

A review of “Economic
Comment on UCLL and
UBA Pricing Issues” by
Sapere Research Group

Prepared for Spark and
Vodafone

DRAFT - September 2015

Executive Summary

We have previously prepared a paper for Spark and Vodafone in which we set out the economic arguments that speak against backdating of Final Pricing Principle (FPP) prices to the date of the initial determination in the context of the New Zealand Commerce Commission's determination of charges for access to Chorus' unbundled copper local loops (UCLL) and unbundled bitstream access (UBA). We highlight the potential downside of applying prices retroactively in terms of creating additional uncertainty, and argue that the majority view expressed in the Commission's further draft determination provides a good assessment of the relative merits from backdating in the case at hand.

We have been asked by Spark and Vodafone to review a submission by Sapere Research Group (Sapere) in which the majority view is portrayed as regulatory end game in which the Commission opportunistically seeks to expropriate investments made by the access provider, potentially because of the misguided belief that the duty to promote competition for the long term benefit of end users requires it to adopt a narrow consumer surplus standard.

Specifically, Sapere suggests that the economic rationale underlying the Initial Pricing Principle (IPP)/FPP framework requires that FPP prices apply from the date of the initial determination, and that any decision by the Commission to deviate from this default would be opportunistic and time inconsistent. Sapere claims that the Commission would have come to a different conclusion if Chorus were in a different stage of the investment cycle, and that this is evidence of time-inconsistent behaviour that will jeopardise the Commission's reputation and regulatory predictability with a detrimental impact on future investment.

Overall, we find that Sapere's claim about the intended function of the IPP/FPP framework are unsubstantiated and the conclusions drawn from this claim are logically flawed. Equally, the claim that the Commission would have come to a different conclusion if Chorus were at a different stage of the investment cycle is unsubstantiated. The arguments put forward by the Commission are part of an assessment of the relative merits of backdating rather than an opportunistic change in regulatory policy which would jeopardise the Commission's reputation for acting in a time-consistent manner and undermine regulatory predictability. On the contrary, as we have set out in our previous paper, the Commission (in its majority view) has correctly identified and properly weighed the detrimental impact that the retroactive application of price changes will have on predictability.

1 Introduction

Sapere Research Group (Sapere) on behalf of Chorus has prepared a paper that discusses various issues in relation to the setting of prices for access to Chorus' unbundled copper local loops (UCLL) and unbundled bitstream access (UBA) by the New Zealand Commerce Commission under its Final Pricing Principle (FPP). Specifically, Sapere considers the question of the date from which prices established under the FPP should apply, and the appropriate margin above the central estimate of WACC that the Commission should use in its modelling.

Sapere argues that FPP prices should apply from December 2014 (and, indeed, from December 2012 for UCLL) and that including a sizeable margin above the central estimate of WACC is justified. Sapere claims that not backdating¹ FPP prices to an earlier date and not including a margin above the central estimate of WACC to account for parameter error would be an instance of the Commission behaving in a time-inconsistent manner, and trying to exploit the fact that the underlying investments made by Chorus are sunk in a regulatory end game where consumer benefits take priority over the need to maintain appropriate incentives for future investment.

In Sapere's view, this behaviour is incompatible with the Commission's duty to promote Section 18 of the Act, which stipulates that the purpose of the Act is "*to promote competition in telecommunications markets for the long-term benefit of end-users of telecommunications services within New Zealand*", in particular as this

¹ We note that Sapere considers "*the question of timing as 'from what date should the FPP determination apply?'*" to be "*subtly but importantly different from framing this question as to whether the FPP prices should be backdated*" because "*the former question aims to identify the appropriate timing relationship between IPP and FPP regulatory periods (and thereby establishes the default position), while the latter considers whether a price established at the date of the final determination should apply to an earlier period (suggesting that any 'backdating' differs to the default position)*" (paragraph 108 of the Sapere submission). With this, Sapere seems to claim that the Commission wrongly approaches the backdating decision in a way that ignores that there is a presumption that FPP prices should apply from the date of the initial determination, suggesting that the use of the term 'backdating' could be prejudicial and that there might be something unusual and problematic about backdating. As we have set out in our original paper, we do not consider that this is the case, and that there may be good reasons for using backdating as a default (though none of these apply to the present case). Therefore, and as the matter under consideration is effectively whether FPP prices should be applied from an earlier date, we continue to use the term 'backdating'.

duty has to be interpreted with reference to a total welfare standard rather than a consumer welfare standard.

