Fibre regulation emerging views

Submission to Commerce Commission

PUBLIC VERSION

16th July 2019

SUMMARY

1. Vocus appreciates the Commission's engagement in relation to the development of the Input Methodologies (IMs) and new regulatory framework for fibre. We consider that, for the most part, the Commission is heading in the right direction, but the emerging views on pricing principles for different layers of unbundled FFLAS services, and the approach to financial losses and double-recovery of fibre-copper services should be revisited. Care is also needed not to over-rely on Chorus and to ensure there are sufficient constraints on Chorus' ability to extract excessive profits.

2. We generally support the Commission's interpretation of its statutory objectives. We agree the objectives don't distinguish between retail and infrastructure-based competition, and don't prioritise the replicating competitive market outcomes objective over promotion of competition.

3. While we consider actual competition can generally be expected to deliver better outcomes for consumers than mimicing competition, we also recognise this needs to be tested and not just assumed. Similarly, the Commission shouldn't just *"assum[e] that in practice the s 166 objectives would generally be met for most of our decisions if they promoted the s 162 outcomes"*.[1] This needs to be tested on a case-by-case (IM by IM) basis.

4. The three key economic principles the Commission is applying are sound but could be complemented and enhanced with additional principles, for both Part 4 Commerce Act and Part 6 Telecommunications Act. We also support adoption of Pricing Principles which the Commission has done for airports and gas (and the Electricity Authority for electricity distribution, where the Commission does not have jurisdiction).

5. We are pleased the Commission is generally adopting a consistent approach to the IMs to that under Part 4 Commerce Act. The Commission has done a reasonably good job at being transparent about the consistency/deviations which we appreciate. The Commission has also usefully made some references to the precedent value of the High Court Part 4 IMs Merit Appeal decision though the High Court decision is much more relevant than indicated by the Emerging Views Paper.

6. There are a lot of elements of the emerging views on the IMs which we welcome and support, including adoption of Part 4 WACC IM, Related Party Transaction Rules, RAB indexing, and intention to follow the Transpower Capex IM (including approval framework). Vocus also fully supports the intention to exclude ACAM and OVABAA from the cost allocation methodologies (consistent with airports) which can be applied for financial separation purposes, and application of a mid-point WACC percentile consistent with copper (Telecommunications Act) and airports (Part 4 Commerce Act).

7. There are also matters we are uneasy about.

8. One of Vocus' concerns is the constrained timeframe for implementing the new fibre regime, and for the first price-quality determination, could result in Chorus' costs and service quality not getting the level of scrutiny and review that is warranted and needed. Our concern is magnified by experience with Chorus' calculation of its TSLRIC cost for copper (UBA and

[1] Commerce Commission, Fibre regulation emerging views: Technical Paper, 21 May 2019, paragraph 69.

UCLL) services and, most recently, its claims about the cost of unbundled fibre services. The experience in telecommunications is markedly different to that with Customised Price-Quality Path (CPP) and Individual Price-Quality Path (IPP) supplier proposals under Part 4 Commerce Act. The success of the supplier proposal model is contingent on the regulated supplier engaging in the process in goodfaith.

9. Related to this, we are uneasy about the Commission's *"bilateral discussions with Chorus to gather more information to support development of the capex IM"*.[2] While the Commission has stated *"We will make such information available during our IM setting process",* we consider the current lack of transparency and visibility to be less than ideal.[3] We do not expect Chorus to have a monopoly over the supply of information relevant to the Capex IM, or other components of price-quality regulation.

10. While we support the Commission generally adhering to Part 4 IMs precedent, the majority of submitters were clear competition issues mean more prescription is required for the Cost Allocation and the RAB IMs.

11. The matter of determining the financial losses Chorus' has incurred in providing UFB services is not something the Commission had to address under Part 4 Commerce Act. (The closest parallel is the previous requirements in the Telecommunications Act for the Commission to determine the net cost of providing TSO services to commercially non-viable customers.) The Commission should be careful to distinguish between the role of a cost allocation exercise for financial separation, and ensuring costs are fully allocated, and the role of determining financial losses (if any) Chorus' has incurred in provision of UFB.

12. Financial loss should be calculated on an incremental cost basis. The Commission's proposal to use an ABAA method would mean Chorus would be more than fully compensated for past losses and would extract excessive profits:

> Return on provision of UFB = SUM of past (economic) losses + return on (ABAA based) valuation of past losses in RAB > normal return on investment

13. The excessive profits would be a pure windfall gain for Chorus and NOT a reward for innovation or efficiency gains. It would be a straight wealth transfer from consumers to Chorus with no compensating benefit to consumers.

14. Vocus would have liked the consultation material to have engaged more directly with some of our submission content, including the views we expressed verbally and in writing about how to navigate double-recovery between Chorus' fibre and copper businesses. While we welcome that the Commission accepted copper-fibre double-counting is a problem, we question whether complexity and practicality are genuine impediments to addressing the issue.

15. There a lot of areas where Chorus has said it will provide supporting evidence some time in the future e.g. *"Chorus have suggested that they will provide further evidence on the justification for an uplift [WACC above mid-point].".* It remains to be seen whether Chorus will

[2] Commerce Commission, Fibre regulation emerging views: Technical Paper, 21 May 2019, paragraph 806.
[3] Commerce Commission, Fibre regulation emerging views: Technical Paper, 21 May 2019, paragraph 806.

provide the ‘compelling’ evidence it has promised, but we will assess and respond if and when Chorus decides to provide it.

16. The Commission rightly identified there will be capex for assets that are likely to become competitive.[4] The Commission should ensure the RAB IM and Capex IM settings do not insulate Chorus’ from the impact of competition. It would be inconsistent with replicating workably competitive market outcomes if Chorus could offset lost revenue from competition (layer 1 access) by raising prices for other services (layer 2).

[4] Commerce Commission, Fibre regulation emerging views: Technical Paper, 21 May 2019, paragraph 764.

INTRODUCTION

17. Vocus welcomes the opportunity to provide feedback on the Commission's emerging views in relation to the rules and Input Methodologies (IMs) that will underpin the new regulatory regime for fibre networks.

