Fibre regulation emerging views

Cross-submission to Commerce Commission

PUBLIC VERSION

31st July 2019

INTRODUCTION

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

2. We were dissapointed the Commission provided limited extension to the cross-submissions in response to our request. This has limited the extent to which we have been able to engage with submissions.

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

Johnathan Eele
General Manager Commercial and Regulatory
Vocus Group (NZ)

johnathan.eele@vocusgroup.co.nz

PROCESS ISSUE IN RELATION TO THE ENABLE NETWORKS AND ULTRAFAST FIBRE JOINT SUBMISSION THAT NEEDS TO BE ADDRESSED

4. The Enable Networks and Ultrafast Fibre joint submission commented that: *"In … this submission we focus on eight key issues. The fact that we have not commented on other aspects of the EVP … does not mean we necessarily agree with those views; we propose to deal with other relevant issues in the cross-submission process"* [emphasis added].

5. It would be a novel approach to effectively split a submission into two separate componments with one component included in the cross-submission.

6. If elements of the Enable Networks and Ultrafast Fibre submission are submitted late as part of their cross-submission they should either be disregarded by the Commission or otherwise made available to other stakeholders for further cross-submissions.

SOME GENERAL OBSERVATIONS BASED ON EMERGING RSP AND CONSUMER CONSENSUS, AS WELL AS CHORUS' SUBMISSIONS

7. We note the following observations based on emerging views from submissions:

   - **Risk of over-reliance on Chorus needs to be managed:** A challenge for the Commission is ensuring it is not overly reliant on Chorus for information on costs etc required for the price-quality path determination.
   - The limited timeframe for development of the new fibre regulatory framework and the first price-quality path determination risks advantaging Chorus. That is why it (successfully) lobbied for a substantially condensed legislative timeframe, despite

having expert advice on what is required for IPPs and CPPs under Part 4 Commerce Act.

- **Chorus is isolated in the view that section 162 has primacy over section 166:** Chorus continues to persevere with arguments that section 162 has primacy over the section section 166 arguments. We have addressed these claims previously.

  The legislation does not need to *"provide … objective criterion to assess how to make 'trade-offs' between the two potentially conflicting policy objectives"*. The Commission has to continually make any number of trade-offs between conflicting policy objectives, including the subparts of section 162 (and the Part 4 equivalent of section 52(1)A).

  Chorus' claim *"promoting workable competition for the long-term benefit of all end-users in section 166(2)(b) cannot be 'relevant' where doing so does not promote outcomes consistent with WCMs for the long-term benefit of FFLAS end-users"* doesn't make any sense. It is not obvious how promoting workable competition would produce outcomes which conflict with workably competitive markets (?). It may be instructive to seek clarification from Chorus about what kinds of scenarios it had in mind when it made this statement.

- **Chorus' can't just rely on assertions about forecasting difficulty etc:** Chorus is overstating difficulty in forecasting demand growth etc. Chorus has not demonstrated these challenges are any different to that which other suppliers in the telecommunications market face, albeit without the same uncertainty driven by impact of competition.

- **Real FCM does not translate to insulating Chorus from the negative affects of competition:** The Commission should ensure the Cost Allocation, RAB and Capex IMs 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). It is clear from submissions, including Chorus, that the prospect of competition is a defining characteristic of the fibre market which distinguishes it from services regulated under Part 4 Commerce Act.

- **Uncertainty over layer 1 unbundling needs to be resolved:** The matter of how layer 1 versus layer 2 services will be priced is a source of considerable uncertainty. Axiom, for example, note *"businesses contemplating acquiring layer 1 dark fibre services need to know how the prices will be set in, say, 2025 so that they can be factored into their investment plans today, i.e., they may be disinclined to deploy capital towards these endeavours if there is a risk that Chorus' prices will ultimately prove uneconomic"*.

- **Financial losses need to be calculated on an Incremental Cost basis to preclude or mitigate excessive profits:** Any common or shared costs included in the financial loss calculation would result in overstatement of financial losses and

excessive profits. 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. 2degrees submission is particularly strong on this point and does a good job of deconstructing all of the Commission's arguments against an incremental cost approach.

