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TelcoFibre@comcom.govt.nz

Submission on Fibre regulation emerging views: Technical Paper

Northpower Fibre Limited and Northpower LFC2 Limited



Thank you for the opportunity to provide feedback on the Fibre regulation emerging views: Technical Paper (**Paper**).

As you know, Northpower Fibre Limited and Northpower LFC2 Limited (together, **Northpower Fibre**) are responsible for the construction and operation of the Ultrafast Broadband (**UFB**) network in the Whangarei and Kaipara districts. Its UFB area accounts for approximately 1.6% of the national UFB network with a potential 33,000 connections once build is complete.

Northpower Fibre is and continues to be focused on delivering a superior retailer and consumer experience and a high level of service which represents value for money to our consumers.

Northpower Fibre remains supportive of and comfortable with the direction and approach that the Commission is taking in developing the input methodologies (**IMs**). On that basis, we have chosen to focus on only the key issues of importance to us in this submission.

We are aware that a submission has been prepared by the other local fibre companies (**LFCs**), Ultrafast Fibre and Enable Networks. We agree with the general principles of that submission.

General Comments

Proportionality

1. As noted in our submission on the Commission's discussion paper, Northpower Fibre remains concerned about the proportionality of the burden of compliance costs with the size of Northpower Fibre's business. We note in the Paper that the Commission recognises the LFCs are all significantly smaller entities than Chorus, with much fewer potential end-users, and the Commission has queried whether or not it would be appropriate to have different input methodologies for the LFCs (as opposed to Chorus) to reduce the regulatory burden they will face. The Commission concluded that the benefits in having standard IM's covering all entities outweighs the potential burden faced by LFCs. We disagree that this will always be the best approach. We believe the benefit of having proportionate regulatory obligations will be reflected back in efficiency and superior service provided to consumers. We discuss this more throughout our submission.

Principle-based regulation

2. The purpose of IMs, under s174 of the Commerce Act 1986 (the **Act**), is to promote certainty in relation to the regulation of FFLAS services. This will be achieved through stable and durable regulatory rules, and in particular stable and durable IMs.

The experience of Part 4 of the Act is that certainty develops over time, if the IMs are stable and the methods around them become increasingly predictable.

3. To achieve stable and enduring IMs, we support IMs which are principle-based rather than prescriptive. This will allow the IMs to remain stable, while specific implementation of those rules can evolve with the market as necessary, and that evolution will be somewhat predictable as a result of the IMs. Additional prescription can be included, as necessary, in specific price-quality and ID determinations.
4. This is the approach which has worked successfully for the Part 4 IMs. For example, the Part 4 cost allocation IM has proven to be durable in the presence of emerging technologies and evolving operating models.
5. As highlighted in the Paper, there is significant uncertainty regarding the future of FFLAS networks and markets, more uncertainty than was present when the Part 4 IMs were determined. This suggests that it may be beneficial for the Part 6 IMs to incorporate more flexibility than the Part 4 IMs, in order to be more enduring. This makes principle-based IMs even more important.
6. Principle-based rules can allow businesses to use their own processes and systems to comply, rather than being mandated to change to a new process/system specifying how RAB assets are to be captured and recorded solely for regulatory compliance purposes. This minimises compliance costs, and avoids 'second-guessing' businesses' own internal decisions. It is proportionate for LFCs, which is a critical factor for Northpower Fibre as discussed above.
7. We consider that the IMs should avoid unnecessary complexity wherever possible, as this only increases compliance costs. In order to help minimise compliance costs, we support:
 - a. The use of GAAP-based information where reasonable (this avoids unnecessary costs of managing non-GAAP financial information solely for regulatory purposes);
 - b. The emerging view for a principle-based approach to ring fencing assets to be included in the regulated service, including a cost allocation IM which does not prescribe actual allocators;
 - c. An asset valuation IM which does not prescribe levels of asset granularity (our asset information is currently grouped based on asset types, commissioning dates and useful lives, which is sufficient to produce a RAB register).
8. We do not support additional regulation for specified FFLAS services or emerging competition, as suggested by some submitters. We support the emerging view in this respect.