18. We appreciate the work and progress the Commission has made since the new fibre regulatory framework consultation, as well as the time the Commission has taken to understand our views through the December 2018 workshop and one-on-one meetings early in the new year.

19. If you would like any further information about the topics in this submission or have any queries about the submission, please contact:

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VOCUS AGREES WITH THE COMMISSION ON A WIDE-RANGE OF ITS EMERGING VIEWS

20. It should be self-evident from our, and the majority of stakeholder, submissions on the new regulatory framework, that there will be a high degree of support for most of the Commission's emerging views.

21. A non-exclusive list of the Commission's emerging views we agree with, includes:

(i) Recognition retail competition isn't more important than infrastructure-based or other forms of competition (contrary to Chorus and Trustpower's arguments): *"The Part 6 purpose is clear that the purpose is "promotion of workable competition in telecommunications markets" [emphasis added], which can include both retail competition, based on access to Chorus' fibre network, and infrastructure-based competition"*;[5]

(ii) Recognition the objectives in sections 166(2)(a) and 166(2)(b) have equal standing: *"Any trade-off that has to be made between section 162 [166(2)(a)] and section 166(2)(b) purposes must maximise the long-term benefit of end-users"*;[6]

(iii) The high degree of consistency between Part 4 Commerce Act precedent and the Commission's emerging views on the fibre IMs (albeit that we and other RSPs consider a more prescriptive approach is desirable for the Cost Allocation and RAB IMs and in relation to service quality);

(iv) Adoption of an approach to WACC consistent with both the Part 4 WACC IMs, and the copper pricing (UBA and UCLL) determinations. So far, Chorus has been *"[re-]running the same arguments that it used in relation to the copper price determination and, in relation to the duration of the term for the risk-free rate, and that were (unsuccessfully)*

[5] Vocus, cross-submission, New regulatory framework for fibre, 1 February 2019, paragraph 47.
[6] Vocus, cross-submission, New regulatory framework for fibre, 1 February 2019, paragraph 49.

used by regulated suppliers during the establishment of the Part 4 Input Methodologies, and subsequent Merit Appeal case";[7]

(v) Adoption of mid-point WACC and the reasoning the Commission relied on in relation to its copper determinations: *"While … there are differences between fibre and copper, there are more than sufficient arguments for setting the copper WACC at midpoint that hold in relation to fibre to confirm a higher WACC percentile for fibre would not be justified or to the long-term benefit of end-users"*;[8]

(vi) Adoption of the RAB indexing approach applied to electricity distribution (re-confirmed during the Part 4 IMs review);

(vii) The intention to adopt the same approach to Related Party Transactions as in Part 4 Commerce Act (which has recently been substantially strengthened, as part of the Commission's Part 4 IMs review);

(viii) The intention to follow the Transpower Capex IM, including an investment approval and testing mechanism (which Chorus' opposed but, as its advisors are well aware, has worked well in electricity);

(ix) The intention to only allow adoption of ABAA under the Cost Allocation IM. We note this is consistent with the Airports Cost Allocation IM, but differs from the electricity and gas Cost Allocation IMs;

(x) Following the way Part 4 IPPs and CPPs have evolved and requiring Independent Verification and consultation on supplier proposals. This process step has worked well in electricity; and

(xi) Rejection of Chorus' position that service-quality standards should not be set for the first price-quality determination or the commercial arrangements between Chorus and the Crown are a substitute for price-quality setting under the new Part 6. Vocus does not accept any of Chorus' contentions. Service-quality setting is an essential part of any price control regime, and *"The commercial arrangements Chorus has agreed with the Crown are not a subsititute for the Commerce Commission's price-quality setting responsibilities"*.

Even if the Commission had discretion not to set service quality, the Commission has noted in relation to Part 4 Commerce Act price-quality regulation: *"… quality standards … are a crucial part of promoting the purpose of Part 4 of the Act. Most directly, they are important for ensuring distributors have incentives to provide services at a quality that reflects consumer demands. However (given distributors' revenues are constrained by the price path), quality standards are also important for ensuring distributors have incentives to invest, and are constrained in their ability to earn excessive profits".*[9]

[7] Vocus, cross-submission, New regulatory framework for fibre, 1 February 2019, paragraph 11.
[8] Vocus, cross-submission, New regulatory framework for fibre, 1 February 2019, paragraph 74.
[9] Commerce Commission, Reasons Paper, Default price-quality paths for electricity distribution businesses from 1 April 2020 – Draft decision, 29 May 2019, paragraph 7.14.

THERE ARE A NUMBER OF AREAS WHERE WE ARE WORRIED THE NEW FIBRE INPUT METHODOLOGIES COULD BE AT RISK

22. While our submission should be seen as supportive of, and overall endorsing, the Commission's work in developing the fibre IMs, there are a number of matters we are worried about at this stage of the process.

23. Vocus and the other RSPs are relatively small organisations without the regulatory resources Chorus has at its command. The Commission's intention to adopt an omnibus consultation on the draft IMs, later in the year, coupled with a tight time-frame for submissions (6 weeks), will put us at a substantial disadvantage and limit the extent to which we will be able to engage.

24. We urge the Commission to consider providing a longer consultation period for the draft IMs, or at least a longer period for certain components of the draft IMs, and to make expert and consultant reports available prior to the consultation start date if they have been completed prior to then. The consultation time for draft IMs consultation needs to be longer than the Commission's Emerging Views consultation given the volume of (highly technical) material that will be consulted on.

25. We are also worried about the types of regulatory short-cuts Chorus is seeking. For example, Chorus has made claims about the difficulty forecasting demand and how this suggests more lenient arrangements should be applied for the Capex IM.[10]

26. Vocus and the other RSPs and stakeholders don't agree with the Commission's position it should take a similar approach to prescription within the Cost Allocation and RAB IMs under Part 4 Commerce Act. This is one of the main areas the Commission should depart from Part 4 precedent.

