

Commerce Commission Fibre Input Methodologies Further consultation draft

- Initial Value of Financial Loss Asset (Reasons Paper)

2degrees Cross-Submission, 1 October 2020





Introduction

2degrees appreciates the opportunity to cross-submit in response to the Commerce Commission's *Fibre Input Methodologies: Further consultation draft (initial value of financial loss asset) – reasons paper*.

An incremental or avoidable cost approach should be adopted to the determination of financial losses

There is a commonality of views amongst RSPs and Vector that the Commission is limited to an incremental or avoidable cost approach for determining financial losses. Application of an incremental cost approach would limit the extent to which pre-2011 assets could be included in the financial loss determination.

We agree with Vector that “Whilst the Commission has justified its proposed [ABAA] approach for the loss assessment as being not expressly prohibited by the Act, this reasoning does not mean it is the interpretation most consistent with the purpose of Part 6 of the Act”.

Consistent with Vector, Spark submitted “For the Commission to adopt an approach that implies significant cost for end users, it would need to establish that this approach was in end user interests. At this stage, there is nothing to suggest that this is the case”. We agree. If the Commission retains the view that it has discretion whether it applies an incremental or accounting-based (ABAA) approach, it should test the price impacts of end-users of the different options as part of its assessment.

The other clear and common message is that an incremental or avoidable cost approach would help limit the extent of double recovery between copper and fibre services.

For example, Vector submitted:

“The proposed approach has created greater risk of double recovery of costs”, and

“A direct actual expenditure approach for the Pre-Implementation Period would ensure there would be no incidental double recovery (i.e. already recouped as part of copper network service tariffs) able to be claimed as part of the FLA.”

While Chorus continues to support an ABAA approach, which increases the cost of FFLAS, their submission does not provide a sound economic rationale or explanation as to why this approach, versus an incremental approach, should be used.



Chorus continues to make unsubstantiated claims that the Commission will underestimate financial losses

The Chorus submission makes a number of claims that are not new or based on new evidence, and simply repeat previous submissions e.g. “Under-estimating Chorus’ financial losses would represent a one-off expropriation of value”, “The approach currently does not deliver on the Commission’s key economic principles of real financial capital maintenance (**FCM**), efficient risk allocation, and recognising the asymmetric consequences of over- and under-investment” and “The Commission’s approach to the initial value of the FLA will not adequately compensate Chorus for losses it incurred during the pre-implementation period, and the combination of the decisions made means there is no expectation of real FCM or efficient allocation of risks in the pre-implementation”.

In common with previous submissions, Chorus does not provide any evidence that the Commission’s proposed approach would result in under-recovery. Multiple other submitters have provided a valid alternative basis for concern: over-recovery of financial losses due to double-recovery between copper and fibre.

Well-informed and sophisticated investors would not have expected a WACC above mid-point

Chorus also repeats an earlier claim that “A 75th percentile estimate should be used, rather than the mid-point estimate to reflect the reasonable expectations investors would have held in May 2011 of a normal return over time”. This claim was also made by Cooper Investors, Investors Mutual¹ and Sapere.

This has already been addressed in previous submissions, including our “Commerce Commission Fibre Input Methodologies Cross-submission” (17 February 2020).

It has already been pointed out in submissions that:

- (i) an above mid-point WACC has never been applied under the Telecommunications Act e.g. mid-point was used in the UBA, UCLL and UBA determinations; and
- (ii) a mid-point WACC applies to Airports under Part 4 Commerce Act.

Any investor that had an expectation of a 75th percentile WACC for telecommunications services in May 2011 would have been poorly informed about the operation of the New Zealand Commerce and Telecommunications Acts.

Chorus and Sapere incorrectly claim “the Commission applied the 75th percentile to ... airport companies”. The Commission has always been clear that “For the

¹ Investors Mutual has suggested that “at a minimum, the 67th percentile should be used”.



purposes of information disclosure, ... (mid-point) WACC estimates will enable interested parties to assess the profitability of a regulated [airport] service”, and “In assessing profitability for the Airports an appropriate starting point for any assessment is the 50th percentile (mid-point) on the range”.

The Commission has also been clear that it uses estimates of the WACC at the 25th and 75th percentiles “to estimate the distribution of the estimate of the WACC”.² If Chorus and Sapere want to rely on the WACC range for forming expectations about what WACC percentile would be permitted, it can just as validly be argued a 25th percentile WACC should be adopted based on airport precedent.

It is also clear that the Commission considers WACC percentiles on an industry-by-industry basis, and that it would always be required to consider the percentile for telecommunications (and fibre) specifically rather than simply adopt a percentile used in another sector or under different legislation. The UBA and UCLL TSLRIC determination process, for example, highlighted substantial differences between energy and telecommunications which would justify different percentiles. It is also clear the Commission’s view regarding the appropriate WACC percentile can change over-time.³

An informed Chorus/investors would not simply assume the *initial* WACC percentile from a *different* regulated industry under Part 4 of the Commerce Act would be applied to Chorus.

It is interesting to note that while Chorus considers a higher WACC percentile must be adopted consistent with certain (not all) Part 4 of the Commerce Act Input Methodologies, it does not consider that other parts of those same Input Methodologies should also apply (for example, the prescriptive Transpower Capex IM).

Vector has raised material concern that the treatment of inflation will result in overstatement on financial losses

Vector has submitted the discount rate used to determine the discounted cash flow should “only provide compensation for actual inflation over the period and to remove the inflation expectations embedded in the nominal WACC” and the approach the Commission is proposing to take will overstate the WACC required to earn a normal rate of return (achieve Financial Capital Maintenance) by 80 basis points.

Given the potential materiality of this issue the Commission needs to fully consider Vector’s concerns before making final decisions on the methodology for determining the value of the Financial Loss Asset.

² Commerce Commission, Input Methodologies (Airport Services) Reasons Paper, December 2010.

³ Notably the Commission reduced the WACC percentile applying in electricity and gas from the 75th to 67th percentile.