



Fibre regulation emerging views: WACC

Cross-submission | Commerce Commission

9 August 2019

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## Executive summary

Thank you for the opportunity to comment on WACC submissions on the Commission's emerging views technical paper. The process has usefully highlighted the key decisions facing the Commission as it looks to develop draft IMs. There are significantly different perspectives between access providers and seekers on the nature of the Fibre Networks and required return.

Chorus proposes, in effect, that the Commission estimate WACC by reference to a hypothetical standalone fibre provider. However, the Act requires the Commission to avoid double recovery, limit excessive provider returns and share efficiencies with end users. Chorus' standalone provider standard won't achieve these beneficial outcomes because it is blind to:

- The efficiencies Chorus/LFC achieve by deploying the fibre network in the context of their existing businesses;
- The benefits of the UFB public private partnership (PPP) with Government under which UFB Fibre Networks were build, and the significant funding and risk sharing provided by UFB arrangements; and
- The risk and required return for an investment of this type, particularly that for PPP infrastructure expected to underpin future telecommunications services in New Zealand.

We believe a proper implementation of Part 6 requires the Commission to consider and share the benefits and efficiencies of deploying the networks using existing network capabilities and expertise.

Chorus further recommends several adjustments to the WACC. Our key concern with these proposals is that they depart from the actual context within which UFB Fibre Networks were deployed. For example:

- Oxera concludes that a notional standalone fibre network has more systematic risk than the provision of copper services, yet Chorus is an integrated copper and fibre network provider and has a natural hedge for key fibre network risks, and the network was deployed in the context of UFB arrangements with the Crown;
- Oxera further proposes that the Commission apply a fair bet uplift be applied as has been done in the UK, yet the UK approach is part of a policy framework that promotes competitive fibre deployment on regulated access to ducts and poles. The New Zealand approach is based on direct Government participation in the market through PPP arrangements;
- Chorus proposes an uplift for the asymmetric risk of under-investment (supported by HoustonKemp (HK)). However, RSPs monitor quality closely and the effects of under-investment will be incremental, readily detected and mitigated in practice through other Part 6 regulatory instruments; and
- Chorus stresses the importance of guaranteeing FCM and Type II risks. However, all the evidence suggests that no party considers these risks material and any remedies very complex and controversial.

Chorus' proposal further imply adjustments to specific WACC parameters while assuming the remainder of parameters remain unchanged. We have reservations over this approach as WACC parameters are interrelated and making adjusted in isolation risks over-estimating WACC.

Accordingly, we believe a better approach is to focus on increasing the comparator dataset, relying more on infrastructure provider, similar risk sharing PPP entities and Crown owned business comparators.

## Introduction

1. Thank you for the opportunity to comment on WACC submissions on the Commission's emerging views technical paper for implementing the fibre regulatory regime set out in Part 6 of Act (**the technical paper**).
2. In this submission we've focused on the key WACC considerations being:
  - a. Cost of Equity and Chorus proposed adjustments;
  - b. WACC for losses calculation;
  - c. WACC uplift and asymmetric risk;
  - d. Financial losses; Stranded assets and truncated returns.
3. These issues are not discrete and there is a degree of overlap through the submissions and in our comment.

## Cost of equity

4. The Commission's emerging view is that it will estimate the asset beta using its established Part 4 methodology with updated data. To do this the Commission proposes to establish a benchmark set from New Zealand and overseas firms with similar business characteristics and risk, and then consider an adjustment to the average asset beta of the sample for regulatory differences or differences in systematic risk.