27. Our concerns include the Commission's position it will be up to Chorus what services fit under the catergory of regulated services or not:[11]

> *"Chorus and the other LFCs will need to determine which of the services they offer are regulated, and which assets are employed, wholly or partly, in the provision of those services. The proportion of the total value of assets included within the RAB for ID or PQR purposes will be impacted by cost allocation."*

28. The Commission has been clear that while *"it … can use … experience in applying Part 4 to inform … application of Part 6"* it *"must always take the specific characteristics of the telecommunications sector and the structure and language of Part 6 into account"*.[12] We consider inclusion of the competition objective etc are relevant specific factors that should mean a more prescriptive approach to the Cost Allocation and RAB IMs is likely to be desirable. These views were well canvassed by RSPs in the previous consultation.

29. We are concerned the Commission's intention not to address double-recovery from copper and fibre, despite recognition *"Legislation proposes different methodologies for the FPP and Part 6, which creates an inherent risk of double or under-recovery …"*[13] We are also concerned the Commission is proposing not to take an economically sound approach to

[10] As per Chorus' commentary at the 25 June 2019 workshop.
[11] Commerce Commission, Fibre regulation emerging views: Technical Paper, 21 May 2019, paragraph 187.
[12] Commerce Commission, Fibre regulation emerging views: Technical Paper, 21 May 2019, paragraph 385.1.
[13] Commerce Commission, Fibre regulation emerging views: Technical Paper, 21 May 2019, paragraph 8.

measuring Chorus' UFB financial losses (for which ACAM is entirely appropriate) which would inflate the loss determination. Both of these factors would only serve to inflate Chorus' cost-base/RAB and undermine the limitation of excessive profits.

THE COMMISSION NEEDS TO CAREFULLY MANAGE THE RISKS ASSOCIATED WITH A SHORT IMPLEMENTATION TIMEFRAME

30. Vocus is fully sympathetic to the challenges and pressures the Commission faces in implementing the new regulatory framework in an unduly short (legislative) implementation timeframe.

31. Our sympathy does not extend to Chorus. Chorus lobbied the Government for a short implementation timeframe, which didn't exist under Part 4 Commerce Act, knowing full well the consequences. Chorus had advice from experts with substantial Part 4 Commerce Act experience, including experts with direct hands-on experience of IPP and CPP regulation. Chorus knew full well based on expert advise the time-frames it was lobbying for would be wholly inadequate.

32. In our previous submissions, we raised concern about Chorus trying to exploit the tight timeframe for development of IMs, and the first price-quality determination, to achieve a softer initial determination. Chorus is aiming to navigate a proposed price-quality path which lacks the scrutiny, and checks and balances, that is warranted, and have service quality regulation shelved altogether.[14]

33. We also raised concern Chorus is seeking bilateral regulatory arrangements with the Commission to deal with transitional arrangements e.g. Chorus argue *"… the Commission and Chorus [should agree] practical solutions for RP1 to ensure that the price-quality path can be implemented in good time"*.[15] The Commission has noted *"… Vocus' view that any transitional arrangements should not be agreed through some sort of a bilateral arrangement between the Chorus and the Commission; and instead should be consulted on through public processes"*[16] but didn't comment on whether it agreed with our position.

34. Chorus has made its own bed and must lie in it. This includes dealing with the challenges of ensuring its asset mangement planning (including opex and capex forecasts) is in order, and it can deliver a price-quality proposal (if that is the approach the Commission requires) which is fully compliant with the yet to be established fibre IMs and other requirements. Claiming forecasting is hard and difficult does not wash. Each regulated supplier, and any business in workably competitive markets, faces the same challenges.

[14] Chorus "Submission on the new regulatory framework for fibre" (21 December 2018), paragraph 23.
[15] Chorus "Submission on the new regulatory framework for fibre" (21 December 2018), paragraph 74.
[16] Commerce Commission, Fibre regulation emerging views: Technical Paper, 21 May 2019, paragraph 858.

35. This is clear from looking at the different types of scenarios Vector has modelled in its Asset Mangement Plan (see figre below).[17] What Vector has provided is the type of analysis it needs to manage uncertainty in asset management planning and forecasting. Chorus, in contrast, has simply made a number of rhetorical claims and assertions which lack meaningful foundation and should not be relied on in the Commission's deliberations.