- **Chorus' own submission explains why an incremental cost approach is *"economic common sense"*:** Chorus (presumably unintentionally) admit financial losses should be determined on an incremental basis in their advocacy of OVABAA. Chorus stated, *"It is efficient … if the regulated business is able to recover at least the incremental costs …", "… under ABAA, the costs that would be allocated could exceed incremental cost because this is an accounting method, rather than an economic method …"*. It is clear from Chorus' comments an incremental cost approach would ensure the service is able break-even and ABAA could make provision of the service appear *"uncommercial and unprofitable"* when it is not.
- **Pre-2011 assets and costs did not contribute to any UFB financial losses:** The financial loss calculation should exclude any pre-2011 assets as Chorus incurred these regardless of whether it provided UFB services and they don't impact the level of losses (if any) that resulted from provision of UFB. Trustpower and Vodafone's submissions are particularly notable on this point.
- **The burden of proof should be on Chorus to demonstrate financial losses:** The High Court made clear the onus was on regulated suppliers to demonstrate the Part 4 RAB IM would not allow them to recover their costs of supply. The same burden of proof should apply to any financial loss determination. The onus should be on Chorus to demonstrate it has incurred genuine losses. It is clear from submissions there are substantial doubts about the extent to which Chorus has incurred any financial losses.
- **Practical issues with double-recovery between copper and fibre are overstated:** Addressing double recovery between copper and fibre services should not be as difficult as the Commission's initial views suggest. The Commission applied a limited scorched node approach to TSLRIC and has full details of the sharing assumptions it made and the common cost allowance that was included.
- **WACC should be set at mid-point with no uplift:** There is no justification for deviating from airport and copper precedent for setting WACC percentile at mid-point. The lack of any real evidence from Chorus (and HoustonKemp) to support uplift is revealing. If Chorus was able to produce credible evidence it has incentives to do so. Tellingly, Chorus has now made it clear it is not committed to providing quantified evidence at all, with Chorus indicating it is only *"… investigating how … quantitative analysis can be done …"*

RETAIL COMPETITION IS NOT ELEVATED ABOVE INFRASTRUCTURE-BASED COMPETITION

8. Given the comments we previously made in relation to Trustpower's position on retail versus infrastructure competition, we welcome that their latest submission is clear they support *"a level playing field [that] … leads to outcomes that do not favour one technology over another …*"

9. It would appear Chorus stands alone in viewing retail competition as more important than infrastructure-based competition. Even then, it would seem Chorus doesn't even agree with itself, at least in terms of time consistency. A core part of Chorus' (née Telecom's) views during the section 64/Local Loop Unbundling investigation was that infrastucture based competition is superior to retail competition.

10. It may be Chorus' thinking has moved on, but this represents a complete u-turn. As far as we can tell, Chorus' reversed its views on infrastructure competition at the time the Government announced the UFB tender and Chorus faced, for the first time, the prospect of genuine infrastructure-based competition if it did not win the lion share of the UFB tender.

THE COMMISSION SHOULD ENSURE EQUIVALANCE AND NON-DISCRIMINATION

11. We fully support Vector Fibre's comments on this topic, including but not limited to the following summarised statements:

> *"While we note and welcome that the Commission has commenced work on the equivalence and non-discrimination obligations in the Deeds in order to provide guidance to the industry, we do not believe that this is sufficient. We are of the view that the Commission should go one step further and develop competition principles that address the application of the non-discrimination and EoI obligations as they apply to FFLAS in the Deeds [footnote removed].*
>
> *"This is especially important in relation to those FFLAS that are key inputs for competitive services, such as unbundled fibre. We have already seen that these issues are contentious in respect of Chorus' proposed commercial PONFAS product, both in terms of the pricing terms and also the other terms such as the stipulated requirement that service providers must consume the end-to-end PONFAS service comprising both the feeder and distribution fibres, as well as associated ancillary services, and the exclusion of NBAPs. We have a number of serious concerns around Chorus' proposed price and product terms for PONFAS that may not be directly relevant to the Commission's emerging views paper, but which we wish to address with the Commission at an appropriate time".*

CHORUS HAS MADE ITS OWN BED …

12. In our submission we raised the matter of the challenges and pressures the Commission faces in implementing the new regulatory framework in an unduly short (legislative) implementation timeframe.

