



## Fibre information disclosure and price-quality regulation: proposed process and approach

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## Executive summary

The Commission has started the process for determining Information Disclosure (ID) and Price-Quality (P-Q) regulation.

We support many key aspects of the Commission's proposed approach, for example

- The planned approach aims to mitigate Chorus incentives to act in a manner inconsistent with the purposes of the Act and to misuse information asymmetries it holds.
- Recognising these incentives, the Commission has confirmed that it will consult widely – drawing in the expertise parties can bring to key decision – and determine the price-quality parameters.
- The approach paper anticipates comprehensive ID requirements applying to prices and across a wide range of dimensions. These requirements are supported by a recognition that ID information must be readily available to parties - in a disaggregated form where necessary - so that the public can assess whether Part 6 purposes are being met.

### Setting service performance

The process paper further confirms that the Commission does not anticipate setting or approving service descriptions for regulated services in the first regulatory period. We believe that a reluctance to specify any of the technical and operational characteristics that will determine much of a fibre customer's service experience is a key gap in the proposed framework and too big a departure from existing regulatory structures.

Commission set regulated service descriptions is a key part of Standard Terms Determinations provided for by Part 2 of the Act, reflecting the ability for regulated telecommunications to shade quality outcomes by amending wholesale service terms and the significant impact relatively minor changes to wholesale service terms have on RSPs and services they provide to end users. Controlling services should be a key feature of Part 6 regulation.

Accordingly, we believe that the Commission should be applying similar controls to fibre regulated services to maintain service quality for end users. We recommend that – at a minimum to make issues transparent and facilitate the Commission returning to this matter – ID require full disclosure of service and operational descriptions and any amendments to these descriptions, including Chorus' own FFLAS use.

### Price volatility

The Commission has also requested comments on the measures it might take to mitigate price volatility for regulated services that are not “declared” price capped services.

We agree that the proposed revenue cap approach leaves end users exposed to price volatility and support the proposed measures. However, these measures are at an aggregate level and are unlikely to be effective given the uncertain demand and price of services that are not price capped. For example, it's unclear what the demand of higher speed and priced broadband services will be relative to the anchor service and this uncertainty leaves uncapped services susceptible to price volatility, particularly data tails used by our business customers.

We recommend that Commission also consider a service specific price change cap, and maximum number of price increases per annum.

### The wash up

The Commission has further asked for comments on how the wash-up should be applied. We agree that section 196 leaves the Commission with discretion to identify the revenues that are under or over recovered and that it can adjust these revenues relative to the earlier period BBM.

However, to be consistent with the purposes of the Act, the wash-up mechanism should only relate to revenues the provider is entitled to receive in the regulatory model, consistent with the intended properties of the control mechanism. For example, the wash-up should not work to insure against risks for which Chorus has specifically been compensated for in the regulatory model such as for stranded assets. To do so would result in a double or over recovery inconsistent with the Act.

Accordingly, we recommend that the Commission should consider its approach to the wash up further, particularly any adjustments relating to the assignment of all demand forecast risk to end users, the stranding of any assets for the which specific compensation has been provided, and to reflect any reduction in services quality or operational changes that have the effect of shifting of costs on to other parties or end users.

## Introduction

1. Thank you for the opportunity to comment on the Commission's *Proposed process and approach for the first regulatory period paper* (**the approach paper**).
2. The approach paper sets out the proposed approach to applying price-quality and information disclosure regulation.
3. We support many key aspects of the proposed approach:
  - a. The proposed approach aims to reflect and mitigate Chorus information asymmetries and incentives to act in a manner inconsistent with the purposes of the Act<sup>1</sup>.

Chorus incentives are to maximise allowable revenues, minimise actual expenditure through the regulatory period and distort competition. Further, the Commission faces information asymmetries and regulated engaging in a manner to optimise their regulatory positioning.
  - b. The Commission has confirmed that while Chorus will make a proposal and provide necessary information, the Commission will determine the price-quality settings<sup>2</sup>.
  - c. The approach paper anticipates comprehensive information disclosure (**ID**) requirements applying to
    - i. The price of regulated services so that it may consider RSP and end user concerns<sup>3</sup>.
    - ii. Quality across a wide range of dimensions. We will be participating in the planned Q1 2021 workshop<sup>4</sup>.