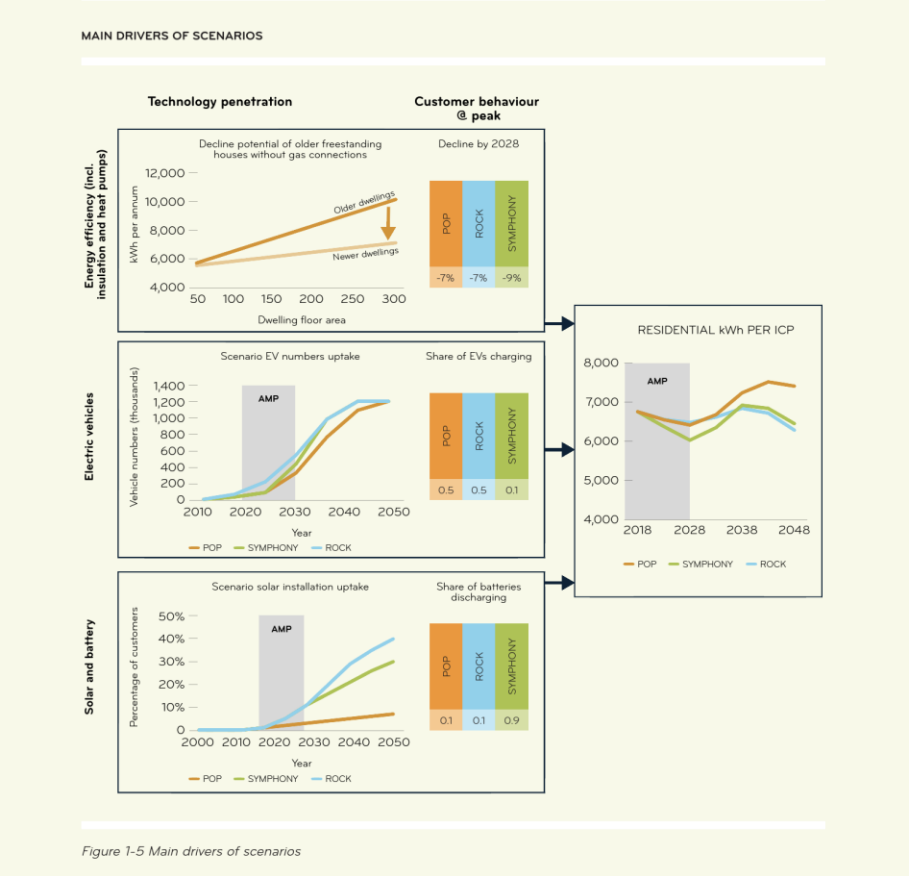

Figure 1-5 Main drivers of scenarios

36. For the Commission the tight timeframe lends itself to a strategy of 'playing it safe' and relying heavily on Part 4 Commerce Act and copper pricing determination precedent. This includes things like adopting Independent Verification as a mandatory requirement, modelling the fibre Capex IM closely on the Transpower Capex IM (which Chorus clearly doesn't want), including elements such as an approval mechanism for major investments, and sticking with a mid-point WACC (copper precedent), and the Part 4 WACC IM (copper precedent).

37. Given the constraints the Commission has to operate within, we suggest the Commission prioritise limitation of excessive profits, and setting service quality standards that reflect end-user demands, for the first regulatory period. These are the two elements of the new section 162 objective likely to deliver the most significant immediate benefits to end-users.[18]

38. We reiterate we do not support Chorus' suggestion of adopting a short-cut *"… approach to setting expenditure for RP1 that differs from the approach that the Commission will adopt in*

[17] Vector, ELECTRICITY ASSET MANAGEMENT PLAN 2019-29, Figure 1-5.
[18] The Commission has stated "The quality of service provided by electricity distributors is one of the Commission's organisation-wide priorities for the 2018/19 year". We think the same focus is relevant for regulated fibre services. Reference: Commerce Commission, Reasons Paper, Default price-quality paths for electricity distribution businesses from 1 April 2020 – Draft decision, 29 May 2019, paragraph 7.16.

the IMs".[19] This would undermine the Commission's ability to limit Chorus' ability to extract excessive profits.

39. In our previous submissions we expressed nervousness about supplier proposals based on experience with Chorus: *"Most recently, the problems with the TSLRIC calculations Chorus commissioned were well documented in the Commerce Commission's UBA and UCLL Final Pricing Principle (FPP) determination"*.[20] Our nervousness would be magnified if short-cuts were taken in respect of the level of scrutiny or consultation the Chorus price-quality proposal is subjected to.

40. Our cross-submission on the new regulatory framework, suggested if Chorus is correct that time constraints will limit the extent it can undertake consultation on any supplier proposal, it should mean: (i) the role of supplier proposals (if any) in the price-quality determination is limited for the first reset, consistent with the approach taken to Transpower's IPP proposals; and (ii) a pragmatic compromise is that information Chorus' provides the Independent Verifier is made available to RSP advisors and experts on a confidential basis at the same time. Chorus will not like either of these suggestions. Again, Chorus has made its own bed in lobbying the Government and officials for a condensed implementation timeframe.

41. While we fully recognise the new fibre regulatory regime will develop and evolve over-time, as reflected in Part 4 precedent, we oppose the types of short-cuts and regulatory free-rides Chorus is advocating, and caution there is a need to ensure the time constraints the Commission is operating under do not result in worse outcomes (higher prices and poorer quality services) for end-users.

WHERE CHORUS RELIES ON SUPPOSITION OR ASSERTION, THE COMMERCE COMMISSION SHOULD GIVE IT LITTLE OR NO WEIGHT

42. The Commission has noted a number of areas where Chorus stated it will provide additional information to substantiate or justify its position, for example:

> *"We will demonstrate that Crown financing is not costless."*[21]
>
> *"Chorus have suggested that they will provide further evidence on the justification for an uplift. We intend to consider any evidence they provide on this, using the existing quantitative framework and may require external advice in considering any input assumptions that they use."* [footnote removed][22]

43. We reiterate Chorus relies heavily on use of supposition in place of fact and evidence in its submissions. This is not new. The same issue arose with Chorus' copper pricing determination submissions. By way of illustration we note the following representative comments from the copper pricing determination hearings:[23]

> *"… in terms of the concerns that Chorus keeps on raising about incentives to invest, the important thing is that investors have confidence that they can expect at least normal return on their efficient and prudent investment,*

[19] Chorus "Submission on the new regulatory framework for fibre" (21 December 2018), paragraph 73.
[20] Vocus, submission, New regulatory framework for fibre, 21 December 2018, paragraph 22.
[21] Chorus "Submission on new regulatory framework for fibre" (21 December 2018), paragraph 176.
[22] Commerce Commission, Fibre regulation emerging views: Technical Paper, 21 May 2019, paragraph 575.
[23] Transcript, UCLL AND UBA SERVICES FINAL PRICING PRINCIPLE CONFERENCE HELD ON 15-17 APRIL 2015, Rob Allen at pages 368 and 369.

and Chorus has provided no evidence to date that the Commerce Commission's draft decision would not provide that … if Chorus wants to persuade the Commerce Commission that there should be a higher, an uplift in the WACC or anywhere else, then the onus is on Chorus to demonstrate that the draft decision would preclude it from earning a normal return. …exactly the same issue came up in the Part 4 merit appeal where the RAB was challenged because it was too low and because it would not incentivise investment, and the High Court decision was that if that argument was going to be persuasive, then the regulated suppliers needed to provide evidence that the RAB or the Commerce Commission decisions would preclude them from earning a normal rate of return. As with Chorus the regulated suppliers did not or were unable to do so."

44. If and when, Chorus' provides the type of evidence it considers will support the positions it has advocated the Commission and stakeholders will be able to assess the evidence on its merits. In the meantime, we reiterate the High Court statement *"Where a proposition is simply asserted … we give it little or no weight".*[24]

RESPONDING TO MISLEADING AND INCORRECT STATEMENTS IN CHORUS' CROSS-SUBMISSION

45. Chorus' cross-submission mis-represented the views of submitters, including our views. One of the tricks Chorus seems to like to play is to not specify which submitter it is responding to and to not use quotes, making it more difficult to verify whether the comments it is claiming to respond to are accurate or are submission points that anyone actually made.

