Further consultation draft (initial value of financial loss asset)

Cross submission | Commerce Commission

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Introduction

1. Thank you for the opportunity to comment on submissions on the further consultation draft (initial value of financial loss asset) reasons paper (**the draft reasons paper**).

2. Chorus substantively reiterates its previously articulated positions relating to WACC and cost allocation matters that are not the subject of the current consultation. While we have not commented on the points which fall squarely outside the scope of this consultation, this should not be seen as acceptance of Chorus' proposed approach. For example, as set out in our submissions on WACC, we believe the Commission's proposed benchmark comparators over-state the required return by failing to reflect the reality of UFB and regulatory arrangements that sees risk predominantly born by Government and end users rather than the regulated provider.

3. In this submission, we comment on:

    a. Submissions relating to the 2011 expected UFB outcomes and the impossible task faced by the Commission if it sought to identify and resolve for these expectations through the Financial Losses Asset (**FLA**).

    b. Chorus cost allocation and Crown funding proposals.

    c. Vector's observation that using expected inflation for FLA purposes is inconsistent with a real return objective.

Submissions highlight the difficulty of using the FLA to solve for expected UFB outcomes

4. Chorus and Sapere submit that the Commission should seek to resolve the financial losses asset for investor expectations at the time they agreed to participate in the UFB[1] and adopt inputs for determining the FLA consistent with those expectations. As set out in our submission, this regulatory environment is not designed to satisfy the hopes and aspirations investors may have had in 2011, and to suggest that the narrow and specifically constrained financial losses provision should do such heavy lifting is well off the mark. The Act does not support the wider revaluation exercise proposed by their submissions.

5. Even If the Commission had the authority to conduct a revaluation exercise of the type proposed, submissions highlight the range of views relating to the decision to participate in the UFB initiative, including the range of expected outcomes and risks faced by the parties.

6. Chorus and Sapere, in effect, suggest that the fibre network should be considered a standalone fibre deployment project, and that the Commission should look to the markedly different Australia and the UK jurisdictions for evidence of the anticipated return on the investment[2]. However, submissions and other available to us highlight that, even if s177 anticipated resolving for 2011 expectations or overall recoupment of costs, this would be a contested and controversial approach. For example, information released at the time indicate markedly different views on the UFB initiative relating to:

    a. **The decision to participate in the UFB initiative.** Telecom UFB releases to investors highlighted the benefits across Chorus' businesses of participating in the UFB initiative rather than seeking approval for standalone fibre deployment. For example, the September 2011 investor roadshow presentation highlighted the key

[1] Chorus submission at para 52
[2] Chorus *FY20 Annual Results presentation* 24 August 2020 at page 30, repeated in investor submissions

benefits Chorus taking a lead role in the Government led fibre initiative, aligning Chorus and Government interests, and avoiding competing with Government backed fibre competition[3]. Grant Samuel characterised the two options as to being to cooperate or compete[4]. The financial business case was built around these options rather than an incremental fibre build decisions.

In essence investors were persuaded that a substantially greater threat to Telecom's financial viability would have been an attempt to compete with a government funded FTTH network.

b. **Chorus risk as a UFB provider.** Chorus was further expected to have the benefit of rolling forward with an existing high-quality customer base and stable revenue streams rather than taking on fibre specific risks[5], i.e. the UFB initiative reduced rather than increased Chorus risks. While we acknowledge Chorus continued to face business risk, the independent expert noted that Chorus was characterised as having s*trong, reliable cashflows; defined asset base in the form of network infrastructure; and few, generally strong customers (including New Telecom).*[6]

The Telecom CEO reinforced the financial and risk reducing benefits of participating in the UFB initiative[7]

> Participation really has the financial advantage of Chorus being awarded NZD929 million in funding, which will help build the UFB network ahead of demand and help de-risk the transition to these new capital intensive high speed broadband networks. So it is a very positive advantage in taking part.

c. **Fibre demand risk.** While there was uncertainty relating to fibre demand[8], UFB policy assumed that the Crown took this risk. The Government invitation to participate[9] (**ITP**) preferred commercial model anticipated the Crown assuming the risk associated with an immature fibre market. For example, the ITP set out that the

> 3. […] model therefore provides that CFH will take on the risks associated with an immature market, specifically where there may be an initial period during which the LFC's Network has insufficient End User take-up and revenues to deliver an economic return on the LFCs investment in fixed infrastructure. This will occur through CFH funding the acquisition by the LFC of its Communal Infrastructure in anticipation of End User demand.
>
> […]
>
> 7. These commercial arrangements mean that, effectively, during the Concession Period the Partner will only be required to fund that portion of the LFC's Network that is 100% utilised.

