CallPlus Limited

Cross-submission on the Commerce Commission's Consultation Paper: Proposed view on regulatory framework and modelling approach for UBA & UCLL services

Public Version

(No Confidential Version)

20th August 2014

Overview

1. Thank you for the opportunity to comment on the submissions on the Commerce Commission's consultation paper: Proposed view on regulatory framework and modelling approach for UBA & UCLL services (**Consultation Paper**). This cross-submission is made by CallPlus Limited (**CallPlus**), representing the views of Slingshot, Orcon and Flip.

2. We have reviewed the submissions on the Consultation Paper. We largely support the views set out in the submissions of Vodafone and Telecom (**Spark**), and note in this cross-submission some areas where our position may differ. In particular, we agree that:

   a) The Act makes it explicitly clear that **relativity is a mandatory consideration**.

   b) The Commission must take the necessary time to ensure it gets the TSLRIC cost model right, and shouldn't rely on Chorus' own cost model. We therefore support Vodafone's recommendation that **the Commission should prepare a model reference paper for further consultation with industry** prior to finalising the model design and parameter inputs.

   c) RSPs are confused about why (and how) the "reasonable investor expectations" test, which adds an unnecessary and unclear layer of complexity, has been adopted. We agree with Spark's submission that **the Act already provides for predictability and certainty of regulatory outcomes**, and that importing this separate and new test could in fact reduce predictability.

3. We agree with Vodafone's submission that "[t]*he current consultation paper does not provide sufficient detail on key modelling parameters to allow all parties to fully address methodology*", its (and Spark's) disagreement with the proposed application of the reasonable investor expectations test, and that the Commission's approach should not *"unduly restrict its discretion to apply TSLRIC in accordance with s 18, because of any short cuts or shortcomings."* We agree that "[t]*o support this, the Commission should release and consult on a model reference paper*".[1]

4. As noted by Spark, the focus is on *"modelling the hypothetical operator that is a substitute for Chorus and that operates in a competitive market"*,[2] and that there cannot be a pre-judgement of issues (including not fully analysing different approaches to asset valuation and sharing). Spark correctly notes that the FPP model should be built to allow the Commission to understand the effect of each of its decisions on the models, and any investment efficiency results they produce. As Spark notes, the model should be capable of flexing to accommodate the multiple approaches. We agree with Spark's questioning of *"the value of applying a separate and new (as far as we are aware) reasonable investor's expectations standard or test as the Commission appears to have done in its principles paper."*[3] As Spark notes, the conventional application of TSLRIC methodology should by definition provide investors with the reasonable expectation of normal returns and meet the Act's requirements in s 18. We also agree with Spark's submission

[1] See paragraphs A3 – A5 of Vodafone's Submission, and the related discussions (including D1.23, D1.37 and E3.1) where Vodafone notes that*: "The Proposed Views Paper expressly acknowledges that there is an "international trend" to include asset reuse in cost models."* We agree with this approach.
[2] Spark Submission, para 2.
[3] Spark Submission, para 12.

that applying *"a further reasonable expectations test to Commission decisions at the FPP could artificially multiply the influence of this factor... in a way that was not intended by the Act"* and that this *"can only reduce predictability."*[4]

5. The remainder of this cross-submission is structured under the following headings:

   a) Relativity is a mandatory consideration under the Act.

   b) The Commission should consult further on the parameters of its TSLRIC model.

   c) The "reasonable investor expectations" test adds an unnecessary and unclear layer of complexity, and could in fact reduce predictability.

   d) Other comments on Chorus' submission.

6. Please direct any questions in relation to this cross-submission to: -

Graham Walmsley
General Manager - Wholesale & Regulatory
CallPlus Limited
Grahamw@callplus.co.nz

[4] Spark Submission, para 14.

Relativity is a mandatory consideration under the Act

7. We do not agree with the submissions of Vodafone and Spark that so long as a "consistent" approach is taken to modelling both UBA and UCLL, relativities will likely be met and no specific relativity adjustments will be necessary.[5] As is the case with the approach to asset valuation, this issue cannot be pre-judged.

8. The Commission's obligation to consider relativity between UBA and UCLL as part of its application of s 18 is explicit in the Act. We agree with the Commission that it "*is not enough simply for* [the Commission] *to adopt TSLRIC pricing*."[6] A failure to actively and properly consider relativity would be inconsistent with the clear direction of the legislature. (In our view the "passive consideration" implied by Vodafone and Spark's submissions would amount to such a "failure".)