Minimising burden of ID requirements

9. The ID requirements must strike a balance between providing sufficient information to achieve the monitoring objectives of ID, and minimising unnecessary complexity and compliance costs. This balance is not always straightforward to achieve, and care should be taken to avoid unnecessary regulatory burden, particularly for relatively small businesses like Northpower Fibre. We submit that the current level of information disclosure strikes the right balance.
10. As FFLAS businesses face competition (as opposed to many Part 4 regulated businesses who do not face such competition) there is more risk of disclosed data being commercially sensitive and detrimental if made available to competitors. This must also be considered when determining ID requirements.
11. We suggest that tightly defined disclosures, similar to the current requirements, should be the first step. If subsequent evidence emerges that this is insufficient for monitoring purposes, the information requirements can be incrementally increased.

Regulatory Cost of Capital

Parameter estimates

12. For estimation of cost of capital (WACC) parameters, we support consistency in approach between Part 6 and Part 4 of the Act. We have no issue with the Part 4 estimation approaches being used for Part 6, assuming they are adequately tailored to the Part 6 and FFLAS context.
13. However, we do not support relying on the Part 4 estimate values themselves. We submit that each parameter should be estimated specifically for Part 6. This is because all of the estimates used for Part 6 need to be internally consistent, and relevant to the context of FFLAS and its providers. For some parameters, consistency in approach may lead to the same value being applied in Parts 4 and 6, but this should be an outcome rather than by design.

Information disclosure

14. We support the use of a range for the information disclosure (ID) WACC, rather than a single benchmark point-estimate (i.e. the same approach that is used for the electricity distribution ID WACC), for the following reasons:
 - a. A point estimate is necessary for price-setting purposes, because it is an ex-ante value used to derive a single price path. But the purpose of the ID WACC is different. It is an ex-post measure, used for monitoring purposes (under s186 of the Act), and is not constrained to a single point-estimate.
 - b. Actual returns may diverge from target or forecast returns, due to unexpected demand or cost changes.

A benchmark range incorporates that fact, and avoids actual returns moving outside of a target level simply due to 'normal' volatility.

- c. Northpower Fibre will be exempt from price-quality regulation, and will not have the same incentives as Chorus to set prices and manage debt within a given regulatory period. It may therefore be appropriate for it to smooth prices and/or returns over years, and to use different input assumptions for determining target returns in a given year. A benchmark range allows for that efficient flexibility.
 - d. The use of a range has worked well in the context of Part 4, and there is no reason why it shouldn't also work well in the context of Part 6.
15. We support consistency with the approach used for electricity distribution ID WACC – that is, the use of the 25th and 75th percentile estimates to determine the range.
 16. We support periodic updates of the ID WACC range. Aligning the periods over which the ID WACC is updated with the periods used for price-quality regulation may be a useful low-cost approach.
 17. We consider that the ID WACC for LFCs should not necessarily be the same as that used for Chorus. LFCs have a different risk profile to Chorus (in particular Northpower Fibre is exposed to city/town-wide competition from Chorus), and hence should adopt a higher asset beta estimate. Furthermore, if Northpower Fibre becomes subject to price-quality regulation in the future, a price-quality WACC for Northpower Fibre will need to be determined (which may differ from Chorus'), and the IMs should allow for that.

Stranding risk

18. There are a number of regulatory tools that can be used to recognise and provide appropriate allowances for stranding risk. The issues that need to be considered are whether ex-ante or ex-post allowances are appropriate, and whether partial or complete stranding is contemplated.
19. As identified in the consultation paper, these tools include:
 - a. Retaining stranded assets in the RAB;
 - b. Accelerated depreciation;
 - c. Some form of compensation allowance;
 - d. An uplift in the WACC.
20. In addition, an unindexed RAB approach may also mitigate stranding risk.
21. We consider that an ex-ante tool is more appropriate than an ex-post tool. There is a risk that ex-post mechanisms cannot be applied in practice, and the impact on end-users may be material.

An ex-ante tool spreads the risks and impacts over time and over a wider group of end-users.

