



**Cross-submission to the Commerce
Commission on the technical
consultation paper “Determining
the cost of capital for UCLL and
UBA price reviews”**

11 April 2014

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Introduction

1. We appreciate the opportunity to comment on the submissions made in response to the Commerce Commission's technical consultation paper, Determining the cost of capital for the UCLL and UBA price reviews, 7 March 2014.

Summary

2. In summary we have the following observations:
- a. Other submissions do not change the Orcon submissions, including that the Commission is required to undertake an empirical analysis under s 18
 - b. Chorus' submission (particularly that of CEG) would require the Commission to re-open aspects of the cost of capital IMs in order to consider "new material". We question whether the timetable the Commission has set for the FPP determinations would allow adequate time for this.
 - c. We agree with the framework Orcon sets out for determining whether to deviate from a mid-point WACC.
 - d. Enable should not assume that higher regulated copper access prices will translate to higher copper prices in the areas that Chorus' competes against Enable and other LFCs.
 - e. We agree with Transpower that the Commission could set a different (lower) percentile WACC for UCLL and UBA under Part 2 of the Telecommunications Act than it does for energy under Part 4 of the Commerce Act. We agree with the example provided by PricewaterhouseCoopers which supports this view.
 - f. Our submission detailed grounds why there may be justification to treat telecommunications and energy differently, when setting WACC. This was not intended to be a comprehensive list. We provided further examples of reasons in support of this proposition in our cross-submission.
 - g. We consider that Vector's submission is unduly focused on the access providers' incentives to invest in (old technology) copper. Part 2 is explicit that the focus of investment incentives should be on new services, whether offered by the access provider, access seekers or other network operators.

Enable's submission supporting a high copper WACC

3. Enable's submission argues that the Commission should set an above mid-point WACC effectively on the grounds that the price of copper services would impact on the competitiveness of fibre, and impact on the transition to fibre.

4. CallPlus cautions against the Commission accepting these arguments:
 - a. The Commission should set a level playing field on which copper and fibre can compete on the basis of the respective cost and service merits.
 - b. As noted in our previous submission, artificially raising the price of copper services to protect fibre would be akin to trade protection.
 - c. We are also doubtful Enable would get the outcome they hope for from the Commission setting an above mid-point WACC/higher copper access prices.

5. The experience of Saturn's (now Vodafone) roll-out of a cable network in Wellington and then Christchurch is instructive. The incumbent, the pre-Chorus separation Telecom, lowered its prices on a street by street basis to compete against Saturn. Chorus can be expected to respond similarly, if it operates in a profit maximising manner, by lowering its prices in LFC areas. Chorus is liable to price at a point that is below 75th percentile, or even mid-point, WACC in order to compete against Enable et al. To achieve the outcome Enable is seeking, the Commission would have to preclude Chorus from price discriminating on a regional basis (which CallPlus would support).

6. We note (and agree with) the following comments from the Commerce Commission:¹

Where **Chorus is not the LFC** – In those LFC areas where Chorus is not the UFB provider, there is the potential for direct competition between Chorus' copper network and the other LFC fibre network in attracting access seekers to use their wholesale inputs. This competition could be intense including the potential for Chorus to price its services below the regulated price cap.

7. Enable also argued that a higher WACC was justified, compared to that for electricity, gas and airports, on the basis that “the telecommunications industry faces Type II asymmetric risks, such as the threat of competitive entry or asset stranding from technical innovations.”²

8. The Commission considered asymmetric risk in its Input Methodologies Reasons Paper, dated December 2010. The Commission rejected that it should take asymmetric risk into account in the setting of WACC:

The IMs do not make any adjustments to the cost of capital for asymmetric risks ... the Commission does consider that it may be appropriate to deal with asymmetric risks though other forms of adjustment or mechanisms, such as adjustment to regulatory cash flows with the use of flexible depreciation (e.g. a front-loaded depreciation profile in the event that asset stranding becomes apparent).³

¹ Paragraph 111, Commerce Commission, UBA update paper, 13 August 2013.

² Paragraph 2.1c), Enable, Submission from Enable Services Limited on the Commerce Commission's “Determining the cost of capital for the UCLL and UBA price reviews”, 28 March 2014.

³ Paragraph H12.1, Commerce Commission, Input Methodologies (Electricity Distribution and Gas Pipeline Services) Reasons Paper, December 2010.