## Data set and systematic risk

5. Chorus has – understandably - suggested several changes to the benchmarking dataset, increasing the weight of higher risk firms, and proposed adjustments for systematic risk.
6. The supporting Oxera report<sup>1</sup> concludes that a notional standalone FFLAS provider has higher systematic risk than a copper provider and an adjustment should be made. Oxera note that it previously advised the Commission that Chorus, as an integrated copper and fibre provider, has a natural hedge for key fibre risks. However, a notional standalone provider has higher risk due to demand, operational leverage and long-term cash flow risks.
7. We believe that Oxera's earlier report more accurately describes the nature of Chorus' Fibre Network provider risk. In practice, the Chorus UFB network was built by an integrated provider in partnership with the Crown. Accordingly, Oxera's updated approach will inevitably capture costs and risks that are faced by a UFB provider and is blind to the benefits and efficiencies of deploying the fibre network in association with an existing business and the Crown. The Part 6 purpose, however, to avoid double recovery and excessive profits, and promote the sharing of efficiencies with end users.
8. It's unlikely that an existing provider deploying a UFB fibre network faced the potential early deployment risks identified by Oxera in practice, i.e.
  - a. Chorus is a provider of copper and fibre network services and has significant experience deploying and operating fixed networks:

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<sup>1</sup> Oxera: compensation for systematic risks

- i. The UFB fibre network was deployed using substantially the existing Chorus operating model, duct and overhead infrastructure and service companies;
    - ii. Build risk was passed to – or shared with - contacting build service companies<sup>2</sup>. The mitigated risk would be built into service company charges and already included in the RAB;
    - iii. As fibre deployment is the natural evolution of the copper network, there are no demand and revenue related risks identified by Oxera in its 2019 report.
  - b. The regulatory framework anticipates copper technologies transitioning to fibre, and this is also reflected in lower demand and funding risks. For example, Chorus is transitioning existing demand to a modern platform and the TSLRIC regulatory approach likewise anticipates transitioning demand (mitigate demand and revenue risk); and
  - c. The UFB PPP arrangements with the Crown mitigate key deployment risks, including:
    - i. Agreed UFB wholesale prices were set relative to copper broadband prices in order to promote customer migration to fibre. TSLRIC regulatory pricing was further expected to promote the migration to fibre and fully fund Chorus through that transition;
    - ii. The UFB invitation to particular (**ITP**) anticipated the Crown assumed funding and uptake risk<sup>3</sup>. While parties could negotiate alternative arrangements, these alternatives were agreed relative to the ITP construct;
    - iii. The sharing of risk through Crown equity funding repayment options, including Crown equity reverting to normal equity funding;
    - iv. The UFB auction process which had the effect of funding any residual project risk, i.e. parties tendered for the subsidy and the competitive process would be expected to have already quantified and resolved uncertainties; and
    - v. Government support for fibre deployment which inevitably reduced market risk and permits lower cost funding.
9. Subsequently, the Part 6 framework provides that fibre assets are valued at cost and the past losses and wash up provisions take these risks forward (if any).
10. We do not believe that risks are sufficiently high during the construction and early growth phases such that an adjustment should be made.
11. Chorus and Oxera further refer to overseas estimates of fibre deployment risks and WACC increments<sup>4</sup>. The Commission should be cautious putting weight on overseas regulatory approaches to WACC as these reflect the policy approach in those economies. As Chorus notes, the UFB PPP model through which UFB fibre was deployed is unique. For example, while New Zealand Government has directly participated in the market through its PPP arrangements, the

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<sup>2</sup> For example, Chorus entered deployments agreements in 2013 <https://www.nzx.com/announcements/235258>

<sup>3</sup> The ITP anticipated the UFB partner repaying Crown funding as customers connected to the network, thereby the Crown assumed the demand risk.

<sup>4</sup> Oxera refer to Brattle and Ofcom approaches.

UK regulatory framework relies on regulated access to ducts and poles and competitive fibre deployment<sup>5</sup>.