The seeks to maxime ID benefits by ensuring that information is readily available to interested parties<sup>5</sup> in a disaggregated form so that parties can assess whether Part 6 purposes are being met<sup>6</sup>.
4. Nonetheless, in this submission, we recommend:
  - a. The Commission consider further how regulated service definitions and operational processes are set and evolve over time.
  - b. Respond to Commission requests for input on how:
    - i. To mitigate the risk of price volatility for services that are not protected by a declared service price cap, and
  - c. Adjustments to the application of the wash-up.

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<sup>1</sup> The approach paper at 3.95

<sup>2</sup> At 3.96

<sup>3</sup> At 3.102

<sup>4</sup> At X70 and 2.26

<sup>5</sup> At X42

<sup>6</sup> At X45

## Controlling regulated services

5. As set out earlier in the context of input methodologies, RSPs need certainty of service specifications of wholesale services and confidence in how these specifications evolve over time so we can invest in our systems and services.
6. Defining the regulated service is important in the fibre regulatory context because:
  - a. **There is significant scope for providers are able to shade telecommunications service quality.** Telecommunications services have multiple quality dimensions and require multiple interactions with customers – there is significant scope to shade service quality.
  - b. **Chorus and LFCs have strong incentives to reduce outcomes or shift costs to retailers with the proposed Part 6 approach.** As Chorus and LFC revenues are largely fixed over the regulatory period, wholesale providers have strong incentives to reduce output and costs, or shift costs on to RSPs.
  - c. **Wholesale service performance directly impact end users.** While RSPs require certainty to build products and minimise costs over time, changes to service specifications flow quickly to end user service experience. End user service experience is determined by processes across wholesale and retail platforms and changes at the wholesale level directly impact customers.
7. However, at this stage, the process paper proposes that for first PQR regulator period, revenue and quality will apply at a network aggregate level<sup>7</sup>.
8. Commission setting regulated service descriptions is a key part of Standard Terms Determinations provided for by Part 2 of the Act, reflecting the ability for regulated telecommunications to shade quality outcomes through by amending wholesale services and the significant impact relatively minor changes to wholesale services have on RSPs and services they provide to end users.
9. We believe that Commission oversight of service and operational specifications for fibre regulated services is a key Commission roll in price-quality regulation setting.
10. The Commission has taken steps that reduce concerns:
  - a. The recent equivalence and non-discrimination guidance helpfully confirms that Chorus and LFCs must provide the same inputs - and use the same processes to change existing or develop new services - as it does for its own downstream business. While incomplete we expect this should provide a limited constraint on some input services, i.e. the practical consequences of service changes would also impact Chorus' own operations.
  - b. Further, information disclosure (ID) requiring disclosure of service and operational descriptions and amendments to these descriptions potentially help make transparent changes to regulated services.
11. However, at this stage it is unclear whether ID will extend to service and operational descriptions. The Commission plans to hold a quality workshop on current fibre industry practices, service levels and relevance of Part 4 lessons in Q1 2021<sup>8</sup>. Further, we believe these

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<sup>7</sup> At 5.15

<sup>8</sup> At X70, 2.26 and 4.45

measures can only ever partially resolve performance concerns. For example, ID will only make some risks transparent at best, and we should expect Chorus and LFCs to consider only their own costs rather than overall wholesale and retail costs in making changes to regulated services.

12. We believe that the Commission should consider regulating price and quality of fibre services by specifying the key terms of regulated services as it did for Part 2 STDs. This could be easily done by, for example, setting service descriptions based on the existing wholesale service agreements with an amendment approval process.
13. The Commission could facilitate this by:
  - a. Ensuring ID requirements make transparent wholesale service descriptions and operational processes and changes to those descriptions.
  - b. Close monitoring of EOI and non-compliance compliance to ensure these are effective, i.e. so that Chorus is required to use the same service and operational processes for its own downstream businesses.
  - c. Aligning the proposed wash-up adjustments so that changes to service quality or operational processes that have not been agreed with retail service providers are reflected in the wash-up calculation (discussed below).

