ENABLE NETWORKS LIMITED AND ULTRAFAST FIBRE LIMITED

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

9 AUGUST 2019

1. **Introduction**

1.1 This second cross-submission is made by Enable Networks Limited (**Enable**) and Ultrafast Fibre Limited (**Ultrafast Fibre**) (collectively referred to in this submission as **LFCs**) in response to submissions on the Commerce Commission's *Fibre regulation emerging views: Technical Paper* dated 21 May 2019 (**EVP**). This cross-submission responds to submissions relating to the cost of capital (including stranded assets) only; other issues are covered in our first cross-submission dated 31 July 2019.

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

1.3 A report from Castalia dated August 2019 (**Castalia Report**) commissioned by the LFCs in support of the matters raised in this cross-submission is attached.

2. **The case for firm-specific asset betas**

2.1 Oxera submit that "*a stand-alone FFLAS will face similar demand risk from other technologies (copper, fixed wireless). As the demand risk exposure of LFC's and Chorus FFLAS is similar, a sector-wide asset beta would be appropriate to capture the total systematic risk exposure of fibre access services in New Zealand*".[1]

2.2 However, as Oxera acknowledges, the comparator set used by the Commission does not contain any pure-play fibre companies, so does not reflect the systematic risk facing a stand-alone supplier of FFLAS.[2] Oxera therefore concludes that the asset beta for a standalone FFLAS should be above the mid-point of its revised comparator set.[3]

2.3 LFCs agree that if an uplift is applied by the Commission to set the appropriate stand-alone FFLAS asset beta, some of the differences between LFCs and Chorus identified in the WIK Report[4] (asset stranding, business model) may be partially compensated for. However, stark differences will remain in competition, demand, growth and operating leverage. Consequently, a firm specific asset beta would still be required for the reasons set out in the WIK Report.

2.4 The Castalia Report provides further detail of the differences between the risks faced by LFCs relative to those faced by Chorus, and explains why the Commission should adopt "*a beta range for LFCs that is higher than that for Chorus FFLAS*".[5]

3. **Dealing with stranded assets**

3.1 We agree with Chorus that FFLAS providers should have an opportunity to receive a return on and return of capital since 2011 and over the life of the assets[6]. Professor Yarrow also endorsed this concept in reference to the UFB GPS[7].

3.2 We also agree with Chorus that a number of regulatory tools are available to mitigate the risk of not achieving this objective, due to asset stranding, including a WACC margin, an escrow

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[1] Oxera, *Compensation for systematic risks*, Final Report, 15 July 2019 [3.13] (**Oxera**)

[2] Chorus, *Submission in response to the Commerce Commission's fibre regulation emerging views*, 16 July [133] (**Chorus**)

[3] Chorus [140], [143]

[4] WIK-Consult, *Report in response to the Commerce Commission's 'Fibre regulation emerging views: Technical Paper' of 21 May 2019*, 10 July 2019 (**WIK**)

[5] Castalia, Rate of return of Information Disclosure Profitiability Monitoring of Local Fibre Companies, August 2019, p5 (**Castalia Report**)

[6] Chorus [39]

[7] George Yarrow, *Questions relating to the regulation of fibre fixed line access services (FFLAS) in New Zealand, Report for Chorus* (**Yarrow**) pp22-23

account, pricing flexibility, depreciation and retaining assets in the RAB[8]. As we have previously submitted, an un-indexed RAB can also be applied for this purpose, as endorsed by Vector:

> *In its paper, the Commission sets out the potential asset stranding risks that providers might face from technological change, emerging competition and/or insufficient take-up of fibre services. To the extent that these risks are significant, they would all be addressed to some degree by applying an unindexed approach [to the RAB].*[9]

3.3 We endorse Chorus' request that the Commission provides clarity on when and how tools to address Type II asymmetric risk will be applied. Chorus also suggests alternative depreciation policies can be employed to address potential stranding risk.[10] We support consideration of further regulatory tools to better align revenue and demand, such as depreciation alternatives.

3.4 Trustpower suggests that as competition will continue to evolve it will be difficult for the Commission to determine accurately whether and when assets may be stranded, and recommends caution in considering reducing asset lives, or an increase in the WACC, in the face of competition.[11]

3.5 It is because it may be difficult to identify and quantify asset stranding at the time it occurs that ex-post mechanisms to address stranding risk are less effective at compensating for Type II asymmetric risk. Ex-ante mechanisms are more effective at compensating for this risk, and therefore are more consistent with achieving the FCM objective.