### Fair bet adjustment

12. For the same reasons, we do not support Oxera's proposed "fair bet" increment for the WACC<sup>6</sup>.
13. Oxera reports that the "fair bet" adjustment has been applied by Ofcom to reflect the risk that future fibre profits will be regulated. A firm considering an investment will recognise a distribution of possible returns and, if these returns are truncated at the top end by the risk of regulation, then a regulated firm cannot expect a normal return on its investment. Accordingly, Ofcom has indicated that if it regulates Openreach fibre services it will add a margin to compensate for this risk.
14. Again, we believe the Commission should be cautious adopting specific elements of an overseas regulatory framework in isolation. Ofcom's strategy<sup>7</sup> is to promote the wide and extensive availability of multiple competing fibre networks and has, amongst other initiatives:
  - a. Moved to ensure unrestricted regulated access to the existing duct and pole network. Companies will have greater flexibility to use Openreach's poles and ducts; and
  - b. Indicated that, if it were to regulate Openreach fibre prices, it would add an increment to recognise that Openreach needs the opportunity to make higher returns when a risky investment is successful in order to compensate it for the chance a risky investment fail.
15. New Zealand has taken a different path with direct Government funding and participation in the roll out of fibre networks through PPP. A competitive process was used to select the PPP partner, and recognition that UFB networks would be regulated. In other words, the parties knew that Fibre Networks would be regulated at the time UFB arrangements were agreed and investment commitments made.
16. We also believe it would be very difficult to estimate the fair bet increment retrospectively to PPP arrangements. Oxera's worked example demonstrates the information difficulties associated with the calculation, i.e. it was necessary to base the estimate on assumed regulatory WACC (the mid-point of CFH's assumed WACC range), assumed expected investor returns from the mid-point of CFH assumed revenue scenarios, and assumed normal distribution with assumed standard deviation of 2.5% to 5%.
17. The worked example highlights the complex information requirements and difficulty applying the approach in our context. For example, the Commission would need to estimate:
  - a. The regulatory WACC, ensuring that comparators were adjusted to remove similar risks already built into comparator estimates;
  - b. Expected project returns, likely inferred from similar PPP comparators. While there might be some comparators - i.e. the Thames Tideway Tunnel project which appears to have not dissimilar risk sharing characteristics to UFB resulted in a competitively derived 2.5% real rate of return<sup>8</sup> – these are likely limited; and

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<sup>5</sup> [https://www.ofcom.org.uk/\\_data/assets/pdf\\_file/0025/116539/investment-full-fibre-broadband.pdf](https://www.ofcom.org.uk/_data/assets/pdf_file/0025/116539/investment-full-fibre-broadband.pdf)

<sup>6</sup> Oxera: compensation for asymmetric type 2 risk

<sup>7</sup> Ofcom's UK approach is set out in this June 2018 strategic policy position

[https://www.ofcom.org.uk/\\_data/assets/pdf\\_file/0025/116539/investment-full-fibre-broadband.pdf](https://www.ofcom.org.uk/_data/assets/pdf_file/0025/116539/investment-full-fibre-broadband.pdf)

<sup>8</sup> See OECD ITF 2018 report [https://www.itf-oecd.org/sites/default/files/docs/thames-tideway-tunnel\\_1.pdf](https://www.itf-oecd.org/sites/default/files/docs/thames-tideway-tunnel_1.pdf)

- c. The shape of the returns. UFB is a unique project and the shape of returns would be difficult to establish, i.e. it would not be unreasonable to expect downside returns to be likewise truncated by Government PPP project support.
18. The approach would be at least as difficult to apply in the New Zealand context as a WACC adjustment for other type II risks, and any results unreliable and contentious.
19. We appreciate the difficulty of finding comparators with informative value for estimating fibre network returns and information has already emerged demonstrating the risks of estimates:
- a. Dr Lally has advised that the beta used prior to pre-implementation day could be set to zero or the rate used post implementation. Where either option has errors, it may be that the lower estimate is more likely to result to support Part 6 purposes;
  - b. There are indications that UFB arrangements implied a lower expected project return than would be suggested by a regulatory WACC and cost model. For example, the fair bet logic would suggest that, where regulation was known to occur and would cap returns, then revealed expected project returns would be less than the regulatory WACC by a margin at least equivalent to truncated returns. Otherwise, the parties would not have entered into the UFB arrangements; and
  - c. The UFB project has been highly profitable at prevailing UFB fibre prices and uptake<sup>9</sup>. Oxera note that the CFH expected project return at 35% fibre penetration by 2020 was over 10%, whereas actual take up already exceeds 50%.
20. Therefore, rather than point adjustments that are as likely to take the estimate away rather than closer to the true WACC, the Commission may want to consider:
- a. Adding further comparators to the dataset to ensure more weight is given to infrastructure and PPP provider comparators; and relaxing the decision to exclude Government owned comparators as these likely have informative value for determining the appropriate beta; and
  - b. In parallel to setting WACC parameters, develop profitability reporting like that being developed by the AER<sup>10</sup>. This would provide transparency of actual outcomes to those anticipated by Part 6 implementation.