Quality Standards

The specificity of IMs

22. We do not consider that the quality IM should set out the specific quality metrics required to be disclosed for ID purposes. We consider that the IM should describe the overall approach to quality standards at a high level, and leave the specific disclosure requirements for the ID Determination (IDD). This could include a description of the services to be regulated, but not metrics or measures, which are better suited to price-quality and ID determinations.
23. The main reason for this is that the specific metrics are likely to evolve as the regulatory regime matures and the networks and technology change. If any changes to the specific quality measures can be managed through amendments to the IDD rather than the IMs, this makes the IMs more durable.

The measures included for ID purposes

24. We do not consider that the same metrics used to set Chorus' price-quality path should necessarily be used for ID purposes for Northpower Fibre. The relevance of each metric should be separately considered against each of the two types of regulation and their respective purposes.
25. While many measures of service quality are largely within our control, many others are not. For example, internet speed at the premise will be affected by the routers retailers or consumers use and Northpower Fibre has no control over this. We submit that the ID quality metrics should focus on the former, and exclude the latter. If metrics are included which are largely outside our control, this will make monitoring of our performance via ID unnecessarily difficult.
26. We currently publish a number of metrics regarding the quality of our services. These include outage times for faults and layer 2 traffic measurements. We consider that these measures cover all areas of our FFLAS, and are sufficient for Part 6 ID monitoring purposes.
27. We do not support any requirement which necessitates that we create new systems to measure particular information. The cost of creating such systems can be significant, and we expect that the benefit to users of having access to this new information would not outweigh the costs of providing it. Before the Commission decides to include any such requirement, we submit that it should demonstrate that the likely benefit outweighs the cost.

Assets and Financial Losses

Asset valuation

28. We support the emerging view to recognise assets in the RAB once they are commissioned for providing FFLAS.
29. We support a consistent approach to asset valuation between Chorus and the other FFLAS businesses.
30. We support further analysis of the merits of whether, and how, the RAB should be revalued. If revaluations are included, we support the use of CPI, for simplicity and its consistency with Part 4 businesses which have a revalued RAB. However, the Paper discusses an alternative approach applied to Transpower, where the RAB is not revalued, and we consider that the relative merits of this approach require further consideration. As noted above, one benefit of such an approach is that it would mitigate asset stranding risk.
31. We support a process for establishing the initial RAB which is led by the businesses themselves (with audit and certification support as necessary). This worked well when developing the Part 4 initial RAB values, and appropriately minimises compliance costs.
32. It is proposed that the initial RAB include all existing assets which are used to supply FFLAS. We note that, the majority of those assets are recorded in Northpower Fibre's financial reporting accounts, but a small number are reported elsewhere. It is our understanding that, when the initial RAB is established, all relevant assets will be included, regardless of their historical reporting.

Financial Losses

33. We support the amortisation of financial losses over time. This ensures financial capital maintenance, and is consistent with the legislation. We consider that the weighted average remaining life of the physical assets (at the time of the initial RAB) is an appropriate period over which to amortise the financial loss value, since it aligns the recovery of the cost of investing in the initial assets with the period over which those assets will be used.
34. When applying the asset valuation, cost allocation, cost of capital and taxation IMs, and hence in calculating building blocks revenue, we support consistency between past financial losses and future profitability assessments. We make the following specific points in this regard:
 - a. The approach to determining the WACC should be the same for past and future periods (although the WACC values will differ).
 - b. The regulatory tax method needs to be applied retrospectively to calculate past losses. We assume that this method will include a roll-forward of regulatory tax losses during the historical years, and there may be some unused regulatory tax losses at implementation date.

Crown-funded assets

35. We support the emerging view to, for the purposes of calculating past financial losses, exclude Crown-funded assets from the return on capital building block but include them in the depreciation building block.
36. We consider that this is an appropriate treatment, ensures financial capital maintenance, and recovers costs over an appropriate timeframe. It also avoids the complexity associated with alternative options.
37. We note that allowances for the cost of Crown funding could be included within opex. When the initial RAB is established, FFLAS businesses should be able to determine the magnitude of these costs.

We thank you again for the opportunity to provide feedback, and look forward to continuing to work closely with the Commission in developing the regulatory framework for fibre, for the benefit of all consumers.

Please contact Darren Mason (darren.mason@northpowerfibre.co.nz) if you would like to discuss any aspect of this submission further.



Darren Mason

Chief Executive

Northpower Fibre Limited