The Commission should consult further on the parameters of its TSLRIC model

9. We agree with Vodafone's submission that the "*TSLRIC model must be robust, comprehensive and rigorously tested*" and that the Consultation Paper does not provide sufficient detail on the key parameters of the model.[7] Accordingly, we support Vodafone's recommendation that the Commission release and consult on a model reference paper to minimise the risk of constructing a model on unsound assumptions. We consider this is the best way for the Commission to "*ensure its FPP models are built in such a way as to allow it to understand the effect of each of its decisions on the models, and the investment efficiency results they produce*".[8]

10. Given the lack of specificity in the Consultation Paper and resulting inability to submit fully on the key parameters, this approach would allow industry to contribute its views on how the model would best be constructed, and help ensure that the Commission's model does not "*unduly restrict its discretion to apply TSLRIC in accordance with s 18*".[9]

11. In any event, we agree with Spark that the Commission's model should be "*capable of flexing to accommodate multiple approaches*".[10]

12. We have previously submitted on a number of factors that we consider important for the Commission's modelling approach, but note the following with respect to the latest round of submissions:

    a) **Asset sharing**: We agree with Vodafone's submission that "*a hypothetical efficient operator deploying an MEA network in New Zealand would engage in considerable asset sharing*"[11] and its recommendation 20 that "[t]*he Commission must ensure an appropriate level of infrastructure sharing in the MEA, including internal sharing with Chorus network and use of third party infrastructure which reflects international best practice*." We have previously

[5] Spark Submission, para 73. Vodafone submitted at para A7 of its submission that "[t]*he Commission should make no specific relativity adjustment absent compelling evidence that further unbundling would encourage efficient investment, when assessed against the Commission's preference for promoting dynamic efficiency benefits*".
[6] Consultation Paper, para 74.
[7] Vodafone Submission, para A3.
[8] Spark Submission, para 6.
[9] Vodafone Submission, para A5.
[10] Spark Submission, para 6.
[11] Vodafone Submission, para A8.

submitted that the sharing of network elements is integral to building an efficient and effective network, and that the Commission should therefore incorporate asset sharing into its TSLRIC model.[12]

While Chorus has acknowledged that "*opportunities for sharing on third party assets should be considered*"[13] it cautions the Commission to ensure that any assumptions are "*grounded in reality and supported by evidence*".[14] We do not consider that this detracts from the Commission's preliminary view that asset sharing should be taken into account. Further, we note that Chorus has provided a "real world" example of asset sharing, noting that it has been approached by Vector to participate in several overhead to underground conversion projects in Auckland.[15]

b) **ORC vs re-use of assets**: We disagree with Chorus' preliminary view that "[a]*ll assets should be valued at ORC as this will send the right price signals for efficient build / buy incentives*"[16] and prefer Vodafone's submission that the Commission "*should consider re-use of Chorus assets as consistent with the objectives of section 18.*"[17] Further, we agree with WIK's view that a "brownfield" approach is appropriate for deriving the costs of a MEA network to minimise the risk of double cost recovery of fully depreciated civil engineering assets and avoid inefficient network investment decisions.[18] For avoiding doubt, we do not consider that an ORC approach is appropriate.

We are concerned at the Commission's preliminary view set out in para 86 of the Consultation Paper:

> "*Our preliminary view is that our intention to respect reasonable investor expectations to avoid the risk of chilling investment, when combined with the associated positive externalities and migration efficiencies from the generally higher prices that may result (from our decisions on the performance adjustment, and re-use of Chorus' assets), will best give effect to the section 18 purpose – without directly raising prices further*."

This elevates the non-statutory "reasonable investor expectations" test, adding additional factors (positive externalities and migration efficiencies) and appears to be used as the basis for adopting a pure ORC approach. As Spark has submitted, if this approach is to be adopted, the assumptions should be modelled and sensitivities-tested.

c) **Choice of MEA**: We agree with Spark that the Commission should extend its consideration of FWA (ie not restrict this to the RBI footprint), and should apply the same rigour to modelling FWA as it plans to apply to fixed technology options.[19]

d) **Chorus' cost model**: More generally, we agree with the principle that the Commission's TSLRIC model should be based on the costs of a hypothetical efficient operator, not the costs of Chorus. We agree with Spark that "[t]*he Commission is not modelling Chorus' costs, or the costs of a new entrant entering today's market to compete with Chorus – it is modelling*

[12] CallPlus Submission, para 9.
[13] Chorus Submission, para 18.
[14] Chorus Submission, para 107.
[15] Chorus Submission, para 72.
[16] Chorus Submission, para 18.
[17] Vodafone Submission, para A8.
[18] WIK Consult Report for Spark and Vodafone, para 3.
[19] Spark Submission, para 16c.

the costs of a hypothetical operator that is a substitute for Chorus and that operates in a competitive market."[20]

While Chorus' own cost model may be a useful reference, the Commission must take particular care to ensure that it is not unduly influenced by it such that it becomes the *de facto* TSLRIC model (or otherwise becomes an "anchor" or "benchmark"). The Commission should adopt a robust approach towards its review of Chorus' cost model – critically analysing the assumptions upon which it has been prepared and acknowledging the inefficiencies that would likely exist for an incumbent/monopoly service provider.