## WACC for losses calculation

### Risk free rate

21. The Commission emerging view is to base the risk-free rate estimate on a rolling average as this is likely to limit the potential impact of anomalous market conditions during the pre-implementation period.
22. Chorus has proposed (supported by the HK report) that the Commission should consider the 2011 to 2022 period to be a single regulatory period and, accordingly, apply the 10-year risk free rate from just prior to 2011 for the whole period. Alternatively, the Commission could adopt Chorus' actual funding cost.
23. We support the Commission's proposed approach, based on Dr Lally's advice, to apply a rolling average as a pragmatic means of estimating the risk-free rate. To lock in the 2011 10year rate

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<sup>9</sup> On an incremental basis.

<sup>10</sup> <https://www.aer.gov.au/networks-pipelines/guidelines-schemes-models-reviews/profitability-measures-for-electricity-and-gas-network-businesses>

ignores the fact that rates have fallen through the period and would inevitably overstate Chorus' costs.

24. Further, we do not believe it would be practical to adopt Chorus' actual funding cost because this also reflects Chorus' wider business and funding choices. For example, there is evidence to suggest regulated firms use high debt as insurance against regulatory risks and this insurance effect will impact actual funding costs<sup>11</sup>. Accordingly, it would be difficult to unpick and identify Chorus' comparable fibre debt funding cost for the purposes of the BBM.

### **Crown financing**

25. The Commission's emerging view is that the actual financing costs of Crown financing is likely to be zero. We support the Commission's proposed approach.
26. Chorus proposed that – with supporting Incenta report – financing should also reflect the project risk associated with that funding. In other words, the Crown hasn't accepted an equivalent level of project risk for the capital it contributed. Therefore, Chorus would bear the residual risk in relation to Crown financed investment. In this case, Incenta suggest that Crown financing should be considered subordinate debt, and this means that other investors take on equity like risk. Incenta deduct the estimated cost of subordinate debt from the overall WACC, and notes that the residual must be picked up by other investors.
27. We have reservations over the Incenta approach. Incenta suggest that Crown funding has the nature of debt and should be assessed on that basis. However, we understand that UFB arrangements provide that, from 2025, Chorus has the option to redeem Crown equity securities at the issue price or issue of Chorus shares. This means that the Crown is exposed to equity related risk, although investors have an option on any upside.
28. Further, the Incenta approach assumes that the Crown financing has no impact or relationship to residual funding, i.e. its only benefit is the provision of debt. However, Crown funding is likely to have reduced overall project risks and other parties funding costs.

### **WACC uplift**

29. A WACC uplift is an increase to the Commission's mid-point WACC estimate where it considers it would best promote the Part 6 purposes. An uplift has been considered where there might be: asymmetric consequences of under-investment; infrequent catastrophic events that could produce large losses (Type I); and the risk of competitive entry or expansion stranding assets (Type II).

#### **Uplift for consequences of under-investment**

30. The Commission's emerging view is that there is limited evidence of material consequences of under-investment that would require an uplift.
31. We support the Commission's emerging views approach that no uplift is required for asymmetric risk of under-investment. The Commission has rightly taken a cautious approach that recognises both the significant end user costs associated with a general uplift to the WACC, and the likelihood and impact of any potential under-investment. We believe the High Court clearly

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[https://www.researchgate.net/publication/5023795\\_Capital\\_Structure\\_and\\_Regulation\\_Does\\_Ownership\\_Matter](https://www.researchgate.net/publication/5023795_Capital_Structure_and_Regulation_Does_Ownership_Matter)

signalled in Auckland Airports that the Commission should be caution when considering any uplift and that there must be evidence to justify any proposed adjustment of that nature<sup>12</sup>.

32. Chorus submits, with a supporting report by HoustonKemp (**HK**), that substantive ongoing investment is required, and an uplift should be applied to the WACC mid-point.