13. We noted that our sympathy does not extend to Chorus, as Chorus lobbied the Government for a short implementation timeframe, which didn't exist under Part 4 Commerce Act, knowing full well the consequences. Our view is Chorus has made its own bed and must lie in it.

14. It will come as no surprise we do not support Chorus' views on transitional arrangements. We recognise the regulatory regime for fibre will evolve over-time, as it has done under Part 4 Commerce Act, with incentive mechanisms (IRIS, service-quality & revenue links etc) being prime examples. This does not extend to softening of service-quality requirements (*"targets rather than strict standards"*) or Chorus' position *"A modified approach is also appropriate for some expenditure process and evaluation requirements given the challenging timeframes to implement a new regulatory regime"*. We are particularly concerned with Chorus' suggestion the Independent Verification be voluntary and limited (Chorus' euphemistically uses the term *"tailored"*) to *"a material subset and range of our capex programmes"*.

15. Chorus should have raised issues about the challenges from a tight timeframe for implementation when the legislation was being introduced, rather than advocating the tight timeframe it is now complaining about.

WE ARE DISSAPOINTED BY CHORUS' ATTEMPTS TO MARGINALISE THE ROLE OF CONSULTATION WITH STAKEHOLDERS, AND INDEPENDENT SCRUTINY

16. Vocus would like to see signs Chorus' intends to engage with the new fibre regulatory framework and with stakeholders in goodfaith, and in an open and transparent manner.

17. Chorus position that the Commission should *"defer any obligation for us to engage with consumers on the development of our price-quality proposal for RP2 … is due to the timing challenge for developing a price-quality proposal"*[1] is entirely a consequence of its iwn successful lobbying of Government for a severely constrained implementation timetable.

18. The same observation is applicable to Chorus position on RP1 Independent Verification: *"for RP1 there needs to be allowance for the short timeframes to develop the price-quality proposal and conduct IV while IMs are being set. So for RP1 we support voluntarily engaging an independent verifier of our proposal and submitting the IV report with it to the Commission … We also consider that a tailored IV proposal (verifying a material*

[1] Chorus, Submission in response to the Commerce Commission's fibre regulation emerging views dated 21 May 2019, 16 July 2019, paragraph 114.

subset and range of our capex programmes) is appropriate for RP1 given the timing challenges and resource impacts of servicing a full IV".[2]

19. We are also concerned about Chorus' other attempts to limit consultation and independent verification, beyond the transition for the first regulatory period including, for example, Chorus' proposal that *"The process for applying for a reopener application should not require us to consult with relevant consumers or require IV"*.[3]

THE TRANSITIONAL ARRANGEMENTS CHORUS IS SEEKING ARE SIMPLY NOT TENABLE

20. Chorus claim that *"the Commission has mischaracterised our proposal for transitional arrangements in the EV Paper"*.

21. This claim is made on the basis that the Commission said: *"Chorus suggested not setting targets for quality regulation (as part of the price-quality path) for the first regulatory period as a potential transitional arrangement"* versus the Chorus submission that *"Using reporting requirements in the first regulatory period (RP1) rather than strict quality compliance thresholds would also support a pragmatic and appropriate approach to implementation"*.

22. The distinction Chorus is now attempting to make is pure sophistry. What Chorus is advocating amounts to no more than Information Disclosure for the first regulatory period. A service quality standard without compliance repercussions amounts to not serving service quality targets at all.

THERE ARE RELEVANT INDUSTRY SPECIFIC DIFFERENCES BETWEEN SERVICES REGULATED UNDER PART 4 COMMERCE ACT AND FIBRE SERVICES REGULATED UNDER PART 6 TELECOMMUNICATIONS ACT

23. With respect, we do not consider the Commission has sufficiently taken account the differences between sectors regulated under Part 4 Commerce Act and fibre services regulated under Part 6 Telecommunications Act, particularly in the context of establishing the RAB, cost allocation, and pricing principles.

24. We agree with Spark that *"The Commission is tasked with applying Part 6 utility regulation to a notional Fibre Network operated by an access provider with substantial interests in both substitute connectivity services and in adjacent markets, and with the prospect of the regulatory setting leading to distorted competition in markets. This is a level of complexity that sets Part 6 regulation apart from other sectors subject to utility regulation".* Other submitters have expressed variations on this view.

