

CallPlus

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

28 March 2014

Public Version



Table of Contents

Table of Contents	2
Executive Summary.....	3
TSO is the most relevant precedent, and the mid-point was chosen	3
Part 4 provides limited precedent for selecting above or below mid-point WACC	3
Other matters	4
Introduction	5
Precedent for determining WACC: TSO.....	6
Number of factors suggest the Commission should err on the side of a low WACC for telecommunications.....	7
Wording of the purpose statements under the Commerce and Telecommunications Acts	8
... The nature of the markets with competing technologies and infrastructure in telecommunications	8
Negative impact on take-up of broadband and Chorus roll-out of fibre.....	9
Distinction between sunk and new investment.....	10
Timing of the cost of capital IMs review	12
Consistency of approach to asymmetric cost across jurisdictions	13
Concluding remarks.....	14

Executive Summary

1. CallPlus has a number of comments on the Commerce Commission's technical consultation paper, Determining the cost of capital for the UCLL and UBA price reviews, 7 March 2014.
2. We are pleased to see the Commission consulting early on how to set the WACC for UBA and UCLL services.

TSO is the most relevant precedent, and the mid-point was chosen

3. We note the precedent of the Commission setting WACC at the mid-point when determining the net cost of the Kiwi Share Obligation (residential telephony Telecommunications Service Obligation (TSO)).
4. We note the Commission considered whether to provide an increment on WACC over and above the mid-point and rejected this for each of its TSO determinations.
5. We also note the Commission has stated that whether a mid-point WACC, or a WACC above the mid-point, should be selected should be determined on a case-by-case basis.

Part 4 provides limited precedent for selecting above or below mid-point WACC

6. There are generic aspects of the WACC determination which mean the Part 4 cost of capital Input Methodologies (IMs) should be used as a starting point for the determination of the UBA and UCLL service WACCs.
7. There are, however, substantive differences between telecommunications and Part 2 of the Telecommunications Act 2001 and energy and Part 4 of the Commerce Act 1986 which limit the relevance of the adoption of the 75th percentile WACC for energy as a precedent for telecommunications. These differences mean the case for an above mid-point WACC may be weaker in telecommunications than for energy. The corollary to this is that a mid-point or below WACC could best serve the long-term interests of end-users of telecommunications services, regardless of whether a 75th percentile WACC is preserved under Part 4 of the Commerce Act.
8. The differences between the sectors include, but are not necessarily limited to:
 - a. The Part 4 Commerce Act purpose statement reference to incentives to invest is limited to the incentives of the regulated supplier in relation to the regulated service. The Part 2 Telecommunications Act purpose is broader and relates to both Access Provider and Access Seeker incentives to invest, and to new services that aren't necessarily regulated.
 - b. This reflects a fundamental difference between energy and telecommunications; specifically that both Access Providers and Access Seekers invest in network infrastructure to deliver services to end-users of telecommunications services. The incentives to invest by Access Seekers can be hurt by setting higher network access prices e.g. if a higher WACC is selected. Specific to copper also, allowing Chorus higher prices and returns for copper services could undermine its incentives in relation to roll-out of fibre services.

- c. The Commission would need to take into account the impact of higher network access prices for UBA and UCLL services on the uptake of broadband services by end-users.
- d. The distinction between copper (old technology) and fibre (new technology) also provides a clearer distinction between sunk and new investment. In terms of MEUG's proposal for a two-tier WACC approach, for example, copper services could be treated as sunk investment (warranting a lower WACC) and fibre could be treated as new investment (although even UFB fibre is an already committed investment¹). This may be a cleaner distinction than exists in energy.

Other matters

9. We note Vector's concern that the Commission has been more sympathetic about taking asymmetric cost into account in its price determinations under Part 2 of the Telecommunications Act than under Part 4 of the Commerce Act. Vector also argue this has resulted in the Commission being more permissive towards erring on the side of higher rather than lower price determinations under the Telecommunications Act than the Commerce Act. In this context they reference their estimate that the Initial Pricing Principle (IPP) Determinations for copper services would result in much higher returns than the Commission allows in other sectors and jurisdictions.