46. Chorus, for example, claimed *"Areas of alignment in submissions include … that there should be no shocks for anyone"*,[25] whereas it was made clear in submissions that the price shock provisions relate to consumers and price increases only. Our cross-submission noted *"The provisions in both the Commerce and Telecommunications Acts relating to "price shocks" are included for the sole purpose of protecting end-users from large, sudden, price increases"*[26] and *"It appears Chorus has confused "price shocks" with the provisions relating to "undue financial hardship to the regulated fibre service provider""*.[27]

47. Likewise, Chorus claimed there was *"Acknowledgement that competition is principally relevant at the retail level"*.[28] Trustpower was the only RSP that held this view, which reflects its retail-only strategy. All other RSPs were clear about the importance of both retail and infrastructure-based competition.[29] Chorus' predecessor Telecom provided a great amount of detail why it considered infrastructure-based competition more important than retail competition.[30]

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[24] WELLINGTON INTERNATIONAL AIRPORT LTD & ORS v COMMERCE COMMISSION [2013] NZHC [11 December 2013] at [1745].
[25] Chorus, New regulatory framework for fibre: cross-submission on Commission's proposed approach, 1 February 2019, paragraph 5.1.
[26] Vocus, cross-submission, New regulatory framework for fibre, 1 February 2019, paragraph 58.
[27] Vocus, cross-submission, New regulatory framework for fibre, 1 February 2019, paragraph 59.
[28] Chorus, New regulatory framework for fibre: cross-submission on Commission's proposed approach, 1 February 2019, paragraph 5.7.
[29] Chorus could refer back to its predecessor, Telecom's, views on retail and infrastructure-based competition during the Commerce Commission's section 64 LLU review, where it was very clear it considered infrastructure-based competition was much more important than retail competition.
[30] This was one of Chorus' (née Telecom) main submission points in response to the Commerce Commissions section 64 Local Loop Unbundling investigation.

48. Chorus' cross-submission misrepresented submitter views to create 'strawman' or 'Aunt Sally' arguments, which it could more readily debunk than the actual submitter arguments.

49. For example, Chorus purported to be *"concerned that a number of submitters are conflating the promotion of workable competition with the promotion of the interests of individual competitors"*[31] without saying who the submitters are or what statements were made which resulted in it having such concerns.

50. It should be evident from the purpose of promoting competition for the long-term benefit of end-users that competition is intended to serve the interests of end-users and the individual competitors are the conduit for achieving this. Chorus' comments were also strange given they advocate that the relevant type of competition is retail competition only, but contradict themselves by stating (correctly) *"Promoting workable competition in section 166(2)(b) does not … imply any particular market structure (e.g. a particular level of unbundling or infrastructure bypass)"*.[32]

ACHIEVEMENT OF THE SECTION 162 AND 166 OBJECTIVES REQUIRES A FOCUS ON PROMOTING COMPETITION

51. Vocus supports the Commission's position that promotion of retail competition does not have supremacy over infrastructure-based or other forms of competition, in promoting competition, and different elements of the Commission's objectives do not have supremacy over others e.g. *"… there is no basis to give s 166(2)(a) primacy over s 166(2)(b) if we are required to make trade-offs between the two objectives. We consider that this is clear from the language of s 166(2) which simply says that we must make the decision that best gives effect to both purposes"*.[33]

52. Where the Commission and Vocus appear to differ is that we questioned the Commission's *"assumption that in practice the s 166 objectives would generally be met for most of our decisions if they promoted the s 162 outcomes"*. Vocus has expressed the following alternative views:[34]

> *"We question the Commission's expectation that "in practice the s 166 objectives will generally be met for most of our decisions if they promote the s 162 outcomes". By way of analogy, the statement is equivalent to suggesting it would be fine to replace the Mona Lisa in the Louvre with an imitation or reproduction. Promoting outcomes that replicate competition is distinct from promoting actual competition, and should only be applied where competition is not possible. Replicating competitive market outcomes can be expected to be inferior to actual competitive market outcomes."*[35]

53. Our views reflect that section 162 is a subset of section 166, and does not include *"promotion of workable competition in telecommunications markets for the long-term benefit of end-users*

[31] Chorus, New regulatory framework for fibre: cross-submission on Commission's proposed approach, 1 February 2019, paragraph 40.
[32] Chorus, New regulatory framework for fibre: cross-submission on Commission's proposed approach, 1 February 2019, paragraph 40.
[33] Commerce Commission, Fibre regulation emerging views: Technical Paper, 21 May 2019, paragraph 72.
[34] Commerce Commission, Fibre regulation emerging views: Technical Paper, 21 May 2019, paragraph 69.
[35] Vocus "Submission on new regulatory framework for fibre" (21 December 2018), paragraph 53.

of telecommunications services". While the Commission acknowledged our views it did not directly engage with them, or detail whether it agreed with us or not.

54. The Commission stated though that *"As incentive regulation is an imperfect substitute for workable competition, where feasible, we consider that workable competition is more likely to be the preferred mechanism to promote the relevant outcomes under ss162 and 166(2)(b)"*.[36] This statement is directly consistent with our views.

55. The Commission made the observation, in a number of places, that it should not make presumptions about what would best achieve the statutory objectives, and needs to consider the matters on their merits. This includes, for example, the Commission's comment *"… a preference for actual competition over the theoretical replication of workable competition would always have to be evaluated against the requirement to best give effect to the purposes described in s 166(2)"* [footnote removed].[37] The same holds for the relationship between section 162 and 166. The Commission should not make the *"assumption that in practice the s 166 objectives would generally be met for most of our decisions if they promoted the s 162 outcomes".*

THERE IS MERIT IN EXPANDING THE KEY ECONOMIC PRINCIPLES

56. Vocus can understand the Commission's reluctance to deviate from the three key economic principles it applies in relation to Part 4 Commerce Act; notwithstanding the Commission's view that it can't just rollover past decisions in other jurisdictions and needs to decide again afresh. The economic principles are non-contentious and have been usefully and successfully applied under Part 4 Commerce Act.