The "reasonable investor expectations" test adds an unnecessary and unclear layer of complexity, and could in fact reduce predictability

13. We share Vodafone's disagreement with the Commission's proposed importation and application of a "reasonable investor expectations" test. As noted by Vodafone at para A4 of its submission, "[t]*he consultation paper does not define the proposed test or provide evidence for its application in reaching its draft views.*"[21] We submitted to the same effect, also confirming that such a test is "*not noted, let alone defined, in the Act*."

14. We also support Spark's questioning of the value of applying a "*separate and new test*".[22] To the extent that the Commission considers it necessary to place weight on predictability and investor certainty in its application of s 18 (although we reiterate that the *dominant* consideration in s 18 is the promotion of competition in telecommunications markets for the long term benefit of end-users), we agree with Spark's submission that the Act already provides "*high levels of predictability to investors and end users*".[23]

15. As noted by Spark at paras 13 & 14 of its submission, a conventional application of TSLRIC methodology by definition should provide investors with a reasonable expectation of normal returns. By applying a further reasonable expectations test at the FPP stage, the Commission risks artificially multiplying the influence of this factor in a way that was not intended by the Act and not applied during the IPP process, which can only reduce predictability.

16. As noted above, the Commission should not, as it appears to be suggesting, use this "reasonable investor expectations" test as the basis for its choice of asset valuation.

Other comments on Chorus' submission

17. We make the following further comments with respect to Chorus' submission:

    a) Chorus refers at para 3.9 of its submission to an "*intention that entry level fibre pricing should be attractive as compared to copper*". As the Commission has consistently and correctly noted, copper should remain a competitive constraint to fibre – a view which is evident from the IPP. More generally, there is no statutory mandate for transitioning to fibre.

[20] Spark Submission, para 2.
[21] Vodafone Submission, para A4.
[22] Spark Submission, paras 12 and 14.
[23] Spark Submission, para 10. See in particular sub-paras 10a-c.

b) Chorus makes numerous references to the "*real world*" and ensuring that decisions are "*grounded in reality*", yet this really appears to be another way of (incorrectly) asking the Commission to model its existing copper network (ie substituting its own costs and investment decisions for those of an efficient HNE). Ignoring the technologies that would likely be adopted by a HNE (including as to relativity between those technologies) cannot give a result that is "grounded in reality" and those views cannot be reconciled. Chorus appears to be asking the Commission to place any "real world" considerations that may decrease price in the "too hard" basket, using the risk of regulatory error as a "cop-out".[24]

c) Chorus downplays the efficiency and uptake of FWA, referring to deployment figures used in TSLRIC models of 9% in Norway and 3% in Portugal, without giving any further information on these countries (for example, these models may have been constructed when FWA was not as advanced a technology as it is now). This is also inconsistent with its own targets to achieve 20% aerial deployment in UBA areas.[25]

d) Chorus' views on incentivising unbundling are inconsistent with the fact that the Commission does not intend to incentivise or disincentivise bundling. We note Chorus' view at para 3.10 of its submission that "[p]*ositively incentivising unbundling will undermine the incentives for the industry to transition to fibre, the UFB business case and future investment in non-UFB areas*." This is compared to the Commission's correct preliminary view at para 88 of the Consultation Paper that "*section 18, and relativity, is best met for UBA by a position of competitive neutrality in respect of unbundling. The UBA price (and the method by which this is constructed under a TSLRIC model) should not independently incentivise or disincentivise unbundling. This will allow for unbundling to occur where it is efficient.*"

[24] See, for example, Chorus Submission, para 16: "*An FTTH model is more complicated and uncertain than modelling a copper network. There is less hard data on the design, build and cost of a national FTTH network in New Zealand, and many more assumptions will need to be made. This translates to a higher risk of a pricing error. By contrast, a nationwide HNE copper model grounded in reality (with efficiency assessments) will produce TSLRIC prices for the regulated SLU, UCLL and UBA services with less "re-construction".*"
[25] Chorus Submission, para 18.