3.6 The ENA's submission also supports ex-ante methods to address stranding risk. The ENA notes that ex-ante methods are consistent with the long term interests of end-users, because the stranding risk is shared:

> *The ENA supports ex-ante methods to address stranding risk, particularly partial stranding risk. This is in the long-term interests of end-users because it spreads this risk over time, and over the useful life of the assets/services. It avoids significant burdens on end users in the future, while compensating investors for the risks they face in providing regulated services.*
>
> *At a general level we have concerns with any mechanism that transfer the costs of stranding risk to the future and onto other consumers because it creates an inefficient subsidy arrangement and shifts the burden of a lack of competition to those who are reliant on non-stranded assets. That is inequitable and not consistent with competitive markets.* [12]

3.7 Professor Yarrow criticises ex-post mechanisms for similar reasons. For example, in response to the options of retaining assets in the RAB or establishing a compensation fund, Yarrow states:

> *If the RAB is sliced and diced by later partial deregulations, it will be steadily shrinking and ever higher burdens will be placed on the remaining customers. In the end, much or all of the reallocated capital may turn out to be irrecoverable anyway and the whole process may come to be seen as having been something of a deception. In any event, loading up the burden*

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[8] Chorus [41]

[9] Vector, *Submission to Commerce Commission on the Fibre Regulation Emerging Views Paper* 16 July 2019 [23] (**Vector**)

[10] Chorus [41]

[11] Trustpower, *Submission: Fibre Regulation Emerging* Views 16 July 2019 [3.7.5] (**Trustpower**)

[12] Electricity Networks Association, *Fibre IMs: Emerging Views*, 16 July 2019 p4

on captive customers raises equity issues and is unlikely to be consistent with Smith's 'benefit principle'.[13]

In respect of a compensation fund, the monies will have to be sourced from somewhere and it therefore requires ex ante measures to do that. What better base for that finance than those customers who switch early to the new service and, in effect, become voluntary contributors to the recovery of the costs of the joint asset by being willing to pay more for early use of that asset? If the compensation fund is sourced from surcharges in earlier periods, the position of end consumers will not be much affected whether the additional revenues go to the investing business or to the fund, but the latter will introduce another layer of regulatory discretion that might be expected to have chilling effects on investment in the longer term.

3.8 Vodafone expresses an alternative view, and suggests that:

The Commission must start with the assumption that the WACC as currently specified is sufficient to cover all stranding risk.

Asset stranding will be at least partially a systematic risk.[14]

3.9 We agree that the baseline WACC specification is intended to cover systematic risk. However the Type II asymmetric risks of asset stranding are the additional risks, defined in the EVP as *risk of competitive entry/expansion (eg: asset stranding through technological innovation, other competitive effects)*[15], which are not reflected in the WACC, and require further compensation.

3.10 Finally, Vodafone suggests that stranding risk should only be assessed for assets which are 'irreversible investments', and states that a significant amount of fibre investment is reversible, particularly layer 2 assets.[16] We disagree with this assertion, and note that dedicated layer 2 assets comprise around 5% of each of Enable's and UFF's asset base.

4. Beta comparators

4.1 We agree with the wide-spread criticism in submissions[17] of the beta comparators used by CEPA, and with the analysis undertaken by Oxera for Chorus.[18]

4.2 A common theme of submissions is that CEPA's comparator "wholesale-only' group of satellite and telecommunications tower operators were not appropriate because their demand systemic risk was low[19], and that the integrated service provider peer group should have been limited to operators who derived more than 50% of their revenue from fixed line services[20]. Making these adjustments to CEPA's calculations increases the beta range from 0.46-0.55 to 0.51-0.63.

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[13] Yarrow p22

[14] Vodafone, *Submission on Fibre Regulation Emerging Views* 16 July 2019, p10 (**Vodafone**)

[15] EVP [546.3]

[16] Vodafone p8

[17] Scroder Investment Management Australia, *Submission on Commerce Commission Emerging Views Paper,* 15 July 2019 p1(**Schroders**), TelstraSuper, *Feedback on Emerging Views Paper* p2 (**TelstraSuper**), Ubique Asset Management, submission, 15 July 2015 p3 (**Ubique**), Paradice Investment Management, submission, 10 July 2019, p2 (**Paradice**), Black Crane Capital, *Submission on Fibre Input Methodologies: Emerging Views* Paper 15 July 2019 p3 (**Black Crane**), Investors Mutual Limited, submission 16 July 2019, p1, L1 Capital, 16 July 2019, p5 (**L1)** , Chorus [132ff]

[18] Oxera , *Compensation for systematic risks*, Final Report, 15 July 2019.

[19] TelstraSuper p2, Ubique p3, Paradice p2, Black Crane p3, Investors Mutual p1, L1 p5

[20] Ubique p4, Black Crane p3, TelstraSuper p2, Investors Mutual p1, L1 p13

4.3 As explained by WIK and Oxera, because there are no fibre-only providers in this comparator set, the asset beta for a stand-alone supplier of FFLAS is likely to lie above the mid-point of this range.[21]

4.4 The Castalia Report highlights further shortcomings with the CEPA comparator set and provides useful reference points that the Commission should consider when setting the beta for LFCs.