We have been asked by Spark and Vodafone to provide a review of the arguments put forward by Sapere to support the claim that FPP prices should apply from December 2014.

Overall, we find that Sapere's arguments hinge upon unsubstantiated claims about the intended function of the IPP/FPP framework and conclusions drawn from these claims that are logically flawed. The allegation that by not backdating FPP prices the Commission would try to play a regulatory end-game, jeopardise its reputation for acting in a time-consistent manner and undermine regulatory predictability is unjustified. On the contrary, as we have set out in our previous paper², the Commission (in its majority view) has correctly identified and properly weighed the detrimental impact that the retroactive application of price changes will have on predictability.

In the remainder of this report, we:

- provide a brief summary of Sapere's reasoning (Section 2);
- highlight the flaws in the claim that the IPP/FPP framework implies that FPP prices would apply from the date of an IPP determination (Section 3);
- discuss Sapere's allegation that the Commission would be acting in a time-inconsistent and opportunistic manner if it were not to backdate FPP prices to December 2014 (Section 4); and
- summarise our conclusions (Section 5).

² DotEcon, *Backdating of FPP prices in New Zealand*, August 2015.

2 Sapere's reasoning

The main arguments put forward in Sapere's report to support the claim that FPP prices should apply from December 2014 (and, indeed, from December 2012 in the case of UCLL) are that:

- the IPP/FPP framework is intended to provide an assurance to affected parties that prices set on the basis of long run incremental cost will be applied whenever requested, and that this assurance function requires that FPP prices would apply from the date of any IPP determination; and that
- the arguments put forward by the Commission for not applying FPP prices from the date of the IPP determination indicate that the Commission is behaving in a time-inconsistent manner, which will have a detrimental impact on its reputation as a regulator that can be trusted not to exploit the sunkness of investments through a redistribution of surplus from producers to consumers.

Specifically, Sapere claims that the IPP/FPP framework is "*best viewed in economic terms as providing assurance to affected parties that prices will reflect the TSLRIC pricing method if requested, within a wider regulatory design that attempts to lower the cost of regulation by way of an initial benchmarking approach under the IPP*" and that "*for this assurance function to be credible and effective ... affected parties ... need to have confidence that the FPP prices will in practice be used in the supply of the regulated services, if requested*" which, in order to be complete, "*requires that the FPP determination, and the resulting prices, apply from the same date as the IPP determinations apply.*"³

Sapere further says that this timing requirement is not addressed by the Commission's view that the IPP/FPP error would be symmetric and not systematic and would therefore not create undiversifiable risks for future investments because the investor may have very different views of the probability that the IPP is above or below the FPP price.⁴

In Sapere's view, the question of the date from which FPP prices should apply can be completely separated from the question of the profile of prices that should apply over the regulatory period. Specifically, Sapere claims that "*[i]ssues related to the profile of prices*

³ Sapere, paragraphs 103 and 104.

⁴ The Commission makes the point about the non-systematic nature of the IPP/FPP error in paragraph 886.7 of its *Further draft pricing review determination for Chorus' unbundled copper local loop service* of 2 July 2015. Sapere references these arguments in paragraphs 91 and 110 of its submission.