10. If Vector is correct this brings into question whether the Commission's approach to asymmetric cost in telecommunications is too generous for Access Providers. The Commission should consider Vector's comments in the context of its WACC determination for UBA and UCLL services, and for its consequent Final Pricing Principle (FPP) determinations.

¹ Noting that investment in UFB fibre is driven by Government contract.

Introduction

11. We note that aspects of our submission may have consequential implications for the Commission's consideration of review of its cost of capital Input Methodologies (IMs) under Part 4 of the Commerce Act 1986.

12. A number of previous consultations are relevant to the Commission's technical consultation paper on WACC. We refer the Commission, for example, to submissions made to the Ministry of Business, Innovation and Employment (MBIE) in response to its discussion document "Review of the Telecommunications Act 2001", August 2013. The submissions have useful common themes about the impact of setting copper prices artificially-high.

13. Similarly also the Commission's preceding consultation papers, such as the "Process and issues paper for determining a TSLRIC price for Chorus' unbundled copper local loop service in accordance with the Final Pricing Principle", 6 December 2013, also have relevance to the determination of the WACC for UBA and UCLL services.

Precedent for determining WACC: TSO

14. The Commission precedent for determining the WACC of an Access Provider under the Telecommunications Act 2001 is the determination of the net cost of the Telecommunications Service Obligation (TSO) for local residential services. In all of the Commission's determinations it selected the mid-point (50th percentile) WACC. The Telecommunications Act at the time did not have subsection 18(2A) so no explicit requirement to consider the incentives to invest of Access Seekers or on new services which would have further reinforced the choice of a mid-point (or lower) WACC.²

15. The pre-Chorus separation Telecom advocated, at the time, that the Commission should add a premium or mark-up on this WACC. The Commission rejected this proposition.³ The Commission retained selection of the mid-point WACC through each of its TSO determinations from 2003 through to the last TSO determination in 2009, even though it calculated WACCs below and above the mid-point in its determinations.

16. The Commission has established a 75th percentile WACC for electricity and gas network price determinations under Part 4 of the Commerce Act. We note though that it also applies a range of 25th, 50th and 75th for Information Disclosure purposes for energy and airports under Part 4. The 75th percentile WACC may or may not be retained following the Commission's review of whether to adopt a 50th or 75th percentile WACC following the direction for review from the High Court merit appeal.⁴

17. Even if the Commission retains the 75th percentile for its Part 4 energy pricing determinations, CallPlus does not believe this should necessitate the Commission adopts a 75th percentile WACC for UBA and UCLL services under Part 2 of the Telecommunications Act or that the Commission should assume opting for 75th percentile WACC would best meet the statutory objective under section 18 in Part 2 of the Telecommunications Act. The Commission has noted that "[t]he extent to which the Commission departs from the mid-point is a matter of judgment and must be assessed on a case-by-case basis."⁵

² Various submissions made to the Commission on its TSO determinations pointed out that the TSO cost determinations amounted to a tax on competition and, therefore, the higher the TSO cost determination the more detrimental it would be to competition.

³ Refer, for example, to the section "Increment to WACC" in the Commerce Commission's Determination for TSO Instrument for Local Residential Service for period between 20 December 2001 and 30 June 2002, 17 December 2003.

⁴ Wellington International Airport Ltd & Ors v Commerce Commission [2013] NZHC 3289 [11 December 2013]. Additionally, MEUG has sought leave to appeal the Court's decision not to reject the 75th percentile WACC.

⁵ Paragraph 128, Commerce Commission, Draft Guidelines: The Commerce Commission's Approach to Estimating the Cost of Capital, 1 October 2005.

Number of factors suggest the Commission should err on the side of a low WACC for telecommunications

18. While CallPlus considers pan-industry consistency to be important, we agree with the Commission that "Different considerations are relevant for UCLL and UBA, compared to services regulated under Part 4 of the Commerce Act."⁶

19. There are a number of factors that distinguish telecommunications and Part 2 of the Telecommunications Act from energy and Part 4 of the Commerce Act. An implication is that the grounds for selecting a lower, mid-point or below, WACC may be stronger under the Telecommunications Act than the Commerce Act.