57. We acknowledge retention of the three key economic principles *"Provide predictability to stakeholders"* and *"Stakeholders are familiar with these principles and supported their use in the Part 6 regime. These three economic principles can also help provide cross-sectoral consistency, which will assist the predictability of the regime"*.[38] This does not impact our view that there should be new and additional economic principles.

58. There is substantive difference between developing alternative new principles which may conflict with or substitute for the existing three principles, and the addition of new, complementary, principles.

59. In relation to the proportionality principle we proposed, the Emerging Views Paper stated *"We do not consider it is necessary to explicitly adopt additional principles … proportionality for the purposes of supporting the regulatory decisions in Part 6. This is because we consider that these form part of regulatory best practices that we adhere to"*.[39]

60. With respect, we do not consider this argument to be compelling. Part of the purpose of the economic principles is to make transparent the Commission's reasoning. The Commission has not detailed any detriment from being explicit about principles that fit under regulatory

[36] Commerce Commission, New regulatory framework for fibre: Invitation to comment on our proposed approach, 9 November 2018, paragraph 5.43.
[37] Commerce Commission, Fibre regulation emerging views: Technical Paper, 21 May 2019, paragraph 131.2.
[38] Commerce Commission, Fibre regulation emerging views: Technical Paper, 21 May 2019, paragraph 117.2.
[39] Commerce Commission, Fibre regulation emerging views: Technical Paper, 21 May 2019, paragraph 117.2.

best practice. It could equally be argued the three existing economic principles also fit under regulatory best practice and, therefore, are not needed. Furthermore, the Commission's reasoning appears to be contrary to the fact it explicitly applies a proportionate scrutiny principle to Transpower's Capex IM[40] and Part 4 Commerce Act CPP requirements.[41]

IF THE COMMISSION DOES NOT ADOPT PRICING PRINCIPLES FOR THE FIRST PRICE-QUALITY DETERMINATION IT SHOULD REASSESS ITS POSITION IMMEDIATELY AFTER

61. The Commission has made a repeated number of references to its view that decisions on cost allocation rules between FFLAS and economic Pricing Principles should be considered in the future (after the first price-quality determination for regulated fibre services) e.g.:

> *"… our emerging view is that an additional principle on pricing is not necessary at this stage, because … the Act (at s 195) prevents us from specifying the prices that regulated suppliers can charge prior to the reset date for the regime (as declared under s 225) for any FFLAS other than anchor services and DFAS (as specified in 198(2)(d) and s 199(2)(d), respectively)"*[42]
>
> *"We note that the adoption of a pricing principle might be more appropriate in subsequent regulatory periods given that market developments might require revisions to other aspects of the regime, eg a move from a revenue cap control to a price cap control."*[43]
>
> *"… the decision on how to allocate costs between FFLAS may be better determined in the future. This will allow for future analysis such the application of economic pricing principles that consider the future context."*[44]

62. Vocus acknowledges the Commission's rationale, but it should be recognised the matter of cost allocation and pricing for different FFLAS services is a live issue, with Vodafone and Vocus already facing issues with Chorus' proposed pricing of unbundled fibre.[45] Vocus and Vodafone announced a joint venture to unbundle Chorus' fibre network in June last year.[46]

63. If the Commission confirms its position and does not address economic Princing Principles and rules for allocating costs between different FFLAS services, as part of implementation of the first price-quality determination, we request the Commission commit to undertake this work immediately after the first price-quality determination has been finalised.

64. We also question the merit of some of the arguments against the specific economic Pricing Principles which have been proposed in submissions.

65. For example, the Commission claims that *"a principle requiring efficient pricing, such as Ramsey pricing: would be undermined by the non-cost based pricing rules that the Act imposes on Chorus, such as geographically consistent pricing (at s 201)"*.[47] The section 201

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[40] Commerce Commission, Fibre regulation emerging views: Technical Paper, 21 May 2019, paragraphs 141 and 825. Commerce Commission "Input methodologies review decisions. Topic paper 2: CPP requirements" (20December 2016), paragraphs 125-146.
[41] Commerce Commission, Fibre regulation emerging views: Technical Paper, 21 May 2019, paragraphs 141 and 797.4. Commerce Commission "Input methodologies review decisions. Topic paper 2: CPP requirements" (20 December 2016), page 67. Commerce Commission "Transpower capex input methodology review" (15 May 2017), paragraphs 8387.
[42] Commerce Commission, Fibre regulation emerging views: Technical Paper, 21 May 2019, paragraph 135.
[43] Commerce Commission, Fibre regulation emerging views: Technical Paper, 21 May 2019, paragraph 136.
[44] Commerce Commission, Fibre regulation emerging views: Technical Paper, 21 May 2019, paragraph 326.
[45] https://www.stuff.co.nz/business/111607991/chorus-pricing-for-unbundled-fibre-lines-labelled-ridiculous
[46] https://news.vodafone.co.nz/article/vocus-group-and-vodafone-announce-joint-venture-accelerate-fibre-innovation
[47] Commerce Commission, Fibre regulation emerging views: Technical Paper, 21 May 2019, paragraph 129.1.

requirements simply apply a limitation on application of efficient pricing. This is little different to 2degrees observation that the requirements of section 1777 undermine the allocation of risk principle. The Commission's response to 2degrees applies equally in relation to the Pricing Principles:

> *"We note 2degrees' concerns that the requirements of s 177 of the Act undermine the allocation of risk principle. While s 177 limits our role in setting the rules for the calculation of the initial value of fibre assets and thus, for applying the allocation of risk principle to this rule-setting, this is only one specific example where the allocation of risk principle could have been useful in guiding our decisions. We consider that there are many other situations where the allocation of risk principle will help us make or explain our decisions when setting the Part 6 regime. The principles will only be applied to the extent they assist us in giving effect to the legislative requirements of the Act and the purposes in s 166(2)."*[48]

66. The principle that price should be between incremental and stand-alone costs provides another example where the Commission's views would benefit from further consideration. The Commission responded that while the monopoly pricing/subsidy free principle is sound *"such a principle would impose a significant monitoring burden on both Chorus and us given the detailed cost information at the service level that would have to be collected"*.[49]

