



Vodafone New Zealand submission on further consultation draft (initial value of financial loss asset)

10 September 2020

Thank you for the opportunity to provide comment on the further consultation of the financial loss asset. The paper is a significant step forward in the analysis of the financial loss asset, and we are broadly supportive of the direction of travel.

Our submission focusses on three matters:

1. treatment of volumes lost to alternative networks, such as fixed wireless;
2. how to minimise double-recovery of costs already recovered through copper prices; and
3. applying a 5 year WACC term in the pre-implementation period.

Treatment of volumes lost to alternative networks

In our submission on the Emerging Views paper we highlighted that the copper prices set through the Final Pricing Principle (FPP) were a price cap.¹ That means Government intended Chorus to face volume risks. The way the financial loss asset is implemented must not unwind this decision.

¹ Vodafone, *New regulatory framework for fibre: Submission on Fibre Regulation Emerging Views*, 16 July 2019, p18.



In this further consultation paper the Commission has clarified that under the FPP volumes were considered as the total copper and fibre volumes. Therefore Chorus should not face volume risk from the transition from copper to fibre.

However, the Commission appears to accept that Chorus should still be subject to risk if the aggregate copper and fibre volumes decrease. For example the Commission notes that fibre revenues should not compensate for a reduction in copper volumes where customers churn to fibre fixed line access services (FFLAS) deployed by other LFCs.²

This same logic must apply to customers who migrate from copper on to an alternative network like fixed wireless access. In the absence of the UFB deployment, Chorus would have lost these customers and suffered a revenue reduction, providing them the incentive to continue to compete. The financial loss asset must not unwind this outcome.

If the Commission is correct that the most consistent allocation between copper and FFLAS is volumes connected, then figure 1 below is a stylistic representation of the allocation of costs.

Figure 1: Stylistic representation of allocation of costs between copper and fibre with volumes lost to fixed wireless

Shared costs are initially all allocated to copper.
The FPP allows Chorus to recover these costs on a per customer basis



But Chorus' market share during pre-implementation was less than assumed in the FPP, because some customers switched to alternative technologies



If shared costs are just allocated between copper and fibre they will be over-allocated. In this example, rather than 40% to fibre it will be 50%



² Commerce Commission, *Fibre input methodologies: Further consultation draft (initial value of financial loss asset) – reasons paper*, 13 August 2020, para 2.89.



The volume risk from fixed wireless' growth is most appropriately applied to copper revenues. This is because fixed wireless is primarily a competitor to copper, it has not stood in the way of remarkable fibre growth, well in excess of all expectations.

The simplest way to account for volume risk, while also being consistent with the allocation method inherent in the FPP, is to apply the volume estimates from the FPP as the measure of total connections. For example where the appropriate allocation method is volumes connected, then this should be determined as:

$$\frac{\text{Volumes connected}}{\text{Total volumes estimated in the FPP}}$$

The Commission must implement all alternative tools to minimise double-recovery

We are pleased that the Commission agrees that they have discretion on whether or not to include assets commissioned prior to December 2011 in the calculation of the financial losses asset. However, as we have raised throughout this consultation process, the Commission needs to exercise that discretion to provide the best outcomes for the long term interests of consumers, not the short term interests of the LFC's and their investors.

The tools the Commission has proposed to minimise double recovery are a good first step in addressing this issue.³ All of these tools must be implemented together to ensure an appropriate allocation.

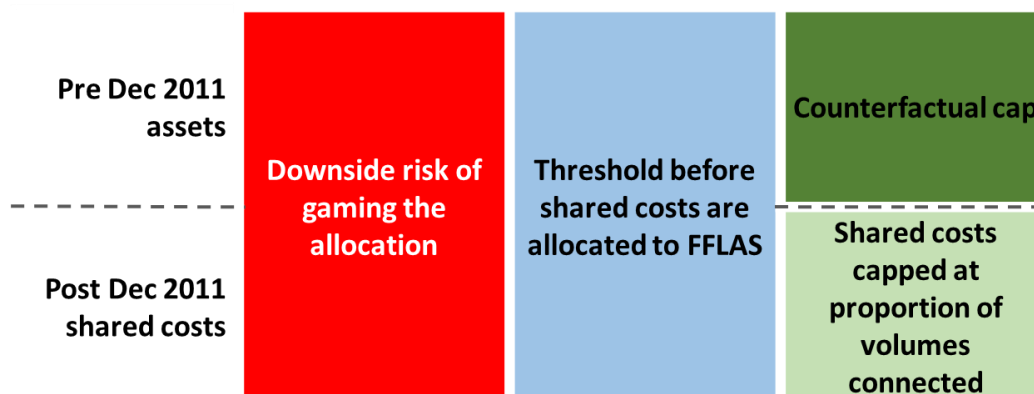
Further, these mechanisms must be applied to all shared costs during the pre-implementation period, not just assets commissioned prior to December 2011. The same risks apply for over allocating shared costs commissioned during the pre-implementation period.