20. It could be quite reasonable for the Commission to reach different determinations on WACC between the two jurisdictions, such that even if it determined that a 75th percentile WACC should be retained under the Commerce Act it could decide a 50th percentile (or below) WACC should be applied under the Telecommunications Act.

21. These factors include, but are not necessarily limited to:

- a. Differences in the wording of the purpose statements under Part 2 of the Telecommunications Act and Part 4 of the Commerce Act, and other legislative differences;
- b. The nature of the markets with competing technologies and infrastructure in telecommunications;
- c. The negative impact higher copper prices would have on take-up of broadband and Chorus roll-out of fibre; and
- d. The clearer distinction between sunk investment (copper) and new, modern, technology and investment e.g. fibre in telecommunications.

22. The Commission, in its Input Methodologies Reasons Paper, has argued "Incentives for dynamic efficiency can have significant benefits for consumers over the long term, so it is important to preserve incentives to invest and innovate. Accordingly, this consideration has been given greater weight than limiting suppliers' ability to extract excessive profits"⁷ and "For application in DPPs/CPPs, the IM uses the 75th percentile estimate of the WACC to ensure there are sufficient incentives to invest in regulated services for the long-term benefit of consumers."⁸

23. CallPlus agrees it is important to preserve and ensure incentives to invest and innovate. Consideration of incentives to invest in sectors such as electricity and gas networks is somewhat one dimensional than for telecommunications though. The Commission's consideration of incentives to invest can largely be limited to the Access Provider being regulated, and to the particular regulated good or service (particularly in the context of subsection 52A(1)(a)). It is

⁶ Paragraph 101, Commerce Commission, technical consultation paper, Determining the cost of capital for UCLL and UBA price reviews, 7 March 2014.

⁷ Paragraph 6.7.12, Commerce Commission, Input Methodologies Reasons Paper, December 2010.

⁸ Paragraph 6.8.8, Commerce Commission, Input Methodologies Reasons Paper, December 2010.

understandable then in the energy/Part 4 context, whether valid or not, that the Commission has previously reached the conclusion that incentives to invest equates to incentives for the Access Provider to invest and this, in turn, equates to allowing higher prices/profits for the Access Provider.

24. In the telecommunications context consideration of incentives to invest is not so simple and one-dimensional. When the Commission considers incentives to invest in the telecommunications context it needs to take into consideration, amongst other things, that there can be multiple competing networks and technologies and investment by both Access Providers and Access Seekers.

Wording of the purpose statements under the Commerce and Telecommunications Acts ...

25. We agree with the Commission that the purpose statements in the section 52A of Part 4 of the Commerce Act and section 18 of Part 2 of the Telecommunications Act are an example of the different considerations relevant for UCLL and UBA, compared to services regulated under Part 4 of the Commerce Act.⁹

26. Both purpose statements are consumer-centric, and place primary importance of promoting the long-term interests of consumers/end-users. A higher WACC can only be allowed if it results in better outcomes for consumers. The references to incentives to invest under the two purpose statements is, however, quite different with the Telecommunications Act offering a broader reference than the Commerce Act.

27. The reference to investment incentives under section 52A of Part 4 of the Commerce Act one dimensionally refers to the "promoting outcomes .. such that suppliers of regulated goods or services ... have incentives to innovate and to invest ..."

28. The purpose in section 18 of Part 2 of the Telecommunications Act has a much broader reference to incentives to invest stating at (2A) that "To avoid doubt, in determining whether or not, or the extent to which, competition in telecommunications markets for the long-term benefit of end-users of telecommunications services within New Zealand is promoted, consideration must be give to the incentives to innovate that exist for, and the risks faced by, investors in new telecommunications services that involve significant capital investment and that offer capabilities not available from established services" (emphasis added).