There is low risk of under-investment and any impacts would be limited

33. We agree that, as noted in the technical paper, the telecommunications sector is not susceptible to the same risks as seen in Part 4 sectors.

34. We do not see evidence of the same concerns as identified by HK in its report:

***Impacts are incremental and alternatives available in an outage for key applications***

35. HK notes in its report that substitute mobile and wireless services are unlikely to mitigate the effect of an outage because these, first, rely on the fibre network and, second, mobile services aren't close substitutes.
36. However, while mobile and wireless networks do rely on the Fibre Network for backhaul, they typically rely on highly reliable - and less prone to deterioration or outage - direct fibre access (**DFAS**) links. We purchase direct fibre services for our mobile network. These direct fibre services are less complex, and have less components that can fail, than layer 2 or GPON services. Accordingly, we expect mobile networks to remain unaffected by many of the failure conditions that would concern the Commission.
37. Further, while mobile and wireless networks are not a full substitute for fibre, they do carry many important consumer and business applications such as emergency calling, email and service resiliency. For example,
- a. A significant number of consumers have voice and data mobile connections;
  - b. Operators already offer connection guarantees whereby mobile data is available in a fibre outage; and
  - c. Many of our corporate customers use links over our 4G network into sites for network redundancy purposes.
38. Accordingly, we agree with the Commission's emerging view that the availability of wireless services reduces risks associated with the fibre networks.

***Access seekers monitor specifications and performance closely and underinvestment is observable***

39. A key feature of our sector is that RSP and wholesale capabilities must be integrated in order to provide useful services to end users, i.e. the specification and quality of an RSPs service is directly related to the capability of, and integration with, the Chorus or LFC network. Therefore, RSPs are fully aware of performance changes in the wholesale providers network because we see these changes in the end services we provide to customers.
40. RSP reliance on the wholesale provider networks mean that, for example:

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<sup>12</sup> For example, see Wellington Airports at around para 1486.

- a. RSPs are directly impacted by degradation of the fibre network and monitor change closely. In practice, as noted in the technical paper, we see network degradation as observable and increasing faults or packet loss over time.

Network performance is discernible from UFB reporting and, indirectly, through our own end to end reporting;

- b. Fibre network innovation is observable by RSPs as RSPs must invest in parallel to deploy new capabilities - and to integrate with- new fibre network capability in order to realise the benefits of that innovation. For example, our service performance is impacted by single points of failure and we have been in discussions with Chorus over time relating to UFB handover redundancy.

41. Accordingly, fibre network innovation, or lack of, will not go unnoticed by the sector.

***No additional incentives are required to expand the footprint***

42. HK also suggest that an uplift would ensure further UFB expansion. It's unclear whether the Commission should promote fibre network expansion in itself - inefficient network expansion is unlikely to be consistent with Part 6 purposes.

43. Nonetheless, we already see Chorus and LFCs competing for greenfield developments – suggesting there are already incentives to expand the network where efficient – and a lack of investment for efficient network expansion will be discernible through the capex IM process. We don't agree that network expansion is a driver for an uplift.

An uplift is not in end user interests

44. HK further notes that the consequences of overstating are over-stated as, because of the price caps on anchor services, the uplift will be funded from new or higher valued services or extending the MAR. However, an uplift would still result in significantly higher prices for end users. We believe it would be difficult for the Commission agree to proposals solely on the basis that only a subset of end-users are impacted by the decision. The Act requires the Commission to consider the interests of end users and, in this case, there is no reason why the net cost of a WACC uplift are somehow different depending on which end users bear the costs. We expect that a higher MAR will flow through to all end users over time in any case.

45. We support the technical paper position, while the uplift costs are likely excessive, the limited risk, discernible outcomes from failure to invest and easy remedy, and access seeker focus on the issue means that the concerns can be managed.