The IM does not make any adjustments to the cost of capital for Type I asymmetric risk.⁴

The Commission considers that regulated suppliers have not provided evidence to demonstrate that a Type II asymmetric risk exists and needs to be compensated using a real options approach that provides for a mark up in the cost of capital (or regulatory asset base) is not appropriate for dealing with Type II asymmetric risks.⁵

9. There is nothing contained in Enable's submission that would suggest the Commission was wrong or should take a different approach in telecommunications.

PricewaterhouseCooper's submission on selection of WACC within range

10. CallPlus agrees with PricewaterhouseCoopers comparison of the application of a 75th percentile in the cost of capital IMs under Part 4 of the Commerce Act, against the appropriate approach for telecommunications under Part 2 of the Telecommunications Act. PricewaterhouseCoopers' views reinforce the observations we made in relation to the differences between telecommunications and the Telecommunications Act compared to energy and the Commerce Act.⁶

The existing WACC IMs are generally applied to regulated activities using a 'building blocks' or 'regulated rate of return' type framework. In these cases prices are regulated (or monitored) to enable a fair rate of return on investment, with a 75th percentile WACC selected in recognition of what are generally considered to be the asymmetric costs of setting the regulatory WAC too low versus too high. The intention of the regulatory is to avoid the asymmetric consequences of regulated firms under-investing in their regulated activities.

By contrast the UCLL and UBA price reviews are based on a forward looking assessment of a 'market price' for services provided using what are largely sunk investments. While we have not analysed this issue in any depth, the rationale for selecting a regulatory WACC above the mid-point would appear to be less compelling in these circumstances.

Electricity networks' comments on telecommunications matters

11. CallPlus agrees with Transpower's observation that "Adopting a consistent approach to generic regulatory matters, such as the determination of WACC across the different services and regulatory regimes is conducive to a stable and predictable regulatory environment" and "the Commission should favour consistency unless there are good reasons to differ". Those reasons may be substantive, for example the economics or competitive dynamics of

⁴ Paragraph H12.13, Commerce Commission, Input Methodologies (Electricity Distribution and Gas Pipeline Services) Reasons Paper, December 2010.

⁵ Paragraph H12.34, Commerce Commission, Input Methodologies (Electricity Distribution and Gas Pipeline Services) Reasons Paper, December 2010.

⁶ Paragraphs 33 and 34, PricewaterhouseCoopers, "Submission on Commerce Commission's technical consultation paper: Determining the cost of capital for the UCLL and UBA price reviews, 7 March 2014", 28 March 2014.

the sector may differ, or procedural, for example while the policy objectives of the governing legislation overlap they are not identical”⁷ (emphasis added).

12. This is supported by the comments made by PricewaterhouseCoopers, as referenced above. While PricewaterhouseCoopers represents Telecom in this consultation, they also represent the majority of electricity networks in New Zealand on Part 4 matters.

13. Where CallPlus diverges from electricity network comments is in relation to the submission made by Vector.

14. Vector states that they “are not aware of any reason for telecommunications services to require a WACC percentile to be set differently from the WACC percentile in the IMs.”⁸ With respect, we refer Vector to our own submission, and to that of PricewaterhouseCoopers. These submissions both lay out sector specific reasons why a different approach to the matter of WACC percentile selection may be appropriate.

15. We would note that the arguments presented by CallPlus and PricewaterhouseCoopers are not a comprehensive list of the differences between Part 2 regulation of UCLL and UBA and Part 4 regulation of energy. Additional points worth noting, by way of example, include:

- a. Section 52T of the Commerce Act requires that “Any [input] methodologies ... must not unduly deter investment by a supplier of regulated goods or services in the provision of other goods or services”. This further highlights the Commerce Act’s focus on investment incentives of access providers, rather than that of access seekers and competing (if any) network providers.
- b. The Telecommunications Act protects end-users (and access seekers) against the risk that the IPP determination is too high, by allowing access seekers to apply for a FPP. (Likewise it protects access providers against IPP determinations that are too low by allowing them to apply for a FPP. This provides a symmetric safeguard against regulated prices that are too high or too low. The Commerce Act only provides asymmetric safeguard. It enables the regulated supplier (access provider) to apply for a CPP if the DPP is too low, but affords access seekers no equivalent right if the DPP is too high.
- c. The Government afforded copper a three year regulatory holiday, before moving to cost based pricing. The evidence Vector itself has provided suggests that this will have allowed Chorus to continue to earn returns of 20+% on its copper network. Does it need further regulatory cushion? Covec ask the valid question “to what extent

⁷ Page 1, Transpower, Determining the cost of capital for the UCLL and UBA price reviews, 28 March 2014.