67. The Commission's position is inconsistent with adoption of the same principle in relation to airports and gas:[50]

> *"Pricing principles*
>
> *(1) Prices are to signal the economic costs of service provision, by-*
>
> *(a) being subsidy free, that is, equal to or greater than incremental costs and less than or equal to standalone costs, except where subsidies arise from compliance with legislation and/or other regulation … "*

68. The Commission doesn't have jurisdiction over electricity, but the Electricity Authority has also applied the same principle[51] which it has recently reconfirmed as part of revisions to its distribution pricing principles (albeit amending replacing *"incremental cost"* with *"avoidable cost"*).[52]

69. It unclear why a principle that prices be subsidy-free would be appropriate for airports, electricity distribution and gas pipeline businesses, but unsuitable for fibre pricing. We also note many regulatory jurisdictions, internationally, impose reguirements on regulated suppliers to demonstrate things like that their pricing doesn't violate rules about predatory pricing etc. The Cave/Vogelsang report cited the example of applying an economic replicability test as is done in the European Union.[53] This simply reflects international regulatory best practice.

70. At the 25 June workshop, the Commission noted section 52T(1)(b) requires the Part 4 IMs to include *"pricing methodologies, except where another industry regulator (such as the Electricity Authority) has the power to set pricing methodologies in relation to particular goods*

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[48] Commerce Commission, Fibre regulation emerging views: Technical Paper, 21 May 2019, paragraph 125.
[49] Commerce Commission, Fibre regulation emerging views: Technical Paper, 21 May 2019, paragraph 129.4.
[50] Commerce Commission, Gas Transmission Services Input Methodologies Determination 2012, section 2.5.2.
[51] https://www.ea.govt.nz/dmsdocument/1944-guidelines-distribution-pricing-principles-and-information-disclosure
[52] Electricity Authority, More efficient distribution network pricing principles and practice, Decision paper, 4 June 2019.
[53] Ingo Vogelsang and Martin Cave, Pricing under the new regulatory framework provided by Part 6 of the Telecommunications Act, 16 May 2019, paragraph 39c).

or services" but that there is no Part 6 Telecommunications Act equivalent. This means that inclusion of Pricing Principles (or pricing methodologies) is discretionary, but isn't a reason why the Commission should NOT adopt Pricing Principles in the IMs.

DOUBLE-RECOVERY OF COPPER AND FIBRE NEEDS TO BE ADDRESSED TO LIMIT EXCESSIVE PROFITS

71. We agree entirely with the Commission *"that double recovery should be avoided and is not consistent with the purposes of Part 6 such as the need to reduce excessive profits"*[54] and double recovery can occur *"when costs are shared across multiple regulated sectors. For example, the use of different cost allocation approaches in each sector could risk over recovery"*.[55] We also agree entirely with the Commission that *"Legislation proposes different methodologies for the FPP and Part 6, which creates an inherent risk of double or under-recovery …"*[56]

72. The Commission has addressed double recovery in relation to regulated suppliers that provide more than one regulated service under Part 4 Commerce Act, and is *"… proposing to include an explicit requirement that suppliers must not double recover costs across Part 4 and Part 6 through cost allocation".*[57] We support this.

73. The Commission's emerging views that *"For Chorus, the sharing of resources between the fibre and copper networks create complexities for cost allocation"*[58] and *"… it would be impractical to fully ensure that in regard to UFB pass losses and the FPP for UBA there is no double or under-recovery, or to fully demonstrate it"*[59] warrant further consideration.

74. While we acknowledge there would be complexities the Commission has provided no evidence they would be *"impractical"* to resolve. The Commission's task is made easier by the fact the Commission did not apply a 'scorched earth' approach to TSLRIC optimisation, instead adopting a limited scorched node approach and relying heavily on actual Chorus costs and assets, and assumptions about sharing with other services.

75. If the Commission does not take into account shared and common costs between copper and fibre it will, in effect, create a de facto ACAM regime for Chorus' fibre business with Chorus' fibre business treated as if it is the "stand-alone" cost business.[60] This would be problematic because the copper TSLRIC prices explicitly included a contribution to common costs in addition to incremental cost.

[54] Commerce Commission, Fibre regulation emerging views: Technical Paper, 21 May 2019, paragraph 301.
[55] Commerce Commission, Fibre regulation emerging views: Technical Paper, 21 May 2019, paragraph 302.
[56] Commerce Commission, Fibre regulation emerging views: Technical Paper, 21 May 2019, paragraph 385.1.
[57] Commerce Commission, Fibre regulation emerging views: Technical Paper, 21 May 2019, paragraph 253.1.4.
[58] Commerce Commission, Fibre regulation emerging views: Technical Paper, 21 May 2019, paragraph 273.
[59] Commerce Commission, Fibre regulation emerging views: Technical Paper, 21 May 2019, paragraph 385.
[60] We are happy for Chorus' and LFCs' fibre businesses to be treated as the incremental business under ACAM, and this is appropriate for the purpose of calculating financial losses.

FURTHER THOUGHTS ON ADDRESSING DOUBLE-RECOVERY OF COPPER AND FIBRE

76. We provided some tentative comments about how the Commission could address double-recovery during our meeting with the Commission and in our cross-submission. We would be happy to engage further on these matters.

77. The main complexity we see is that the copper TSLRIC price determination and the fibre price determinations are not being done in parallel, so the Commission cannot follow the approach it has taken to electricity-gas, and the proposed approach for electricity-fibre, of allowing the regulated supplier to determine allocation of common costs while avoiding double-recovery. Addressing the issue for copper-fibre will likely require the Commission to precribe rules about how the cost allocation is done to avoid double-recovery.

78. We consider that the complexities due to TSLRIC building blocks modelling being adopted for copper and a different approach being adopted for fibre have been overstated and haven't been substantiated. It is relevant to the practicality of avoiding or mitigating double-recovery that:

    (i) The Commission adopted a limited scorched node rather than a scorched earch approach to TSLRIC optimisation;

    (ii) The Commission relied heavily on actual Chorus costs and assets;

    (iii) The TSLRIC determination included explicit assumptions about asset sharing with other services; and

    (iv) The TSLRIC determination included an explicit adjustment for *"a reasonable allocation of forward-looking common costs"*.