... The nature of the markets with competing technologies and infrastructure in telecommunications

29. The reference to incentives to invest under Part 4 of the Commerce Act clearly refers to the incentives of the Access Provider (the Regulated Supplier) in provision of the regulated service. In relation to the Telecommunications Act, and UCLL and UBA services, the reference is to investors in new telecommunications services which can include provision of non-regulated services such as fibre services by the Access Provider, and other LFCs, and also to services provided by Access Seekers. As the Commission has noted "When setting regulated access prices, investment incentives faced by both the access provider and access seekers are relevant. Although setting a WACC above the mid-point may help

⁹ Paragraph 101, Commerce Commission, technical consultation paper, Determining the cost of capital for UCLL and UBA price reviews, 7 March 2014.

ensure the access provider faces sufficient investment incentives, this may disincentivise investment by access seekers.”¹⁰

30. The Commission needs to consider not only Chorus’ incentives to invest, but also CallPlus’ (and other Access Seekers) investment in UCLL and network expansion. A point we made to MBIE in its consideration of proposals to overrule the Commission, and retain artificially high copper prices, was that “Without the presence of players such as CallPlus and our LLU investments, there is a very risk of a duopoly in the fixed line market of integrated mobile-fixed players.”¹¹

31. The Commission has recognised that the operation of the likes of CallPlus and other Access Seekers is important for competition (and, by inference, investment) when it issued its decision clearing Vodafone’s acquisition of TelstraClear:¹²

... post acquisition [of TelstraClear by Vodafone], Orcon and Slingshot will continue to act as aggressive, price leading competitors in the market. While they lack the scale of Telecom or the merged entity, they are able to compete effectively, especially in areas where they have unbundled (where Vodafone’s fixed network is largest). The Commission considers that, post acquisition, Orcon and Slingshot will provide competitive constraint on the merged entity.

32. We don't consider use of a higher WACC for the regulated copper services would result in greater incentives for Chorus or LFCs to invest in fibre, or greater incentives to invest by Access Seekers. The opposite is more likely.

33. Chorus and MBIE (in its review of the Telecommunications Act) have both relied on arguments that higher copper prices are required to fund or cross-subsidise investment in fibre services. These arguments were largely rejected by submitters in response to MBIE’s discussion document on the matter.

34. The argument that higher prices for regulated services (e.g. copper) are required to finance investment in other services (e.g. roll-out of fibre services) was clearly also rejected in the High Court’s Part 4 Merit Appeal commentary:¹³

The idea that greater revenues produced by higher allowed earnings on past investments (ie on the initial RAB) provide the wherewithal for more future investment is contrary to rationale investment choice. Those existing higher earnings, once earned, are a given. The source of funds for future investments does not influence the riskiness of future investments; nor, therefore, does it influence their attractiveness. If anything, an abundance of capital is likely to lead to wasteful investment.

Negative impact on take-up of broadband and Chorus roll-out of fibre

35. As noted above, the MBIE review of the Telecommunications Act provides useful illustration of the risks of setting prices for UBA and UCLL services too high (including in selection of WACC).

¹⁰ Paragraph 102, Commerce Commission, technical consultation paper, Determining the cost of capital for UCLL and UBA price reviews, 7 March 2014.

¹¹ Paragraph 12, CallPlus, Submission on the MBIE review of the Act Discussion Paper, September 2013.

¹² Commerce Commission, Determination, Vodafone New Zealand Limited and TelstraClear Limited [2012] NZCC 33, 29 October 2012.

¹³ Paragraph [1480], Wellington International Airport Ltd & Ors v Commerce Commission [2013] NZHC 3289 [11 December 2013].

36. While the Government's then proposed intervention was of a magnitude larger than the impact of a decision on whether to use an above or below mid-point WACC, the general themes about negative impacts on incentives, investment and roll-out of new technologies (e.g. fibre) are of general relevance to any Commission decision on whether to err on the side of setting copper prices too high rather than risk setting them too low. Examples include:

- a. It would act as a form of "trade protection" in favour of fibre services, and would not create a level playing field. Fibre should compete on its merits, including by Chorus improving the available UFB broadband speeds, rather than relying on high copper prices to make fibre seem artificially more attractive.
- b. If the price for copper services is kept too high it could undermine demand growth for broadband services. (It should be borne in mind, in contrast to regulated energy services, that fixed broadband is not an essential service for end-users.) Copper broadband services are a stepping stone for fibre services, so anything that undermines demand for copper services could have negative impacts, over-time, for broadband services.
- c. Chorus would have incentives to take a go slow approach to roll-out and uptake of fibre services. This is because its investment in fibre services would cannibalise the profitable (and more profitable with a higher WACC) copper services.
- d. Even if higher copper prices encouraged greater fibre uptake, this would not necessarily be the case in LFC areas that Chorus is not rolling fibre to. This is because Chorus' incentives would be to set its copper prices below the regulated price, in those areas, in order to compete.

37. CallPlus does not consider any of these outcomes would be consistent with the statutory objective in section 18(2A) of the Telecommunications Act and "consideration ... to the incentives to innovate ... and the risks faced by ... investors in new telecommunications services ..."

Distinction between sunk and new investment

38. The MEUG proposal for a two-tier WACC under Part 4 of the Commerce Act is worth considering in the specific circumstances of the telecommunications sector. The concept is that sunk investment warrants a lower WACC than for new investment, because it is the return on new investment that will determine investment incentives. We believe this accords with section 18(2A) of the Telecommunications Act.

39. The High Court, in considering MEUG's proposal, made the following observations:¹⁴

In principle, that proposal is stronger; because by providing the likelihood of higher than normal returns on new investment it overcomes any disincentives that may be claimed to exist (compared to the use of the mid-point) ...

But we were not presented with a clear means of implementing the two-tier proposal, and the Commission's concerns about it were not addressed. Therefore ... we would be unable to provide relief of the type sought because we were provided with insufficient

¹⁴ Paragraphs [1484] and [1485], *Wellington International Airport Ltd & Ors v Commerce Commission* [2013] NZHC 3289 [11 December 2013].

information to ground directions to the Commission with the necessary degree of precision.

40. One of the stumbling blocks to adoption of MEUG's proposed two-tier WACC approach (lower WACC for sunk costs, higher for new investment) is how to distinguish between sunk and new investments.

41. A simple pragmatic delineation may be more straightforward in telecommunications than for energy. CallPlus would suggest that treating the copper network (UBA and UCLL), in its entirety, as a sunk cost would be consistent with MEUG's two-tier WACC proposal. The focus on investment services should be on new technology and "new telecommunications services that involve significant capital investment and that offer capabilities not available from established service" (section 18(2A), Telecommunications Act). The general thrust of the High Court's consideration of WACC is to suggest that what is important, in relation to section 18(2A) of the Telecommunications Act, is the returns on new services such as fibre, rather than on old technology such as copper.

42. The distinction between copper and fibre also fits with the observation, cited by the Commission, of Frontier Economics that the European Commission has highlighted additional risks associated with fibre investment, compared to investment in existing copper networks, due to uncertainty over future demand for fibre services.¹⁵

¹⁵ Page 30, Frontier Economics, Determining a TSLRIC price for Chorus' UCLL service, February 2014.

Timing of the cost of capital IMs review

43. Various of the submissions made to the Commission in response to its consultation on whether it should review the use of 75th percentile WACC this year, and consider adopting 50th, as part of the cost of capital IMs under Part 4 of the Commerce Act¹⁶ stated that:

- a. It would be premature and inappropriate to undertake such a review while the Courts are considering an appeal of its use under Part 4 of the Commerce Act; and
- b. The specific construct of Part 4 and its requirement for the Commission to establish IMs (not applicable under the Telecommunications Act) suggest the IMs should only be amended in limited circumstances. This would help ensure the IMs satisfy the purpose of IMs, under s 52R of the Commerce Act, "to promote certainty for suppliers and consumers in relation to the rules, requirements, and processes applying to the regulation, or proposed regulation, of goods or services under this Part".