In other words, the Crown would retain fibre demand risk

> 105. This structure effectively provides that the Partner only funds that portion of the Network in respect of which an End User has been connected. The Partner only has to invest in the LFC's infrastructure in proportion to End User take-up, does not have

[3] Telecom *Separation Roadshow Presentation* September 2011 page 11
[4] Grant Samuel expert report at page 67 or page 441 of Scheme booklet
[5] Scheme Booklet at page 16
[6] Scheme Booklet at page 419. Grant Samuel noted these characteristics influenced the proposed debt allocation
[7] Transcript *Investors and Analysts Demerger Presentation* 13 September 2011 at page 5
[8] Mitigating this risk was a key policy driver for UFB
[9] New Zealand Government Ultra-Fast Broadband *Initiative Invitation to Participate in Partner Selection Process* October 2009 Appendix 2 at para 3 and 105

> to carry an investment in unused infrastructure, and so is isolated from the risk of uncertain End User take-up.

The LFCs were able to negotiate alternative models. However, the ITP preferred commercial model set the baseline against which these alternative arrangements would have been costed, i.e. the LFC would have been compensated for options whereby they accepted the demand risk. The residual transfer of risk after efficiencies comes in return for increased prices or reduced outcomes.

Whatever the case, Grant Samuel further noted in their report to shareholders that fibre uptake was not a key sensitivity for new Chorus[10].

d. **Risk of build cost over-run.** Build costs remained a key focus, although it's unclear how significant the risk of cost over-runs was. For example, officials advised the Select Committee in 2011 that LFCs were able to be reasonably precise on their build costs and that UFB prices could be accurately set through to 2019[11]. Chorus knowledge of the capabilities of its own network and build costs would likely permit it to assess build costs with a reasonable degree of certainty.

   To the extent that build risk was material, Chorus agreed fixed price contracts with service companies that provided certainty of deployment costs through the UFB deployment period. For example, in December 2014 it announced fixed price arrangements for Auckland deployment[12]. Likewise, any transfer of risk to service companies comes in return for increased input costs.

7. As the Commission rightly observes *it is unlikely that in 2011 investors' expectations were framed in terms of what a BBM with a 10-year horizon might have delivered.[13]* It also makes no sense adopting estimates of fibre returns from other jurisdictions that anticipate a significantly different allocation of risk and approach to fibre deployment.

8. However, even if the earlier 2011 expectations were expected to inform a BBM, the range of views demonstrates the difficult task faced by the Commission. It would need to resolve to the different context within which 2011 decisions were made and address potential double or over-recovery where commercial arrangements transfer residual risk for likely addition input costs.

9. In terms of applying a FLA approach that seeks to recoup shared costs across Chorus fibre and copper business, the only reliable way for the Commission to do this is to apply an approach such as the TERA cross check across both businesses. However, the Commission has indicated it is unwilling to apply the TERA approach.

10. This is the complexity and controversy s177 seeks to avoid.

Cost allocation

11. Chorus further recommends that, while the principles of allocation should be specified in the IMs, an overly prescriptive approach is unlikely to be beneficial[14]. Chorus further notes that:

[10] Grant Samuel expert report at page 71
[11] Officials' report on the *Telecommunications (TSO, Broadband, and other matters) amendment bill* 1 April 2011 at page 13
[12] https://chorus-nzx.hosting.outwide.net/api/announcements/download/2014/aec7258c-94a5-45b0-9b20-12bcd886b867/43529657-379e-4616-a6e8-a03b0ed5fffe/206196.pdf
[13] Commission draft at 3.29
[14] Chorus 10 September submission at 118

a. Context is required when considering cost allocation as some costs that benefitted copper were only incurred because of FFLAS[15]. While unclear from the submission, we take it that Chorus is proposing to also consider *benefit received* in choosing an allocator and not rely solely on, say, a measure of capacity used.

b. It may not be able to support some possible cost allocations or filtering due to limitations of the information available from Chorus systems[16].