79. One approach the Commission could take, which would broadly mirror the building blocks approach it adopted for the copper TSLRIC determination, would be to first determine the incremental cost of the fibre business (treating the existing or copper business as if it is the stand-alone business, and fibre is incremental to those services). If done properly the pure incremental cost determination would have no element of double-recovery (and would also be appropriate for financial loss determination purposes).

80. Secondly, in order to make Chorus' 'whole', the Commission could then add a contribution to shared and common costs. The Commission would need to align this allocation with the approach it took to the TSLRIC determination to ensure the same costs (whether 'optimised' at modern equivalent value or not) aren't recovered through both copper and fibre prices.

81. We don't think this would be technically difficult or complex. It would just require familiarity with the copper TSLRIC modelling and assumptions. The Commission would need to consider:

    (i) what assets that may be required to provide fibre services were included in the TSLRIC determination (these should be excluded in full from the fibre building blocks cost and RAB determination);

(ii) what level of sharing the Commission assumed (as we noted previously *"The lower the level of asset sharing the Commerce Commission assumed in the copper price determinations the larger the adjustment that will be needed to the fibre service cost calculations to avoid double-recovery"*[61]); and

(iii) what allocators were used to determine the allocation of common costs (taking into account the approach used for allocation of common costs under the TSLRIC determination will help avoid the same common cost being allocated twice).

EMERGING VIEW PROPOSALS WOULD OVER-COMPENSATE CHORUS FOR LOSSES IN PROVISION OF UFB SERVICES

82. Vocus does not support the Commission's proposal to determine losses from provision of UFB services on an ABAA accounting allocation basis.

83. The financial losses are simply and solely the extent to which Chorus' profits were lowered due to provision of UFB services. This can only be determined on an incremental cost basis. Any allocation of shared and common costs that would have been incurred anyway would result in overstatement of the losses and overcompensation of Chorus:

> Return on provision of UFB = SUM of past (economic) losses + return on (ABAA based) valuation of past losses in RAB > normal return on investment

84. Whether or not the Commission uses ABAA, ACAM or some other methodology for cost allocation for financial separation purposes (the proposal is for ABAA consistent with Part 4 IMs precedent) is not relevant to how it determines losses from provision of UFB services. They are two separate and different exercises.

85. If, for example, the Commission used ACAM for financial separation purposes (which was previously permitted under Part 4, and now only allowed in limited circumstances) it would need to adopt a reverse application of ACAM for the purposes of calculating financial losses. Under ACAM the regulated business has been treated as the 'stand-alone' business for financial separation. If ACAM is used to determine whether losses are being made the Commission would need to treat the UFB business as the incremental basis.

86. We agree with the views of 2degrees, Frontier Economics, Spark and Vodafone on this matter e.g.:

> *"The orthodox approach to assessing whether a service is being provided below cost is to assess costs on an avoidable or incremental cost approach, which excludes all shared and common costs (and assets). We note this is the approach the Commission takes when it investigates allegations of below cost or predatory pricing under Part 2 of the Commerce Act."*[62]
>
> *"… if the Commission inappropriately allocates common costs to fibre services, either creating or exacerbating financial losses in the process ... the estimation and application of what would, in truth, be an artificial/illusory*

[61] Vocus, cross-submission, New regulatory framework for fibre, 1 February 2019, paragraph 71.
[62] 2degrees, Cross-submission in response to the Commerce Commission's proposed approach on the new regulatory framework for fibre, January 2019.

financial loss would be most unfortunate. It would constitute a windfall gain to fibre operators that took money out of the pockets of end-users for no efficiency benefits whatsoever."[63]

"Common costs should not contribute to any losses."[64]

THE COMMISSION HAS RIGHTLY IDENTIFIED ASSETS THAT ARE LIKELY TO BECOME COMPETITIVE AS AN ISSUE THAT NEEDS TO BE ADDRESSED

87. The Commission has identified a number of potential issues in relation to capex and the Capex IM that are unique to fibre regulation and Chorus' operating environment, including that there will be capex for assets that are likely to become competitive.[65]

88. One of the differences between fibre and electricity networks is that fibre is less of a 'pure' natural monopoly, with elements subject to competition e.g. layer 1 v layer 2 access. This is one of the key reasons why the statutory objectives include promotion of competition and not just replicating workably competitive markets (as per Part 4 Commerce Act).

89. Vocus notes the following relevant considerations to this matter:

    (i) In a workably competitive market a supplier would NOT be able to offset lost revenue from competition (layer 1 access) by raising prices for other services (layer 2).

    (ii) It is not the role of Part 6 Telecommunications Act regulation to compensate Chorus for lost revenue from competition. Nor does the Commission's Financial Capital Maintenance principle guarantee a regulated supplier will be able to recover all its costs.

    (iii) Even if the Commission allows assets stranded due to technological obsolescence etc to remain in the RAB (consistent with Part 4 Commerce Act RAB IM precedent) this does not mean that it should also compensate Chorus for impact of competition by allowing assets that are no longer needed due to competition to remain in the RAB.

    (iv) If Chorus is NOT insulated from the impact of competition it will have incentives to minimise risk of having assets that are not needed by arranging for sell back to vendors, matching orders to demand (just-in-time), moving assets to different locations where they are needed (unless they are genuinely sunk) etc. This highlights that Chorus is best able to manage the risk (not consumers or access seekers) and should bear the competition risk

90. If Chorus was guaranteed any assets that are no longer needed will remain in the RAB and would be able to be fully recovered it would have no incentive to take actions to mitigate those losses – the regulatory framework would permit Chorus to seek compensation from competition losses from consumers. This would be inefficient.

[63] Spark, New regulatory framework for fibre: proposed approach, Cross-submission, 1 February 2019.
[64] Vodafone, New regulatory framework for fibre: Submission on Commission's proposed approach, 21 December 2018.
[65] Commerce Commission, Fibre regulation emerging views: Technical Paper, 21 May 2019, paragraph 764.