are not considerations that need to be addressed by the date from when the regulatory period commences, but rather can be addressed by determining the price profile (within the regulatory period) that best gives, or is likely to best give, effect to section 18.⁵ Arguing that FPP prices are not – as the Commission appears to believe – “a reliable reflection of the long run marginal cost of supply of the regulated service in all locations and markets [whose] precise level is critical to the efficient functioning of those markets”⁶, Sapere suggest that there is considerable leeway in terms of how prices could be adjusted, including the use of a clawback mechanism to make up for prices set at the lower IPP level at the beginning of the period. Using such a mechanism would have a relatively small effect on prices, and any distortion of competition that could conceivably arise from increasing prices above the FPP level if a clawback mechanism were to be used would likely be outweighed by the distortions that come from the averaging that takes place in the determination of TSLRIC-based prices.⁷

Sapere then argues that the Commission's (majority) decision not to apply FPP prices from December 2014 (as well as not to use a WACC above the central estimate to account for the risk of parameter error) is a clear case of time-inconsistent behaviour, as the Commission would have come to a different conclusion if Chorus had yet to invest in infrastructure that would be required for the provision of UCLL/UBA services. Specifically, Sapere quotes some of the Commission's reasons for declining to backdate, namely that *“backdating would only have an effect where there is new investment and/or where some investment would be subject to regulation”* but that it was *“not regulating a new investment”* nor that there would be *“a major new bottleneck investment ... regulated by way of an IPP/FPP.”⁸*

In Sapere's view, this reasoning *“appears to be a version of a regulatory ‘end-game’ where the regulator holds the view its approach to pricing will have no effect on future investment and therefore it can act in a time inconsistent (or opportunistic) manner at no cost to the long term benefit of end-users.”⁹*

Though not being stated explicitly, Sapere seems to imply that the Commission takes this approach because it considers (erroneously)

⁵ Sapere, paragraph 119.

⁶ Sapere, paragraph 125.

⁷ Sapere, paragraphs 125 – 127.

⁸ Sapere, paragraphs 91 and 110, quoting from paragraph 886.6 of the Commission's *Further draft pricing review determination for Chorus' unbundled copper local loop service* of 2 July 2015.

⁹ Sapere, paragraph 114.

that section 18 is requiring it to use a consumer welfare standard rather than a total welfare standard, thus giving more weight to lower prices than greater investment incentives.¹⁰ In Sapere's view, section 18 is not tractable as a consumer benefit test (because, it would not, for example, provide any guidance for how one should be dealing with distributional concerns, including inter-temporal effects, might ignore dynamic efficiency gains and might produce low prices for products that are harmful¹¹) but must be interpreted as a total welfare test. Such a total welfare test would only *"provide for the transfer of rents from producers of bottleneck services to end-users where it is efficient to do so, taking into account the costs of such regulation"* and would *"not task the Commission to identify and transfer economic rents from producers to the firms purchasing the services with the object of benefiting end users."*¹²

¹⁰ For example, Sapere states that *"section 18 does not provide an economic basis for making the allocative choices required under a consumer welfare standard"* (paragraph 4) and that the issue of time inconsistency is related to the fact that *"once the investment is sunk, renegeing on that promise and lowering prices toward short-run marginal costs may be optimal for a regulator that wishes to maximise short-run consumer welfare, or to maximise its popularity (if gains to consumers are weighted more heavily than losses to investors)"* (paragraph 85).

¹¹ Sapere, paragraph 62.

¹² Sapere, paragraph 59.

3 The timing of FPP prices

Sapere's claim that the IPP/FPP framework requires FPP prices (if a request for a determination under the FPP has been made) to apply from the date of the IPP determination rests on the assumption that the economic rationale of the IPP/FPP framework is to provide an assurance that prices will be based on TSLRIC whenever required, and that the effectiveness of this assurance would be undermined if the start date for prices established under the FPP were different from the date of the IPP determination.

Sapere appears to be attributing an economic rationale to the IPP/FPP framework that is independent from, and has no regard to, its correct legal interpretation, though an economic rationale can provide guidance to the correct legal interpretation.