Figure 2 below summarises how the Commission should minimise the risk of double recovery.

³ Commerce Commission, *Fibre input methodologies: Further consultation draft (initial value of financial loss asset) – reasons paper*, 13 August 2020, para 2.98.



Figure 2: Application of multiple tools to minimise the risk of double recovery



Downside risk

At a minimum the Commission must create a downside risk for any attempt to game the allocations to favour fibre. We support the proposal to implement this by removing any assets in their entirety if it is later proven that they have been over-allocated.

However, for most costs the information asymmetries between the LFCs and the Commission will never be resolved. It is therefore unlikely that any downside risk will ever come to pass. This measure must therefore only be considered as a final back-stop, rather than sufficient on its own.

Threshold that must be met before shared costs are allocated to FFLAS

We also support implementing a threshold for when shared costs are included in the regime. The Commission’s proposal to only allow those assets into the regime when they are primarily used for FFLAS would resolve most of our concerns on this matter raised throughout the development of the input methodologies, and is consistent with how firms in a workably competitive market would act.

Another way to approach this is to apply a time based threshold. For example the Commission may determine that no shared costs are included in FFLAS for the first three years of the UFB build. This is consistent with the transition period granted to Chorus, which allowed them to retain the retail minus prices for copper UBA for the first three years following structural separation.



The retail minus UBA prices were known to be well above cost, and were significantly higher than the prices reached under the FPP. Prior to December 2014 the wholesale UBA price was 44.98, \$3.80 more than the price reached for the FPP.

By granting this transition period, government allowed for copper services to meet a significantly larger part of the shared costs. This is consistent with how costs would be allocated in a workably competitive market, ie applying an OVABAA methodology to shared costs allocation to copper services. As noted in our submission to the Invitation Paper, it is common for new services to be protected from the full weight of shared costs. This is likely what was intended by government when it granted the UBA price transition period.

Cap the allocation of assets commissioned prior to 2011 based on the counterfactual

Concerns about the allocation of assets commissioned prior to December 2011 only apply to Chorus. For the other LFCs there is better visibility through the Part 4 regulations of any double recovery of existing assets.

For Chorus' assets commissioned prior to December 2011 there must be a total allocation cap based on the Commission's best estimate of the counterfactual outcome discussed in paragraphs 2.72 – 2.77. As discussed by the Commission, the counterfactual approach is the best way to determine the reasonable expectations of the on-going value of assets commissioned prior to December 2011.

The Commission considers two counterfactual effects. The first effect is that Chorus may have been able to retain more copper customers if they were not the UFB provider. Chorus would have had two main levers to achieve this.

1. Chorus could have reduced copper prices. This may have temporarily kept more customers on copper, but would have had a material cost for Chorus, and it is not clear that the trade-off would have resulted in materially different copper revenues.



2. Chorus could have invested to improve the performance of the copper service. Chorus has enacted this strategy in areas serviced by other LFCs, upgrading more than 270,000 addresses to newer VDSL electronics and vectoring.⁴ But this has had little effect on slowing fibre uptake, with uptake in areas deployed by other LFCs typically higher than Chorus has been able to achieve itself.⁵

It is unlikely that either of these levers would have had any material effect on copper revenues. We consider that this counterfactual effect can be safely ignored.