## Minimising price shocks for end users

14. The Commission has also requested comments on how it might manage price shocks for end users<sup>9</sup>, particularly for those end users not receiving a price capped declared service.
15. The Commission notes that in Part 4 regulation it has assessed price shocks in terms of the rate of increase in allowable revenues<sup>10</sup>. However, a significant proportion of Chorus' revenue will be determined by the uptake of declared price capped services<sup>11</sup>, and Chorus can only control the prices for other services that are no price capped in recovering its allowable revenue.<sup>12</sup> This means that the foregone revenue from any differences between expected and actual demand, for example, could be recovered from a minority of services (resulting in price shocks).
16. The process paper notes that limiting the rate of revenue increases when specifying the revenue path is the primary mechanism for constraining price increases.<sup>13</sup> The process paper notes that the risk could be further mitigated within the regulatory period by:
  - a. In terms of assessing compliance, using the demand forecast from the start of the period rather than from each year within the regulatory period to limit the impact on non-declared service prices.<sup>1415</sup>
  - b. Revenue smoothing at the gross revenue level to limit volatility caused by changes in pass through costs<sup>16</sup>.

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<sup>9</sup> At 5.83

<sup>10</sup> At 5.48

<sup>11</sup> At 5.51

<sup>12</sup> At 5.52

<sup>13</sup> At 5.54

<sup>14</sup> At 5.61

<sup>15</sup> For example, if actual demand were less than forecast and an annual demand used, then more allowable revenue (price increases) would be permitted for non-anchor services.

<sup>16</sup> The approach paper at 5.66

17. We agree, the proposed regulatory framework leaves significant price volatility risk on uncapped services and this should be a concern for the Commission. Accordingly, we support the proposed mitigations as, recognising there is uncertain demand, the differences are better managed in the wash-up account than by permitting pricing volatility for end user prices.
18. However, even with these measures, there is likely to be significant risk in the first regulatory period that actual demand for regulated services varies to forecast or that forecast prices vary to achieved prices. While applying a separate whole of regulatory period forecast to declared and non-declared services may ring-fence this risk, uncertainty remains within non-declared service forecasts and this could drive price volatility for these services. For example, less customers may adopt premium high speed broadband services than expected (preferring to stay on the broadband anchor service) and this would increase allowable revenue to be recovered from other services (such as business data services). Around 30% of Chorus mass market fibre broadband customers are on premium non-anchor variants, and there is uncertainty what the adoption of higher speed accesses will be over the regulatory period<sup>17</sup>.
19. Therefore, we believe the price shock risk is best mitigated with a per service price cap. We recommend that the Commission consider, for example, controlling prices so that no service price may vary by more than, say, 10% per annum and that a services price may change no more than once per 12 month period.

## Wash-up

20. The paper also sets out the general features of the wash-up mechanism required by s196 of the Act and the options available to the Commission in applying the wash-up<sup>18</sup>.
21. The Commission plans to adjust the wash-up to take in to take account of the range of risks and uncertainties within the model, including the transitional implementation issues relating to the RAB and allowable revenues, and differences between forecast and actual CPI, and differences between actual and forecast cost allocators<sup>19</sup>.
22. We agree that the Commission should adjust the wash-up to ensure it is consistent with the regulatory model it is implementing. Section 196 provides that the wash-up mechanism provides for any over-recovery or under-recovery of revenue by the regulated fibre service provider during the previous regulatory period. Accordingly, the Commission has the discretion to determine the revenue against which there is an over or under recovery consistent with the purposes of the Act.
23. However, the Commission should consider the proposed adjustments further. We believe that the Act requires the wash-up mechanism to relate only to revenues the provider is entitled to receive in the regulatory model, consistent with the intended properties of the control mechanism. For example, the wash-up should not work to insure against risks for which Chorus has specifically been compensated for in the regulatory model such as the proposed asset stranding premium. To do so would result in a double or over recovery that all consider inconsistent with the Act.
24. Conversely, we do not agree that s196 requires an unlimited wash-up, there are situations where the wash-up could be capped where this reflected the intended properties of the control mechanism. For example, where the regulatory model anticipated a sharing of demand risk between providers and end users.