5. **WACC Uplift – asymmetric consequences of under-investment**

5.1 Some submitters have challenged the prospect of a WACC uplift to address asymmetric risks of under-investment in FFLAS, citing regulatory precedents for airports and copper[22]. Other submitters have suggested that an uplift is required, citing precedents for energy and the increasing criticality of the services provided (such as for *critical mobile communication assets and next generation fixed telemedicine and tele education and edge computing applications)*[23].

5.2 Our experience is that there is increasing reliance on our network services. Major faults would not be limited to FFLAS, but would significantly disrupt the alternative technologies referred to by the Commission, such as mobile and fixed wireless. The Ultrafast Fibre FFLAS network covers a large number of semi-rural communities; the cost of maintaining this network and providing services to meet consumers' expectations is high. End-users are increasingly reliant on FFLAS for both fixed and wireless broadband services, and disruption to FFLAS network services is costly to businesses and increasingly taxing for households.

5.3 The continued growth in data usage (~30% CAGR) and uncapped and affordable data plans demonstrates an increasing reliance on FFLAS connectivity in almost every aspect of consumers' day-to-day lives. Wireless technology (fixed or mobile) relies of fibre backhaul. Critical (emergency / health) services rely on FFLAS connectivity, in most cases using wireless as a backup. Future emerging services such as autonomous cars, remote surgery and internet of things (to name a few) will all rely heavily on edge computing and FFLAS connectivity.

5.4 The reality is that the asymmetric consequences of over- and under-estimating the WACC for FFLAS is the same as for electricity and gas distribution businesses, and there is no justification for applying a different WACC uplift approach for FFLAS to that applied to those businesses.

5.5 The detailed analysis of FFLAS investment risks undertaken by Houston Kemp for Chorus demonstrates clearly that "*there is a strong qualitative case for a WACC uplift*"[24]. Houston Kemp concluded that there is a strong link between incentives for investment and the regulatory WACC, and that the consequences of over- and under-investment for end users of FFLAS are asymmetric[25].

5.6 The Houston Kemp analysis focuses on Chorus, and therefore omits circumstances that are relevant to the LFCs. In this respect we note:

(a) incentives to invest for LFCs are also linked to the WACC. As is the case for Chorus, new investment undertaken by LFCs will roll into the RAB. Under PQR, Chorus' revenue will be set with reference to the RAB; under ID regulation, LFC profitability assessments (and hence revenues) will also be derived from the RAB; and

(b) LFCs have the same dynamic efficiency objectives as Chorus, in order to ensure FFLAS services continue to be reliable, efficient innovative and competitive. Forward investment

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21 WIK [51], Oxera [4.6]

22 Including Vocus, *Fibre regulation emerging views submission* 16 July 2019 [6] (**Vocus**) and 2degrees, *Submission on Commerce Commission Fibre Regulation Emerging Views Paper* 16 July 2019 p8 (**2degrees**)

23 L1 p4

24 Houston Kemp, *WACC Uplift – asymmetric consequences of under-investment,* 15 July 2919*,* piii [**Houston Kemp**]

25 Houston Kemp pi

plans respond to similar drivers, including new connections, improved resilience, replacements due to age, capacity for growth, and asset performance and monitoring.

5.7 Given these circumstances, and the analysis presented in the Houston Kemp paper, there is no basis to conclude that the asymmetric consequences of under-investment in FFLAS are less than for electricity and gas distribution businesses. It follows that for consistency the Commission must set the cost of capital for FFLAS at no lower than the 67th percentile adopted for electricity and gas distribution businesses. This is also the expectation of investor submitters.[26]

5.8 Finally, Link Economics, for Trustpower, suggests that underinvestment is better dealt with through quality measures.[27] We disagree. As we have previously submitted, the Commission has acknowledged that in practice quality standards may not provide sufficient protection for consumers against under-investment, particularly as quality regulation is still developing and incentives are likely to improve over time.[28]

6. Time period for WACC estimate

6.1 We agree with Investors Mutual submission that as the UFB contracts involved a 10 year network build commitment, with fixed prices over that period, "*the risk-free rate for the entire build period should reflect New Zealand 10 year Government bond yields from 2011*".[29]

6.2 We also agree with the submission by Black Crane Capital[30] that the financing term used to calculate the WACC should "*reflect the investment horizon that debt and equity investors in infrastructure assets typically have*".

6.3 The Castalia Report at [2.2] outlines the case for a 10 year term.

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26 See for instance Black Crane p4, Paradice p2, Investors Mutual p1

27 Link Economics, *Report on the Commerce Commission's Emerging Views on Fibre Regulation* 15 July 2019 p9 (**Link Economics**)

28 NZCC, *Amendment to the WACC percentile for price-quality regulation for electricity lines services and gas pipeline services, Reasons Paper*, 30 October 2014 [3.25]

29 Investors Mutual p3

30 Black Crane p4