In this regard, the review of the Final Report of the Ministerial Inquiry into Telecommunications from September 2000 provides some important insights into the economic efficiency considerations that drove the design of the regulatory regime. Following a period without any sector-specific regulatory provisions, one of the main requirements for the regulatory framework was that it should provide certainty and resolve potential conflicts swiftly and expeditiously.¹³

The efficiency benefits from providing a certain environment, and doing so without delay, are also clearly apparent in the design of the IPP/FPP framework. The use of an initial pricing principle based on benchmarking was very much driven by the fact that this "would

¹³ For example, on page 29 of the Final Report there are references to "the benefit to the industry and to users of resolving any disputes expeditiously; the inability of generic competition law and the courts to establish clearly defined access obligations (including pricing principles) for the industry, and the resulting uncertainty, delay, and cost that this imposes on the industry; and the fact that many contentious issues in relation to access are common to more than one set of access negotiations and that consistency in the resolution of such issues is desirable to produce greater certainty for new entrants." Page 55 of the Final Report states that "[a] further and important benefit of the Inquiry's recommended regulatory regime is that of certainty. The Inquiry has sought to maximise certainty by elaborating processes, powers and principles in legislation and including checks and balances where possible. This is in stark contrast to the existing regime, which has no rules or guidelines governing the interactions and negotiations of industry players."

For the avoidance of doubt, we should emphasise that the notion of 'resolving any disputes' in this context is different from the notion of dispute resolution processes that we have used in our earlier report as a reference to processes where one party contests the terms set by another on the basis that these terms are incompatible with regulatory or other legal obligations. By contrast, here the need to resolve disputes is one of the reasons for introducing an ex-ante regulatory framework under which standard regulatory determination will be made.

*enable the Commissioner to announce his/her decision within a short timeframe.*¹⁴ More specifically, *"[t]he initial determination and (if required) the pricing review determination may require different pricing principles, because it may not be possible to apply a certain type of pricing principle within the timeframe that the initial determination has to be made. This is not a shortcoming of the regime, but rather a design feature to ensure that an appropriate pricing principle can be applied in the first instance for disputes to be resolved expeditiously. The initial determination would ideally get sufficiently close to the 'efficient' price so that both parties accept the determination and decide not to progress to the (longer and more costly) pricing review determination."*¹⁵ A perceived downside of cost modelling was not only that it was time-consuming, but also that it was open to dispute and disagreement, and thus outcomes would not be certain.¹⁶

In light of this, it is difficult to conceive of the IPP/FPP framework as one that is aimed at maximising reliance on the FPP and giving assurance to the affected parties that prices will be set in accordance with the FPP. Rather, it might be more appropriate to be seen as providing affected parties with the option to seek a review of pricing where they consider that IPP prices are not a good proxy for those that would come out of a full cost modelling exercise with all the associated uncertainty.

This acknowledges the obvious benefits from having in place regulated charges without much delay and without the uncertainty that is associated with the outcome of a cost modelling exercise. The initial determination would be made by looking at a range of benchmark charges and selecting the initial price *"on the basis of his/her [the Commissioner's] best estimate of where New Zealand would fall if a full TSLRIC assessment were undertaken. This is consistent with the earlier expressed view that the initial pricing principle should be a proxy for the pricing principle to be used in the pricing review determination."*¹⁷

Even if one were to consider that the primary economic rationale underlying the IPP/FPP framework were to provide assurance to

¹⁴ Final Report, page 32.

¹⁵ Ibid, page 45.

¹⁶ *"As a number of submissions pointed out, cost-based models (e.g. TSLRIC) are complex and take considerable time to develop. In addition, they require numerous assumptions on which there can be legitimate differences of opinion. Thus, not only can cost-based modelling be expensive and take considerable time to complete, but agreement about the appropriate interconnection and data tail access prices deriving from such models can be difficult."* (ibid, page 55)

¹⁷ Ibid, page 68.

affected parties that they can seek a determination of prices on the basis of a detailed cost modelling exercise, there is nothing that would suggest that in order to benefit from having such an option, FPP prices would have to apply from the date of the IPP determination. Providing an option to seek a determination on the basis of the FPP does not imply that any such determination has to be effective from the same date as the initial IPP determination. The claim that this would be the case, as otherwise the alleged assurance function of the IPP/FPP framework would be undermined, is a plain and simple *non sequitur*.