⁸ Paragraph 6, Vector, Vector submission on cost of capital for UCLL and UBA reviews, 28 March 2014.

are any [asymmetric] risks and detriments of setting the UBA price too low already compensated for by the UBA price freeze?”⁹

- d. Covec, using the results from a panel study of 120 countries, found that for every dollar more consumers pay for copper services would imply a direct cut to New Zealand’s GDP of 0.22% or \$440m annually.¹⁰

16. Moreover, Vector’s comment is narrower than simply whether the selected WACC percentile should differ between Part 2 of the Telecommunications Act and Part 4 of the Commerce Act. Vector saying that they “are not aware of any reason for telecommunications services to require a WACC percentile to be set differently from the WACC percentile in the IMs” effectively ignores the decision made by the High Court in the Part 4 IM Merit Appeal. The High Court spelt out a number of reasons why the IMs 75th percentile WACC may not be appropriate, and should be set differently to the existing IMs, that are applicable to both telecommunications and the energy sector.

Additional Vector arguments

17. The additional Vector arguments suffer from the following deficiencies:
 - a. Failure to recognise that the industry is transitioning from old (sunk) technology in copper to new investment in fibre.¹¹ The implication being that the Commission’s priority should be to encourage investment in new services and new technology. We would also reference Vector’s UFB advertising campaign where they likened copper to, amongst other things, trying to use a straw instead of a hose to water the garden.
 - b. The deadweight loss from setting WACC too low will only be the entire area under the demand curve if it results in cessation of supply.¹²
 - c. Harbenger’s triangle¹³ is not relevant where a consumer surplus test is applied. The purpose of “long-term benefit of end-users” is, as Vector has points out in other submissions,¹⁴ a consumer benefit test rather than a total benefit or economic efficiency test.

⁹ Paragraph 42, Covec, UBA Pricing Issues, 3 September 2013.

¹⁰ Page ii, Covec, UBA Pricing Issues, 3 September 2013.

¹¹ Paragraph 12, Vector, Vector submission on cost of capital for UCLL and UBA reviews, 28 March 2014.

¹² Paragraph 12, Vector, Vector submission on cost of capital for UCLL and UBA reviews, 28 March 2014.

¹³ Paragraph 13, Vector, Vector submission on cost of capital for UCLL and UBA reviews, 28 March 2014.

¹⁴ Appendix II: Interpretation of Statutory Objective, Vector, Submission to the Electricity Authority on Transmission Pricing Methodology: Issues and proposals, 1 March 2013.

- d. Investment of a dollar by an access provider should not be presumed to have the same impact as investment of a dollar by an access seeker; particularly if the access seeker faces commercial and competitive constraints that the access provider does not.¹⁵
- e. To the extent that “copper ... access seekers’ investment horizons are very short”¹⁶ reflects the transition to fibre. Chorus is in exactly the same position when considering investment in copper. This argument undermines Vector’s focus on Chorus’ incentives to invest in copper.

18. Overall, Vector’s submission is overly focused on the investment incentives of Chorus in relation to copper services, and fails to consider section 18(2A) matters.

19. If the Commission does decide to select a mid-point WACC for UBA and UCLL services, prior to making a decision on the cost of capital IMs, we will be interested to see whether Vector perseveres with its argument that it cannot see any reason for differing approaches for telecommunications and Part 4. Their submission on this matter would serve as evidence in support of a lower WACC under Part 4.

Concluding remarks

20. Nothing in the submissions made in response to the Commission’s technical consultation paper gives CallPlus reason to change the views we expressed in our submission.

21. The submissions made by PricewaterhouseCoopers and Transpower serve to reinforce our view that the grounds for an above mid-point WACC are weaker in relation to UBA and UCLL services than for other regulated services, such as regulated services under Part 4 of the Commerce Act.

¹⁵ Paragraph 13, Vector, Vector submission on cost of capital for UCLL and UBA reviews, 28 March 2014.

¹⁶ Unnumbered paragraph after paragraph 13, Vector, Vector submission on cost of capital for UCLL and UBA reviews, 28 March 2014.