46. Further, to the degree that there is a risk of under-investment, we believe that there are better mitigations within the Part 6 framework. For example, by:

- a. Ensuring expected performance outcomes are detailed in the Quality IM and PQR determinations;
- b. Including specific quality incentives in the PQR determinations as anticipated by s194 of the Act. The Commission has the specific power to set penalties for failing to maintain or improve the quality of service, including a reduction in the regulated provider's MAR; and
- c. Ensuring that an effective unbundled service is available so that Chorus and LFCs have more incentive to invest and innovate at layer 2.

## Stranded assets and truncated returns

47. The Commission's emerging view is that technology progress and the threat from competition means that the ability to compensate fibre services for type II risks through adjusting cash flows may be lower than for Part 4 businesses.
48. Under the Commission's FCM concept, once the initial capital has been estimated, depreciation in line with the benefit received in each period from the use of the assets represents the recovery of the original funds invested. The technical paper considers the possibility, however, that some of Chorus' fibre assets may be stranded in the future due to, for example, future revenues being insufficient to recover costs (partial stranding risk) or deregulation of assets or services.
49. The technical paper canvasses a range of options to address this risk include shortened asset lives, retaining assets in the RAB, or ex ante compensation through a cash flow allowance or an increment to the WACC.
50. We agree with the emerging view that, even if a material risk could be established, none of the potential solutions are appealing and some, whilst appearing simple, are unlikely to address the underlying risk. Others, whilst theoretically capable of assuaging the risks, are extremely complex and costly to design and implement in practice. For example:
- a. Explicit upfront compensation approaches face the overarching problem of forecasting the amount of additional revenue required to insure for the risk with any degree of precision where relevant events are less likely, more difficult to predict and/or entail far greater costs.  
  
The technical paper suggests that a fixed ex-ante compensation (a WACC uplift) would be easiest to implement but results in significant a challenge in estimating the magnitude of any compensation. We agree, the information difficulties are likely on a par with a fair bet adjustment and would be unreliable and results highly contentious; and
  - b. Making provision by front loading recovery or RAB retention risks, by bringing forward the recovery of costs, promoting the stranding the business is seeking to avoid by bringing forward recovery. The technical issues paper highlights the difficulties of retaining issues in the RAB.

51. An underlying difficulty with all approaches is that they require the Commission to look across prior, current and future regulatory periods, and across regulated and unregulated services that share the assets. Chorus is asking that the Commission to guarantee FCM/NPV=0 across all these domains. Even if this approach were supported by the Act – on which we have reservations - this would be extremely difficult and contentious. For example, at the Commission notes in the technical paper when considering future periods and possible deregulation, there is no reason to believe assets exiting the RAB will have more, less or the same value.
52. Accordingly, we agree that the Commission should only countenance taking pro-active steps to address potential asset stranding if the remedy is consistent with Part 6 of the Act and it is confident that those risks – and the attendant costs – are substantial.

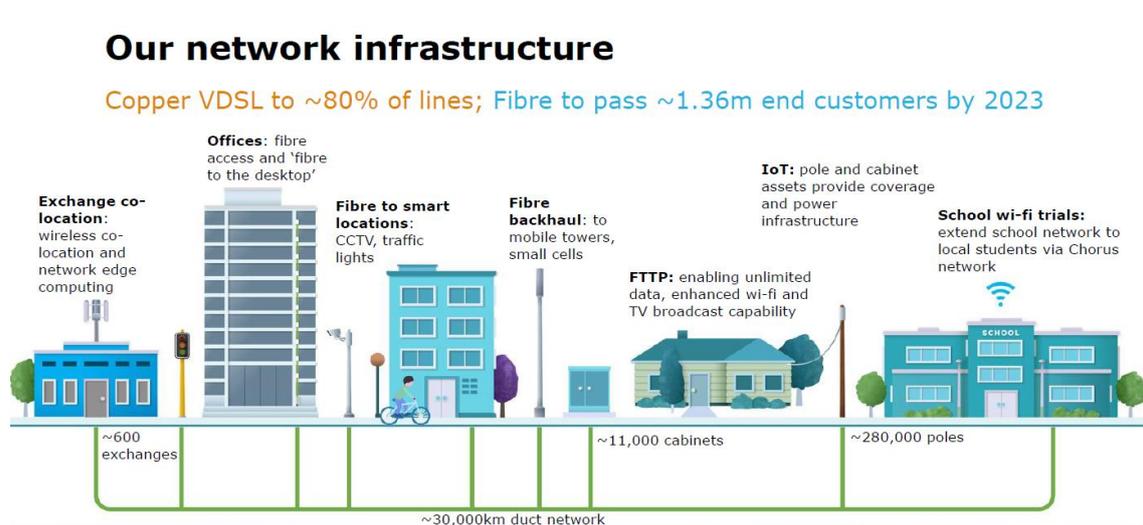
### Type II risks are likely over-stated

