Part 2 of the Act. Accordingly, we support the approach set out in the technical paper at [53].

FFLAS definition

15. Chorus further submits that the Commission will need to define FFLAS. FFLAS services [72]:

- a. Are only those that connect the handover point to an end user premises, building or other access point; and
- b. UFB POIs differ per service, i.e. layer 2 to POIs and DFAS to local exchanges.

16. We agree that the Commission should provide guidance on what FFLAS services are as this will form the basis of the RAB, shared cost allocation and the risks associated with the framework. However, we do not support Chorus proposed approach that would leave important unbundled and wireless backhaul services out of the regulated entity.

17. The implications of Chorus' approach is that unbundled services beyond the end to end services such as PONFAS and backhaul services are not part of the regulatory scope. LFCs have likewise argued that NBAPs should be excluded from regulation.

18. We do not believe the Act limits the range of potential FFLAS services in this way. FFLAS are services that enable access to, and interconnection with, a regulated fibre service provider's fibre network. Therefore, it is open to the Commission should determine the range of services in light of the Part 6 purpose and what's best for telecommunications end users.

¹ For example, see from paragraph 1460 onwards in High Court's Auckland International Airport decision.

19. As the scope of FFLAS is not defined in the Act, we have to ascertain its meaning from the words of the Act and in light of its purpose. We believe that FFLAS includes a wide range of all fibre access and unbundled services supported by the UFB Fibre Network.
20. We further believe that Chorus' proposed approach – i.e. that Part 6 only apply to a subset of Fibre Network services – would likely be difficult to apply in practice:
 - a. Chorus should be expected to act on incentives, facilitated by a narrow regulatory scope, to push revenue, innovation and development (future revenues) into unregulated services; and
 - b. Further, it would be more difficult to apply, for example, FCM across the range of current and future regulated and otherwise “unregulated” FFLAS services associated with the RAB.
21. We believe the Commission should take a wide perspective on FFLAS services, and that it includes access and unbundled services provided by the Fibre Network. This is consistent with the regulatory framework and Part 6 purpose.

The washup

22. Chorus also submits that the Commission should provide guidance on how it sees the wash-up provisions applying² [page 33].
23. We agree. The wash up provisions will have implications for the allocation of risk, forecast incentives, and incentives to withhold capacity and investment. The Commission should put its mind to the washup will work.
24. However, we do not agree that the washup should be unconstrained and wash up all variations between allowed and achieved revenue. The wash up provision leaves a broad discretion with the Commission, simply requiring it to apply a wash-up mechanism that provides for any over-recovery or under-recovery of revenue.
25. Accordingly, the Commission has several options relating to the relevant revenue that might be considered, and the recovery against modelled costs, actual costs or efficient costs. For example, the Commission may choose to set cost elements outside the washup calculation where costs are lower due to lower than forecast demand (revenue). This would reduce Chorus' incentives to over-forecast demand and take the benefit of the lower actual demand.
26. Therefore, the Commission should consider how the washup applies to best support the Part 6 purpose.

Pricing methodologies and cost allocation

27. Submissions indicate that access seekers are concerned at uncertainty relating to how the cost reflective pricing principle will apply to regulated services and potential for Chorus and LFCs, acting on incentives, to allocate costs in a way to distort competition and undermine competing investment. Link Economics, for example, note that pricing of FFLAS at different levels of the value chain will affect the choice of RSP inputs, which in turn will impact competition at the retail level [pg2].
28. This level of access seeker concern is a clear signal that the Commission should prioritise:

² Section 196

- a. Establishing a Pricing Methodology that provides certainty on how cost reflective pricing will be applied as required by the Act;
 - b. Developing a “propose and approve” model to cost allocation methodologies that provides transparency, enables testing of tested proposed allocation approaches and better supports the Part 6 purpose; and
 - c. Ensuring there is sufficient granularity in the model that preserves the Commission’s ability to respond to future uncertainties. If this is left to Chorus, we should not expect the provision of information on which the Commission can respond to future changes.
29. Access seekers are considering business plans and investments now, this is not something that the Commission should defer until 2025 as Chorus suggests.

Past losses and double recovery

30. Submitters have differing views on past losses. Chorus proposes an approach that assesses past losses against modelled costs and allocation of shared costs to fibre services. We believe that Chorus’ proposed approach would ensure it is compensated for losses it did not incur in practice. Conversely, access seekers recommend an approach that assesses losses in context of Chorus’ existing business and recommend that the Commission be alive to an over-statement of these losses.
31. As set out in our submission, we do not believe there are material past losses. The regulatory framework at the time was set considering UFB deployment and expected to leave Chorus fully funded over that period. Therefore, there is unlikely to be any losses. It is up to Chorus to make the case that losses have occurred in practice.
32. Nonetheless, while fundamental differences in approach, submitters agree is that there should be no double recovery when assessing costs. Chorus submits that there should be no double or over-recovery. However, while a double recovery check is feasible between Part 6 and Part 4 of the Commerce Act [116], the same analysis was not possible between the Fibre Network and copper because:
- a. The sharing of assets is substantial and asset valuation methodologies are not consistent across the services. Therefore, a simple comparison cannot be undertaken; and
 - b. The regulated prices for copper services are locked in and, therefore, can’t revise copper prices to remedy an incorrect assumption.
33. We asked TERA Consultants to consider where double recovery might lie and advise on how the Commission might adjust for double recovery in practice. TERA advise that:
- a. Double recovery should be avoided because this leads to an overstatement of costs;
 - b. The coexistence of two models with different modelling approaches and principles means that there is a risk of double recovery across a range of dimensions, including allocations of capex and opex, efficiency considerations, and assumptions relating to the reuse of assets and asset lives;
 - c. A BBM can only be applied in a way that respects the principle of cost- oriented regulation – i.e. that there is exact cost recovery – by avoiding over/under recovery.