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<sup>17</sup> From graph Chorus Q1 FY21 Connections Update 9 October at page 7

<sup>18</sup> The approach paper at 5.84

<sup>19</sup> At 5.91 and X60

25. Accordingly, we recommend that the Commission could consider further its approach to:

The allocation of risk relating to actual to forecast demand.

26. The Commission's draft approach assumes that a maximum revenue specified price path must allocate all demand risk to end users. However, it is unclear why this is necessarily the case as a revenue cap model can be applied to share the risk with the regulated provider. Section 196 does not tie the wash-up to any particular revenues, and the Commission has considered demand risk allocation in past revenue caps. For example,

- a. The Commission applied a cap on EDBs wash-up amount in order to share the risk between the distributor and consumers that the quantities of services provided are significantly lower than forecast quantities<sup>20</sup>, and
- b. Further, the Commission considered a range of factors – i.e. the ability to forecast and influence demand, efficiency, and price stability – in deciding to move GTBs from a lagged demand to a current demand revenue cap<sup>21</sup>.

27. The AER further notes that ActewAGL is subject to an average revenue cap and therefore faces the revenue increases or decreases associated with volume risk (i.e. actual volumes being different from forecast) over the current regulatory control period<sup>22</sup>.

28. Accordingly, the Commission should consider whether Chorus is better placed to manage and influence fibre network demand, what approach will best promote efficient outcomes and purpose of the Act, and would be consistent with the intended properties of the BBM. For example, at a minimum, the approach should align the approach to demand differences with the risks faced by the comparator group used to estimate WACC.

Ensuring the wash-up is aligned with other BBM control properties

29. Further, the Commission should ensure that the wash-up is aligned with the intended properties of the BBM control settings. The Commission is implementing incentive regulation with specific properties and the wash-up should align with these properties. For example,

- a. The Commission has determined that a premium be applied to RAB assets in order to compensate regulated providers for stranding risk. As Chorus has already been compensated for this risk, if the risk were to eventuate then an adjustment should be made to the wash-up calculation to avoid the double recovery of cost.
- b. An adjustment to reflect any reduction in services quality or operational changes that have the effect of shifting of costs on to other parties or end users.

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<sup>20</sup> Commerce Commission, 27 November 2019 *Default price-quality paths for electricity distribution businesses from 1 April 2020 – Final decision Reasons paper* Date of publication at H123. [https://comcom.govt.nz/\\_data/assets/pdf\\_file/0020/191810/Default-price-quality-paths-for-electricity-distribution-businesses-from-1-April-2020-Final-decision-Reasons-paper-27-November-2019.PDF](https://comcom.govt.nz/_data/assets/pdf_file/0020/191810/Default-price-quality-paths-for-electricity-distribution-businesses-from-1-April-2020-Final-decision-Reasons-paper-27-November-2019.PDF)

<sup>21</sup> Commerce Commission Input methodologies review decisions, 20 December 2016 *Topic paper 1: Form of control and RAB indexation for EDBs, GPBs and Transpower* at para 178 [https://comcom.govt.nz/\\_data/assets/pdf\\_file/0018/60534/Input-methodologies-review-decisions-Topic-paper-1-Form-of-control-and-RAB-indexation-for-EDBs-GPBs-and-Transpower-20-December-2016.pdf](https://comcom.govt.nz/_data/assets/pdf_file/0018/60534/Input-methodologies-review-decisions-Topic-paper-1-Form-of-control-and-RAB-indexation-for-EDBs-GPBs-and-Transpower-20-December-2016.pdf)

<sup>22</sup> AER submission to Australian Energy Market Commission draft rule *NSW and ACT revenue smoothing rule change* June 2017 at page 8. <https://www.aemc.gov.au/sites/default/files/content/61e5ddf7-1387-49d6-9d92-31d1eb43c7a5/RuleChange-Submission-ERC0210-ERC0216-Australian-Energy-Regulator-170623.pdf>

30. While it may be difficult to specify the adjustment that will apply to reflect actual outcomes ahead of applying the washup, the Commission should signal at this stage the principle that only entitled revenues will be washed up, and only where it is consistent with the properties of incentive regulation it is applying.

**[End]**