---

[2] Chorus, Submission in response to the Commerce Commission's fibre regulation emerging views dated 21 May 2019, 16 July 2019, paragraphs 115 and 116.
[3] Chorus, Submission in response to the Commerce Commission's fibre regulation emerging views dated 21 May 2019, 16 July 2019, paragraph 6.

25. Link Economics articulates well *"There is a significant level of complexity with regard to the way in which competition may be affected by Fibre IM decisions, and likely substantially more so than for IMs decisions relating to other sectors regulated under Part 4"*, including but not limited to:

(i) *"The pricing of Fibre Fixed Line Access Services (FFLAS) at different levels of the vertical supply chain, such as unbundled services, Direct Fibre Access Services (DFAS) and layer 2 services. The resulting relativity in prices of vertical services, which will be affected by IM decisions such as those relating to cost allocation, will affect the choice of inputs used by RSPs, which in turn will impact competition at the retail level."*

(ii) *"The pricing of inputs used to supply telecommunications services via other networks such fixed wireless and mobile networks. Some of these services will be complementary services to retail fibre services and some will be substitutes."*

(iii) *"… in respect of telecommunications sector there is also a heightened impact on dynamic efficiency as a result of potential impacts on incentives for investment in alternative networks as well as for downstream competition."*

(iv) *"IM decisions have the potential not only to impact on incentives for infrastructure-based competition but also on the dynamics of retail competition, for example, by influencing the relative price of alternative FFLAS products that may be used by different RSPs."*

(v) *"With regards to competition implications, in the electricity sector all retailers pay the same price and use the same access product. In contrast, for telecommunications supply there may be options to invest in an alternative network, whether fixed (such as fibre), fixed wireless or mobile, as well as choices between FFLAS services. The way in which costs are allocated between services could distort incentives for investment in other networks and selection by RSPs of FFLAS services."*

26. Link Economics, consistent with RSP submissions, provided cost allocation as an example where industry specific differences should be relevant to the Commission's decisions on the IMs: *"Cost allocation decisions will potentially have a very significant impact on outcomes and require a rigorous and transparent process. While there may be difficulties in determining upfront rules in the IMs with a high degree of specificity, as an alternative Chorus could be required to engage in a consultative process when determining cost allocation rules, with its resulting rules subject to independent verification and approval by the Commission".*

27. Spark (and Axiom) usefully build on and emphasis these points by detailing some of the incentives Chorus would have, absent prescriptive direction from the Commission. We agree with their conclusions *"care is required in setting regulatory parameters that limit or mitigate these incentives, and address information asymmetries that facilitate them*" and *"the technical paper proposals - which devolve many of the key regulatory decisions to*

Chorus - are unlikely to be effective when faced with these incentives. … the framework will need to be more directive and give the Commission, within general principles, the ability to more directly determine key parameters of the approach".

28. Spark observed that *"For example, Chorus indicated during the initial phases of the roll out that it planned to reuse much of its existing network for UFB deployment, including 29,000km of existing fibre network and much of its existing duct network (half of Chorus' network is already ducted). Further, depending on how FFLAS services are defined, around 65% of new fibre assets could require allocation between regulated and unregulated services"* [footnotes removed]. This highlights the scope Chorus has to dictate the pricing and cost allocation outcomes under non-prescriptive rules like those applied under Part 4 Commerce Act.

CHORUS TRIES TO RUN 'FIBRE IS DIFFERENT' ARGUMENTS BY RECYCLING ELECTRICITY NETWORK ARGUMENTS

29. Chorus has submitted that *"… we acknowledge that there are always risks in a technology industry. The dynamic nature of the industry means there may be future market developments that could see a significant impact on our ability to receive a return on and of our capital"*.

30. It is notable the arguments Chorus has run about the risk to future recovery of its investments from new technology directly parallel the arguments electricity networks ran in the statutory review of the Part 4 IMs, and on matters such as revenue versus price caps, accelerated depreciated and RAB indexing.

31. We note the cautious approach the Commission has taken to these matters under Part 4. The Commission allowed electricity networks to switch from price cap regulation to revenue cap regulation (the same as Chorus' fibre business), rejected overtures for a change to RAB indexing and, while it has provided provision for accelerated depreciation, the Commission has rejected (draft decision) the one application that has been made for accelerated depreciation.