The second source of additional copper revenue in the counterfactual is from selling existing copper assets to whoever won the UFB contract. We expect that this effect is likely to be small. Any alternative bidder for UFB would have had to also come with their own existing assets to be able to compete against Chorus. For example the smaller LFCs all won their UFB contracts on the basis of re-using their electricity distribution assets. While some LFCs also lease some assets from Chorus it is unlikely that they do so to the same extent to which Chorus re-used its assets. We also know that the most likely counterfactual for the Auckland region was Vector. They made it very clear that their bid was based on re-using their electricity distribution assets.⁶

This second counterfactual effect can be estimated based on extrapolating the value of existing copper assets Chorus was able to lease to the smaller LFCs. For example if across all LFCs 10% of copper assets were leased to the LFCs, then the allocation of the pre-December 2011 assets should be capped at 10%.

Cap shared assets commissioned after December 2011 based on the proportion of volumes connected

To be consistent with the Commission's interpretation of the allocation method inherent in the FPP, shared costs commissioned after December 2011 must be capped at the proportion of volumes connected.

As covered above, once the FPP was implemented the proportion of volumes must be calculated against the volume estimate in the FPP. This is the only way to preserve the volume incentive on the UBA/UCLL prices required in the Telecommunications Act 2001.

⁴ Chorus, *Annual Report 2018*, p4.

⁵ For example UFF has reached 67% uptake, compared to 60% for Chorus.

⁶ <https://www.nbr.co.nz/article/vector-boss-confident-victory-ns-86291>



To the extent that shared costs are allocated to FFLAS prior to the FPP, other existing forecasts of volumes will need to be found. If these are not available, it may be appropriate to use the proportion of FFLAS active connections to total connections as the demand risk in this earlier period may not be material.

We also note that some of the default allocators proposed by the Commission remain inappropriate. If the FPP allocated costs between copper and fibre based on active connections, then this must be the default allocator across the board. Allocators such as premises passed would in this context result in double recovery. For example a premise currently connected to copper, but with the potential to move to fibre would be paying for the shared costs through the FPP prices. If these costs are also allocated to FFLAS, it is clearly double-recovery. There must be a very strong rationale from moving from an active connections allocation basis.

Applying a 5 year term to the pre-implementation WACC

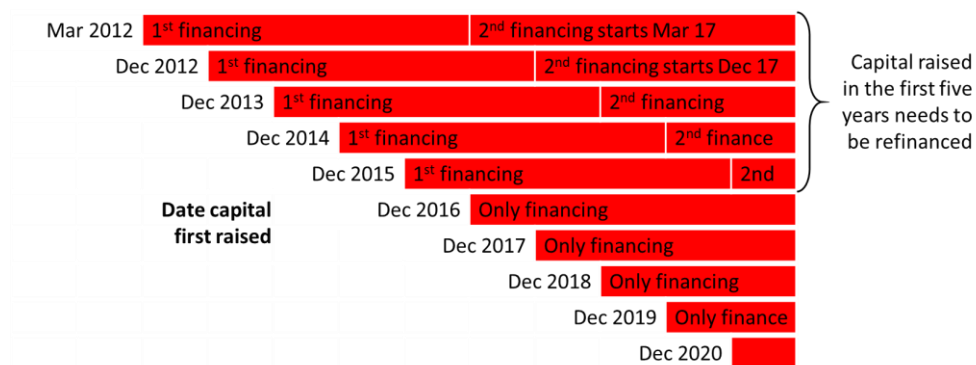
We broadly agree with the change to a DCF model for the pre-implementation period. It is simpler and a better reflection of the costs faced by the LFCs. We also support the careful analysis from the Commission that supports the use a five year term.

However, we are unsure why the Commission has decided to apply a five year rate for periods of up to 10 years. We consider it inconsistent to assume that a five year term can continue to roll forward at the same rate well after the term has expired. This is not a requirement of a DCF model, which when correctly implemented takes account of how the cost of capital changes over time.

We propose that the Commission adjusts the financing assumptions in the DCF model to account for refinancing when the five year term ends. This is represented in figure 3 below. When the five year term of the financing expires the WACC should be refinanced at the current rate. For example financing secured on a five year rate in March 2012, would need to be re-financed after five years in March 2017.



Figure 3: financing terms of capital raised during the pre-implementation period



We also note that after the implementation date was confirmed, it may have been prudent for the LFCs to adjust the finance terms to align with the new regime. That is, any financing that took place after 23 November 2018 may have been at a shorter term so that it finished at the same time the new regime started.