This is not to say that the framework could not have been designed in a way that would give less weight to the swift resolution of uncertainty that the IPP provides. Indeed, it would have been easy and straightforward to specify that, in the case that one or more parties sought a determination under the FPP, this determination would be effective from the date of the initial determination. However, this is not what the legislator has done, and from an economic perspective there are good reasons for not specifying such a requirement.¹⁸

As we have set out in our original paper, requiring that the outcome of an uncertain and time consuming FPP process be applied with retroactive effect exposes market participants to additional uncertainty with all the associated costs. It would effectively undo much of the benefit of having in place a framework that provides for the determination of prices in an expeditious manner in order to provide certainty to market participants at the earliest opportunity.

Sapere's claim that the commencement date of the regulatory period for FPP prices can be considered entirely separately from the question of what prices should apply at particular points in time (the 'profile of prices') appears to ignore that prevailing prices will affect the behaviour of users of the regulated services and that this will have efficiency implications. Sapere seems to believe that detailed price profiles do not matter, provided that the suppliers of the regulated service will earn revenues that are equivalent to the revenues that they would have earned if FPP prices had applied throughout the regulated period. This completely overlooks the fact that both investment and usage decisions depend on actual

¹⁸ On the contrary, the intention appears to have been that determinations would become effective at the point in time when they were made. Page 32 of the Final Report states that "[f]or disputes related to pricing principles applying to a designated service, either of the parties to the proposed agreement could challenge the Commissioner's determination and request a pricing review determination. Such a challenge would need to be made within 15 working days of the determination being issued. Neither party would be able to appeal an initial price determination in Court. The determination would come into effect and be published by the Commissioner pending completion of the pricing review determination" (emphasis added).

prices and price forecasts, and will be affected and potentially distorted (even if price difference might be small).¹⁹ As we have set out in our first paper, under a general backdating regime, market participants would not be able to rely on IPP charges but would have to form expectations about what the prices they pay and the revenues they earn will eventually be, and act on the basis of these expectations (which they might not be able to do). This undermines much of the benefits from speed and certainty that the IPP provides.

Interestingly, even though Sapere does not draw any attention to the fact that the retroactive application of regulatory determinations will create additional uncertainty, and that prices will affect the behaviour of end users, the paper makes it clear that Chorus would benefit from having higher FPP charges applied to past volumes because these are certain (and presumably higher than they would have been if past usage decisions had been made on the basis of the higher FPP prices): *"The more the price increases (relative to the IPP) are deferred to the latter years of the regulatory period, the greater are the risks to the supplier that its overall revenue requirement (as per the TSLRIC models) will not be met, which would erode the assurance function of the FPP. The volumes for the period from December 2014 to date are known and therefore it would be preferable, from a revenue risk perspective, for those volumes to be matched against the FPP prices and a lump sum amount identified that is payable to Chorus."*²⁰

In summary, even if the purpose of the IPP/FPP were to provide affected parties with the assurance that they could seek a review of an IPP determination that would eventually replace IPP charges with FPP charges, there is no logical necessity for FPP charges to

¹⁹ The presence of past distortions and the role of regulated prices in sending correct price signals is clearly acknowledged by CEG, which makes reference to the Sapere paper in its report for Chorus: *"[a] policy of backdating will ensure that prices reflect the efficient estimate of costs at most points of time ... A decision to backdate now cannot reverse the errant consumption signals of the past but may influence longer term investment decisions for access providers and access seekers"* (CEG, Response to the further draft determination, August 2015, paragraph 298). This broadly corresponds to the arguments made in our earlier submission, but ignores the impact of uncertainty associated with backdating.