LOGIC OF CHORUS' ARGUMENTS SUPPORT PROVIDING EARLY CERTAINTY OVER LAYER 1 AND 2 PRICING

32. Chorus criticise the Commission for adopting a *"'decide and explain as we go' approach"* and warn *"regulated suppliers will simply not have enough certainty to continue to make the required future investments, innovations and efficiency improvements"*.

33. While Chorus made no mention of access seekers, their point applies to access seekers and future pricing of layer 1 and layer 2 services. From our perspective as an access seeker, the sooner certainty is provided over layer 1 and 2 service pricing the sooner we will be able to make firm commitments in relation to our investments and service delivery.

This is a view that is commonly shared amongst RSP submissions, and their expert consultants.

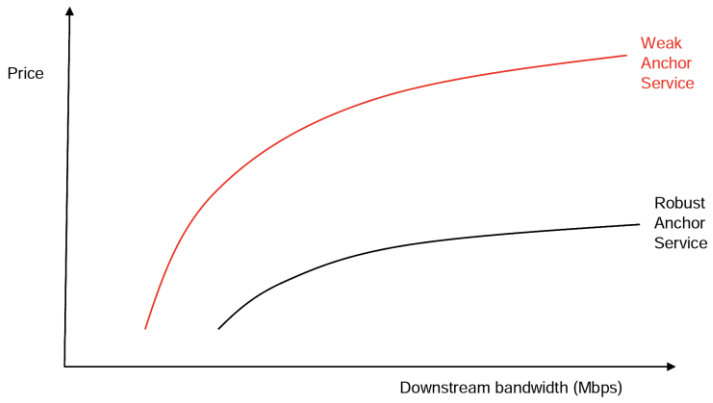
ANCHOR SERVICE REGULATION PROVIDES CHORUS WITH MORE THAN GENEROUR FLEXIBILITY

34. According to Chorus *"A complicating factor for FFLAS regulation, in addition to the dynamic nature of the market itself, is the number of existing and proposed restrictions in the regime design"*. Chorus offers anchor services as an example, and complains *"These regulatory constraints may interfere with the discovery of information about the pricing and revenue profile that will best ensure the return on and of our capital as we move to the point where the demand for our services supports increased capital recovery"*.

35. In actuality, the opposite is true.

36. Provision of anchor services provides Chorus with considerable flexibility over the pricing of other, e.g. higher specification, services. If the anchor service is meaningful and well specified it will limit Chorus' ability to abuse its market power and set excessive margins between the anchor service and higher specification services.

37. We note that 2degrees' cross-submission in response to the Commerce Commission's proposed approach on the new regulatory framework for fibre helpfully demonstrated that if the anchor service is poorly specified and/or out-of-date it will substantially weaken the extent to which it serves as an anchor. A weak Anchor Service, say if it was set below or materially below 1GB, would allow Chorus to constrain service quality to keep prices high (monopoly price).



COST ALLOCATION NEEDS TO BE MORE PRESCRIPTIVE WHERE IT IMPACTS COMPETITION

38. There is a clear consensus amongst RSPs that the Commission needs to adopt a more prescriptive approach to cost allocation and pricing than it has applied under Part 4 Commerce Act. This reflects genuine industry-specific differences and relevance of consideration of the objective to promote competition.

39. Vocus agrees with 2degrees opposition to *"… LFCs determining which of the services they offer are regulated and which assets are employed, or partly employed, in the provision of those services"*. We agree *"The Commission should be clear about what is and is not included as part of FFLAS. We note despite it being clarified to legislators that the new Part 6 of the Act does include ICABS, Chorus' are seeking these to be excluded"*.

40. We also agree with Trustpower that even if the Commission adopts a non-prescriptive Cost Allocation IM, the Commission should err *"on the side of prescription in relation to this IM, particularly in those sensitive areas where a misallocation of costs are likely to impact competition"*. Axiom make the same point in detail in their expert report.