53. In any case, we believe that the likelihood of Fibre Network stranding has been over-stated and, while the possibility of disruptive technologies and business models can never be discounted, it is no more likely than any other business on which comparators are based (and probably less):

***There will continue to be strong demand for the Fibre Network under any future scenario***

- 54. To date, the competition concern has related to the growth of fixed wireless demand and concerns that these services may undermine Fibre Network economics. However, while we have seen fixed wireless growth over time, this has been predominantly at the expense of poorly performing copper lines. Chorus now reports minimal fibre losses to wireless operators.
- 55. Further, we are seeing significant fibre demand and data demand growth. Chorus further reports that that average demand on the fibre network is 343GB per user, and expects data demand to be 1,000GB per user by 2023<sup>13</sup>. A wireless network that can support this level of demand would make extensive use of the fibre network.
- 56. Chorus has further outlined the growth opportunities arising from higher performance fibre services, IOT delivery, expansion into the fibre to the desktop services, wireless edge computing sites and broadcasting services<sup>14</sup>. These opportunities suggest significant new Fibre Network revenues. Figure 1 highlights the range of services and capabilities of the Fibre Network.

Figure 1: Our network infrastructure



- 57. It is likely that applications will migrate to mobile networks in the same way that voice service demand is not predominantly met by mobile operators, and there will be more over time. We are seeing significant growth in mobile data demand and expect further innovation and increased growth with the deployment of new 5G networks and services.
- 58. However, new applications and services that rely on Fibre Networks are also being developed. It is not unreasonable to expect continued growth across the sector. Accordingly, while there is some uncertainty relating to the mix of Fibre Network services, there will continue to be high demand for the Fibre Network platform in any future scenario.

***Commentators stress the utility nature of the fibre network***

- 59. Further, commentators consider fibre networks to be low risk infrastructure investments, for example:

<sup>13</sup> See Q4 connections update and Investor Roadshow Presentation March 2019.

<sup>14</sup> Investor Roadshow March 2019.

- a. Chorus sets out in presentations that the fibre network is the fourth utility, has been built in partnership with Government, and suggests returns and value comparable to utility providers such as Vector and overseas national fibre utility networks<sup>15</sup>;
  - b. Moody update on Chorus highlighted that, once the BBM has been completed, it expects Chorus to display a utility like revenue profile<sup>16</sup>; and
  - c. NBN Link analysts report that fibre networks are resilient businesses due to predictable and regulated revenue streams<sup>17</sup>.
60. Commentary from interested parties indicate that Fibre Networks are not considered at risk from technology or competitive changes, rather they suggest the opposite; that this is low risk utility business.

***Flexibility has been added to the regulatory framework so it can respond to these market changes***

61. Further, flexibility has been added to the regulatory framework so it can respond to these market changes. For example, access providers have flexibility in the specification and pricing of Fibre Network services, subject to a limited number of anchor services, and consideration of Part 6 unbundled services has been deferred until the end of the first regulatory period. The Commission should avoid settings that limit this flexibility by, as discussed in our earlier submission, adopting a narrow definition of FFLAS services.
62. Submitters also suggest that the geographic price averaging obligations may increase bypass risk in high cost areas. We believe that this effect is unlikely to be significant in practice because:
- a. While costs are generally related to customer density and UFB has been rolled out only to urban areas where the relative density/costs are less significant, i.e. a suburb in Dunedin can have similar density and costs to an Auckland suburban area<sup>18</sup>; and
  - b. Some cost differences are captured through differentiated UFB funding, i.e. the Crown contributed more per home passed for UFB2 outcomes reflecting the higher costs.
63. If regional differences were a concern, the Commission could promote transparency (and flexibility to revisit this issue at a later date) by requiring specifying reporting and allocating UFB subsidies based on implied cost, i.e. zero in MDUs reflecting low costs through to higher cost UFB2 areas.