12. We agree that selecting from a list of cost allocators, on its own, is unlikely to be beneficial and produce outcomes consistent with the purposes of the Act. The Commission should prescribe the approach that best promotes the Part 6 end user and competition outcomes.

13. Chorus' submission highlights:

a. That if Chorus had the leeway to apply a benefits received approach, it would have opportunities to maximises its returns beyond what could be achieve if the Commission set more prescriptive guidance based on the purpose of Part 6.

b. That applying filters to the shared costs - i.e. applying filters relating to geographic footprint of the UFB networks, usability, timing - may not reduce cost allocation concerns as the Commission had hoped[17].

c. That the PQR process must be alive to, and seek to mitigate, Chorus incentives[18] to apply allocators that maximise Chorus' return rather than advance the purpose of Part 6.

14. The Commission set out in the draft reasons paper practical concerns relating to allocation of shared costs[19] and potential tools for mitigating the providers incentives to over-allocate shared costs to fibre services[20]. We agree that the options set out in the draft reasons are worth pursuing further[21].

15. The risk inherent in Chorus' submission reinforces the importance of setting prescriptive guidance in the IMs through, for example, cost allocation principles. This can be done by, for example,

a. Specifying that the relevant costs for the purposes of the FLA relate to those specifically incurred as a consequence of providing FFLAS in the UFB initiative.

b. That only efficient allocations to the fibre network should be permitted.

c. Clarifying in the IMs that the avoidance of double recovery and windfall gains is a consideration for selecting the allocator (in additional to cost causality).

d. Signalling that the Commission will apply an overall cost allocation cap for any shared costs and assets.

[15] Chorus at para 119
[16] Chorus at para 120
[17] Draft reasons paper at 2.88
[18] Chorus has strong incentives to maximise the allocation of the costs of existing assets in to the financial loss calculation, and this risk is heightened by the age of some assets, the ability to configure the network to over-allocate costs and the information asymmetries held by Chorus. Chorus' submission reinforces these concerns.
[19] Draft reasons paper at 2.85
[20] Draft reasons paper at 2.101
[21] Draft reasons paper at 2.96

16. These principles would be in addition to proposed PQR process measures such as benchmarking of costs, applying a TERA cross check and ensuring a wide consultation process and transparency.

Crown contributions that are not Crown funding

17. The Commission revised its decision on the funding of non-standard connections in the July 2020 updated draft reasons paper[22], concluding that the commercial arrangement between the Crown and Chorus should be treated as capital contributions[23].

18. However, Chorus has submitted that it disagrees with approach and intends to engage further on the issue through the PQ determination process[24]. Chorus proposes to facilitate this engagement by amending the draft IM to reference the *value of the obligations assumed by Chorus* under the settlement agreement with the Crown[25].

19. Without Chorus disclosing the settlement agreement, it is unclear what the implications of narrowing the nature of a capital contributions to *value* will be in practice.

20. Nonetheless, we agree with Chorus that the Commission could consider Crown contributions as part of the PQR process, in the same way that it will consider capital contributions from any other party. In our earlier submission we suggested that the Commission may wish to amend the definition of capital contributions to clarify that contributions from any other party *includes any Crown contribution except where it is Crown funding as defined by the Act*.

21. On reflection, the Commission could delete the specific reference to the settlement agreement and, instead, consider the Crown contribution through the settlement agreement along with other Crown contributions as part of the PQR process as we have proposed.

Real versus nominal returns

22. Vector highlights in its submission a potential disconnect between the expected inflation rate applied

23. Vector notes that the Commission has acknowledged that, over the Pre-Implementation Period, expected inflation using the IM inflation forecasting methodology was materially higher than actual inflation compensating for expected inflation in the discount rate[26]. Therefore, using a historical discount rate without adjusting the embedded historical expected inflation in the discount rate for the FLA for Chorus and LFCs will provide a windfall gain[27].

24. Vector's submission suggests that, in seeking to identify real returns, there may be a material over-statement of costs where forecast inflation was higher than actual inflation. We agree the Commission should consider this disconnect further, particularly as it relates to required equity returns for the FLA period.

[End]

[22] Commission July 2020 draft at 3.55
[23] Commission draft at 3.63
[24] Chorus at para 48
[25] Chorus at page 3 of appendix A
[26] Vector 10 September 2020 submission at para 7
[27] Vector at para 8