As the TSLRIC model is already in place, controls should be applied to the BBM to remove any double recovery;

- d. This controlling for double recovery in the BBM can be practically done and the Commission should, as an initial first step,
 - i. Address the proposed level of prescription and granularity with which data is provided. TERA note that the Commission will need to do this in any case to ensure it has flexibility to respond to future changes and mitigate Chorus incentives to preserve information asymmetries;
 - ii. Ensure the BBM cost categories are at a granularity, at least, of the TSLRIC model. This will facilitate cost controls to remove double recovery;
 - iii. Depending on the approach taken to RAB values for deregulation, consider controlling for the potential double recovery of these adjustments; and
- e. Finally, the Commission should require a double recovery cross check by, in short, comparing total costs allocated to regulated services through the BBM model to revenues across copper and fibre services.

34. We agree that it is feasible to remove double recovery. TERA has identified a reasonable and practical means of controlling for double recovery and that the information requirements to do this are likely no more than would be required for cost allocation and to regulatory flexibility reasons in any case. As highlighted in submissions, past losses are potentially a significant cost for end users and claims for past losses should - accordingly – be critically assessed.

Quality Dimensions

35. Access seekers agree that quality standards are important for certainty and should be set for the first period.

36. Vodafone usefully draws a distinction between a new quality standard relating to minimum service standards – i.e. defining the service capability and boundary between services provided by LFCs and those provided by RSPs – and other dimensions relating to fibre providers performance. We believe both elements should be considered in the quality framework.

37. In terms of building on the approach set out in the technical paper, we believe the priorities for the process should be to:

Identify where service descriptions, non-price terms and measures will sit in the framework

38. Current non-price terms, measures and service arrangements are spread across UFB arrangements³, side letters, UFB Service Agreement (**Reference Offers**) and commercial arrangements. Crown Infrastructure has oversight of UFB related agreements. We need to clarify ongoing applicability of these arrangements and how we can bring them together.

39. The detail of how regulated services work is important for certainty and end users. For example, the UFB Product Forum, Chorus and the LFCs have raised concerns with MBIE and CIP regarding a number of provisions in these contracts that have specific expiry dates and/or are in side letter arrangements and therefore could be interpreted as not falling under the extension, i.e. some standard installation provisions and premises wiring integration.

³ Crown Network Infrastructure Project Agreements and amendments

40. Overall, Part 2 Standard Terms Determinations perform a similar function by setting out the detail of how the service should work in sufficient detail that the regulated service is a practical option for access seekers. The Commission maintains oversight of these arrangements.
41. At this stage, it is unclear where this detail will sit following 2022 when transition arrangements end. There are a number of viable options for developing service specifications.

Agree a change process for wholesale service arrangements

42. We are operating in a dynamic environment where changes to services is likely to, for example, reduce costs of improve services to end users. We do not believe it would be practical lock down all aspects of the service and descriptions for a full regulatory period. Therefore, there will need to be a change process established for changes to existing and new arrangements.
43. Current UFB arrangements include a change process. For example, CIP can approve changes to the wholesale agreements and Change Management Forum agreement is required to amend some aspects of fibre services⁴. However, the number of issues being addressed through side letters suggests the current change processes are not effective. Further, LFC incentive offers need to be brought into the framework. We believe replacement arrangements should likewise permit fibre operators and RSPs to agree changes to aspects of the arrangements relating to, for example, incentives, service descriptions and processes.
44. Accordingly, the Commission could establish the change management and consultation process under the revised arrangements, and then play an ongoing arbitration role in the event the parties cannot reach agreement via the change management forum.

Ensuring 2022 arrangements are fit for purpose

45. Vodafone has proposed quality measures based on current wholesale service agreements. We agree that that arrangements should focus on the key measures that drive performance and end user outcomes. Further, the service descriptions and processes in the current wholesale arrangements should underpin the starting position for 2022 services.
46. However, as set out in our submission, we believe the WSA quality measures may need to be updated to reflect the expected change in fibre network focus from “connect” to “operate” through to 2025, new services such as unbundled fibre, and to capture wider expectations set out in the NIPAs and the implementation of the Part 6 framework. Therefore, while we support Vodafone’s focus on updating current WSA metrics, we believe that some additional measures will be required.
47. While access seekers have set out differing priorities in their submissions, we believe that it is practical to refine the proposals to agreed and focused measures. The Commission could ask the industry, possibly through the TCF, to report back on these matters.

[End]

⁴ The UFB services agreement general terms provides for change management forum <https://www.crowninfrastructure.govt.nz/wp-content/uploads/2018/10/Chorus-UFB-General-Terms-December-2012.pdf>

Attachment: TERA Consultants

[Provided as a separate document.]