Proposed way forward

64. We support the Commission's emerging view that it does not consider Type II risks further until there is evidence of a potential concern. While there is no clear risk at this stage, all the potential options recommended by Chorus are complex and likely to be very contentious.
65. The Commission may have more information on the nature of the risk and options to resolve risks as Part 6 decisions are made. For example, BBM implementation may indicate that efficient fibre prices are on a par with or lower than current prices and this would reduce the risk and enable the Commission to apply the Part 4 remedies for this risk.

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<sup>15</sup> Page 15, Investor Roadshow

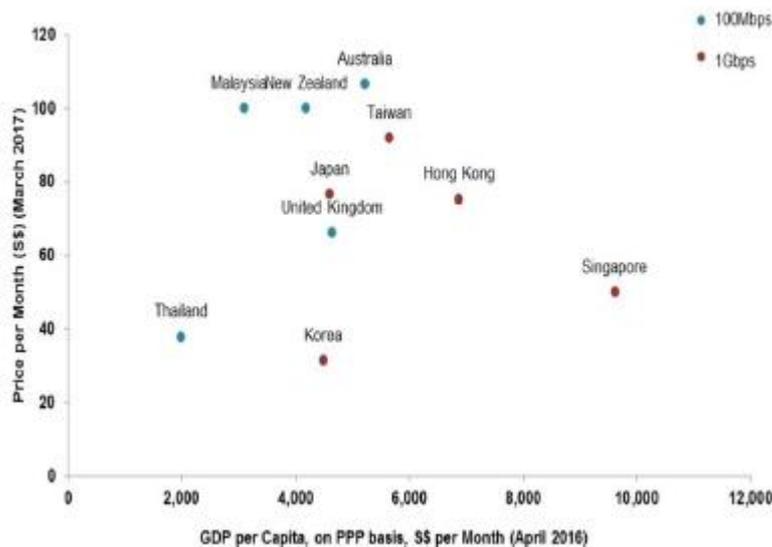
<sup>16</sup> Moody's update 5 August 2019

<sup>17</sup> For example, see DBS Group research August 2017.

<sup>18</sup> MDUs do have a lower cost to serve.

66. There is some evidence that current New Zealand fibre prices are high relative to overseas economies that we compare ourselves to, and it is not unreasonable for end users to expect prices to fall following the first regulatory period. Network Strategies estimate that the median wholesale layer 1 fibre price in benchmark countries is NZ\$25.68 per month<sup>19</sup>, significantly lower than unbundled GPON prices proposed by Chorus and LFCs. Further, as shown in Figure 2, NBN Netlink Trust benchmarking suggests that New Zealand retail fibre prices – reflecting high wholesale prices - are the second highest of the benchmark countries.

Figure 2: Fibre price benchmarking<sup>20</sup>



Source: DBS Bank

67. If BBM implementation is not expected to drive price increases (or result in a reduction in wholesale prices), then the Commission may be able to revisit other options set out in the technical paper.
68. Therefore, while the competition and stranding risk is not apparent, we agree it would be very difficult to identify and implement any approach set out in the technical paper and submissions and not something we believe the Commission could plausibly achieve within the tight 2022 timeframe. It would also be a contentious process as any approach has potentially significant implications for the competitive markets access seekers operate in.

**[End]**

<sup>19</sup> [https://comcom.govt.nz/\\_data/assets/pdf\\_file/0026/151577/Vocus-Group-New-Zealand-and-Vodafone-New-Zealand-Network-strategies-fibre-unbundling-summary-report-11-April-2019.pdf](https://comcom.govt.nz/_data/assets/pdf_file/0026/151577/Vocus-Group-New-Zealand-and-Vodafone-New-Zealand-Network-strategies-fibre-unbundling-summary-report-11-April-2019.pdf)

<sup>20</sup> See DBS analyst report, above.