²⁰ Sapere, paragraph 26. Chorus clearly expresses its preference for receiving a lump sum payment stating in its submission that one of the benefits of a lump sum payment would be that *"it ensures that RSPs pay, and Chorus receives, the difference between the initial and final prices based on volumes of the services taken in the period in which the initial price was operative, rather than having to attribute these sums to future volumes, which may not be consistent as between RSPs or end-users"* (Chorus, Submission in response to the Commerce Commission's Draft Pricing Review Determinations for Chorus' UBA and UCLL services, Public Version of 2 July 2015; we note that it is not clear to us what Chorus means by future volume being 'not consistent').

apply from the date of the initial determination, and there is no indication that it was the intention of the legislator to define such a requirement.

4 The allegation of time-inconsistent behaviour

Sapere claims that the decision not to backdate FPP prices (or, in Sapere's terminology, not to have the FPP determination apply from the date of the IPP determination or December 2014) "*places little weight on the assurance function of the FPP, and by implication on the investment incentive implications of this delay [in the application of FPP prices]. This is based on the view that Chorus faces only limited future investment requirements to supply the UCLL and UBA services, that Chorus is able to cover its costs and that the IPP/FPP pricing method is unlikely to be applied in the future to major new bottleneck investments. This reasoning implies that if Chorus' circumstances were different – that is, if it was at an early stage of the investment cycle for UCLL and UBA services, or if Chorus was not able to cover its costs, or if the IPP pricing was expected to be applied in the future to major new bottleneck investments – then investment incentive implications would be given more weight. We interpret this line of reasoning to be a version of a regulatory 'end game'.*"²¹

Our first observation is that again this line of reasoning includes a logical fallacy (known as 'denying the antecedent'): the Commission's reasoning does not imply that it would have come to a different conclusion if Chorus' circumstances were different. The Commission puts forward many other reasons for not backdating, which would still remain valid even if Chorus were in a different position of its investment cycle, including that:

- there are some doubts about the extent to which it is reasonable to expect Retail Service Providers (RSPs) to adopt draft prices or apply their own TSLRIC modelling in the future, not least because the current decision would not be binding on future Commissioners;²² or that
- a decision to backdate would give "draft decisions a significant price signalling status" which in the commission's view "is not consistent with the legislative scheme."²³

As we have set out in our original paper, we find that the majority view taken by the Commission captures the key issues that should be taken into account when deciding whether to backdate, and in

²¹ Sapere, paragraphs 22 – 24.

²² Paragraph 887 of the Commission's *Further draft pricing review determination for Chorus' unbundled copper local loop service* of 2 July 2015.

²³ *Ibid.*, paragraph 888.

particular the extent to which such a decision would affect future behaviour of affected parties, which in turn depends on their ability correctly to predict what charges would eventually emerge under the FPP, and the extent to which a backdating decision would have precedential effect.²⁴

Considering whether the decision not to backdate might have a disproportionate detrimental impact on Chorus would in this context appear to be more evidence of the Commission's concern about maintaining investment incentives rather than an indication of its intention to behave opportunistically.

More generally, the Sapere paper appears to confuse opportunistic changes in the rules – which are at the heart of concerns about time consistency in regulatory policy – with exercise of discretion under the rules. This may partly be due to Sapere's claim that the regulatory regime requires FPP determinations to be effective from the date of the initial IPP determination, which – as we have argued above – is not the case. The decision whether or not to backdate does not amount to a 'change in policy' but is rather an issue over which the Commission has discretion under the existing regulatory framework. In particular, it is very different from the example of moving from a policy that guarantees full cost recovery ex ante towards "*lowering prices toward short-run marginal costs ... to maximise short-run consumer welfare, or to maximise its popularity (if gains to consumers are weighted more heavily than losses to investors).*"²⁵

In exercising this discretion, the Commission does not appear to give undue weight to consumer surplus and 'hold up' investing firms, as Sapere seems to suggest. Indeed, Sapere's discussion about the proper interpretation of section 18 and what is meant by 'long term benefit to end users' is somewhat surprising and appears to ignore the fact that this is well-trodden ground. The issue is not so much about whether producer surplus (or profits made by suppliers) should be ignored, but about the appropriate timeframe over which benefits are assessed and within which the need for profits as an incentive for investment need to be acknowledged. This is perhaps most clearly expressed in the statement from Professor Hausman (prepared on behalf of Chorus) that is quoted in the Commission's Further Draft Decision on Cost of capital for the UCLL and UBA pricing reviews of 2 July 2015 (at paragraph 238):

²⁴ See the list on p 6 of our original report for the conditions that need to hold for backdating to have efficiency benefits, and pp 22-24 for how these considerations are reflected in the majority view put forward by the Commission.