44. Both of these arguments are Commerce Act specific, and are not relevant to the Commission's consideration of whether it should apply a 50th percentile (or otherwise) WACC for UBA and UCLL services. If the Commission accepts these arguments, and delays review of the cost of capital IMs, the consequence is that the 50th (or below) v 75th percentile review should occur now under the auspices of the UBA and UCLL Final Pricing Principle (FPP) determinations, followed by subsequent review of the IMs at a later date. The UBA and UCLL FPP determinations would then serve as a precedent that would inform the subsequent IMs review.¹⁷

¹⁶ Commerce Commission, Invitation to have your say on whether the Commerce Commission should review or amend the cost of capital input methodologies, 20 February 2014.

¹⁷ Albeit that consideration would be given to the types of sector specific differences raised in this submission.

Consistency of approach to asymmetric cost across jurisdictions

45. We note that Vector has expressed concern the Commission has adopted an inconsistent approach to treatment of asymmetric cost under Part 2 of the Telecommunications Act and Part 4 of the Commerce Act, with the Commission being more permissive towards erring on the side of higher rather than lower price determinations under the Telecommunications Act than it is to regulated suppliers under the Commerce Act.¹⁸

46. This concern was expressed in the context of Vector's estimation, confirmed by Network Strategies, that the Initial Pricing Principle (IPP) determinations for copper services would enable Chorus to extract a return on investment (ROI) of 19 - 23% on its copper network between 2014 and 2019.¹⁹

47. CallPlus agrees with Vector, assuming they are correct and there is an actual inconsistency in approach, that the Commission should either address this inconsistency: (i) adopt an equivalent approach to asymmetric cost under Part 2 of the Telecommunications Act and Part 4 of the Commerce Act (would not have any implications for the UBA and UCLL FPP determinations); or (ii) "cease to provide for asymmetric cost in price determinations under Part 2 of the Telecommunications Act".²⁰ The latter Vector recommendation would have potential implication not only for the WACC that is selected, but also other decisions such as where in a benchmark range the Commission would select a price for an IPP.

¹⁸ Vector, Submission to the Commerce Commission on the Scoping and Issues Discussion Paper for UCLL TSLRIC, 14 February 2014.

¹⁹ Paragraphs 23 and 25 – 29, Vector, Submission to the Commerce Commission on the Scoping and Issues Discussion Paper for UCLL TSLRIC, 14 February 2014.

²⁰ Paragraph 48, Vector, Submission to the Commerce Commission on the Scoping and Issues Discussion Paper for UCLL TSLRIC, 14 February 2014.

Concluding remarks

48. In considering the approach to determination of WACC for UBA and UCLL services that would best promote competition and serve the long-term interests of end-users, CallPlus notes the following points.

49. First, while copper services will play an important role for the foreseeable future, the future is in fibre and other technologies. Chorus' investment in copper should be treated as sunk.

50. Second, consideration needs to be given to the impact of higher copper prices on the uptake of broadband services by end-users.

51. Third, incentives to invest in new capital intensive technologies should not be assumed to equate to a need to provide Access Providers with higher regulated prices for telecommunications services. The opposite could be appropriate.

52. Fourth, incentives to innovate and invest in fibre, and incentives of Access Seekers to invest, are more important than Chorus' incentives to invest in its existing copper network. By way of analogy, concern about incentives to invest in copper would be akin to concerns about whether electronic good manufacturers would continue to invest in manufacture of VHS video recorders, tape decks and tube TVs.

53. Fifth, CallPlus agrees with the High Court that it is not appropriate to conflate the prices for one service (e.g. copper) in order to provide revenue that can be invested in another service (e.g. fibre). Chorus is already receiving a substantial subsidy for fibre roll-out, without additional subsidies from consumers of copper services.

54. Sixth, and finally, CallPlus also agrees with the Commission that "[t]he extent to which the Commission departs from the mid-point is a matter of judgment and must be assessed on a case-by-case basis."²¹ In telecommunications the Commission has previously selected the mid-point (TSO determinations). Just because the Commission is presently using 75th percentile for price regulation under Part 4 of the Commerce Act does not mean it should do the same under Part 2 of the Telecommunications Act.

²¹ Paragraph 128, Commerce Commission, Draft Guidelines: The Commerce Commission's Approach to Estimating the Cost of Capital, 1 October 2005.