²⁵ Sapere, paragraph 85, referencing Ergas (2009), *Time Consistency and Regulatory Price Setting: An Australian Case Study.* Review of Network Economics 8 (2).

“While my view is that the consumer welfare standard is the correct standard to evaluate telecommunications policy and regulation, it is crucial to understand the correct time frame for the evaluation of consumer welfare. Over time, increases in consumer welfare will not occur unless significant investment occurs. And since most investment in telecommunications is sunk cost investment, the investment is riskier than [sic] much other investment. Thus, regulation must create correct economic incentives to encourage firms and investors to commit funds to investment. In my view in concept of the “long-term benefit of end-users” (LTBE) the word “long-term” is very important because it incorporates the effects of investment. In economics “long-term” means taking into account a period long enough so that the capital stock changes, and is not fixed, as it is in the short-term. ...

What I, and other economists mean, is consumer welfare over the “long-term” when the welfare increasing effects of investment and innovation have been taken into account.”

As the Commission further states in this document, it broadly agrees with Professor Hausman, noting that it is important to consider the extent to which producer surplus would ultimately provide incentives for making investments that create long-term benefits for end users.

Against this background, Sapere’s discussion of the relative merits of different welfare standards does not seem to acknowledge that the Commission’s views are much more nuanced. The claim that section 18 “does not include an explicit provision to limit the ability of suppliers to extract excess profits”²⁶ is at the very least surprising if one assumes that excess profits means those profits that are not rewarding risk taking and are needed to recoup past investments and provide incentives for future ones. Sapere would be correct if it said that section 18 does not authorise the Commission to expropriate what might appear to be economic profits in the short term but is actually required to provide incentives for investment and innovation.²⁷ However, this important differentiation between short-term and long-term effect seems to be largely absent from Sapere’s discussion (for example when one of the arguments why section 18 is not tractable as a consumer benefit test is that in doing

²⁶ Sapere, paragraph 46.

²⁷ For the avoidance of doubt, excess profits, properly identified, would have to be eliminated also under a total welfare standard.

so one might ignore the "*potential loss of dynamic efficiency benefits from innovation or improvements to service quality.*"²⁸)

In summary, we find that the majority view of the Commission not to backdate FPP prices does not amount to an opportunistic change in policy, driven by a misguided focus on consumer welfare without due consideration of the potential impact on investment incentives.

²⁸ Sapere, paragraph 62.

5 Conclusion

Sapere's claim that the majority view in relation to backdating of FPP charges set out in the Commission's *Further draft pricing review determination for Chorus' unbundled copper local loop service* of 2 July 2015 amounts to a time-inconsistent and opportunistic change in regulatory policy is unsubstantiated.

It is predicated on the unsubstantiated claim that the IPP/FPP framework is intended to provide "*all affected parties the assurance that prices can and will be set using TSLRIC, should any affected party be sufficiently dissatisfied with the result of the IPP to call for the FPP*"²⁹, and that this requires that any FPP determination will apply from the date of the initial IPP determination that the parties have sought to review. Sapere's argument completely ignores the cost of uncertainty that will result from the retroactive application of prices. By contrast, the benefits from providing certainty to market participants appear to have been an important consideration in the design of the regulatory framework.

Sapere's argument further rests on the claim that the majority view of the Commission would have been different if Chorus were at a different stage of the investment cycle, and the suggestion that the Commission's decision may be driven by a misguided focus on consumer surplus whilst ignoring investment incentives. This is incorrect as a matter of logic and seems to misstate the Commission's position, which very much considers the impact of any decision to backdate on future investments.

²⁹ Sapere, paragraph 17.