41. Axiom offered some 'compromise' options whereby the Commission could allow Chorus to propose how cost allocation should occur, subject to guidance from the Commission (the cost allocations must be consistent with promoting competition) and ultimate Commission approval. This would be better than the approach the Commission currently proposes and would allow the Commission to leverage any supposed information advantage (asymmetry) Chorus may have.

42. We agree with Vodafone that the IMs *"should detail how to costs are allocated between layer 1 and layer 2 on a granular basis. With this information we would be able to assess compliance with LFC's Equivalence of Inputs and non-discrimination obligations. This would provide sufficient information to assess whether workable competition was being stifled or not"*.

PRICE-QUALITY REGULATION IS INTENDED TO PROTECT END-USERS, NOT CHORUS OR ITS SHAREHOLDERS

43. Chorus claims *"… it's important to be upfront with consumers, RSPs and investors that the overarching objective is to ensure that at the point of any FFLAS deregulation, Chorus will have been afforded the opportunity to have received a return on and of its capital since 2011 and over the life of our assets (overarching FCM objective)"*.

44. The overarching objective is actually to protect the interests of end-users, not Chorus and its investors.

45. Deregulation should occur when consumers no longer need price-quality regulation (and Information Disclosure) to protect their interests. At that time, Chorus will be in the same position as every other telecommunications service provider with no surety of cost recovery, and having to rely on its own efficiency, competitiveness and decisions to ensure cost recovery.

46. The real FCM principle has never been intended as a guarantee Chorus would be able to recover its costs and has to be balanced against the allocation of risk principle.

ASSET STRANDING RULES NEED TO MIMIC COMPETITIVE MARKET OUTCOMES

47. Our submission detailed why we consider the IMs (allocation of assets in the RAB etc) should not compensate Chorus for the impact of competition. We agree with Vodafone *"The potential for competition on certain parts of the LFCs' networks means that asset stranding has to function in a fundamentally different way to regulations under Part 4 of the Commerce Act"*.

48. Vodafone's submission also highlights the risks and incentives created by exposing consumers rather than Chorus (and the LFCs) to the risk of competition. Vodafone detailed that *"Chorus and the other LFCs [are] refusing to sell certain assets (like the end-user ONT) on unbundled connections despite this being a way to recoup some of the costs of otherwise unused assets"* and *"This is likely because they believe that they can claim these assets are stranded and retain their costs in their Regulatory Asset Base (RAB)"*.

49. We agree with ENA's concern *"… with any mechanism that transfer the costs of stranding risk to the future and onto other consumers because it creates an inefficient subsidy arrangement and shifts the burden of a lack of competition to those who are reliant on non-stranded assets. That is inequitable and not consistent with competitive markets"* [emphasis added]. The ENA position appears to be inconsistent with their recommendations, however, as the options they advocate, including adjustment of WACC, would transfer the costs of stranding risk onto consumers.

FINANCIAL LOSSES NEED TO BE DETERMINED ON AN INCREMENTAL COST BASIS

50. The Commission should adopt an orthodox economic approach to consideration of the different cost allocation options for determining financial losses (if any).

51. Vocus notes 2degrees provided substantive critique of the entire analysis the Commission relied on to oppose an incremental cost approach to financial losses. (Vodafone provided an abbreviated version.) We agree with the analysis. It reinforces the RSP consensus that losses need to be calculated on an incremental cost basis.

52. We also agree with 2degrees conclusion that *"Each dollar of common cost capitalised in the RAB equates to a monopoly profit allowance with no benefit to consumers from the higher prices"*.

53. Vector Fibre makes a similar observation: *"We note that, if financial losses are overstated, then customers will be burdened with excessive prices for years to come, which would also be inefficient and inequitable. As we point out in our covering letter, this treatment of losses was not anticipated at the time of the original ITP. The Commission should be acutely aware of the risk of loss overstatement when it estimates past losses".*

54. These observations are reinforced by Vodafone's comments that *"The proposed approach to losses is overly generous"* and *"Applying assumptions, short-cuts or simplifications on the basis of time or resource pressure is simply not acceptable on a*

decision of this magnitude" and *"Chorus … does not look or act like a business that has suffered any losses"*.

55. Trustpower's submission helpfully provides clarification that, consistent with an incremental cost approach, the only investments relevant to calculation of financial losses are *"investments under the UFB initiative [that] were made post-2011"*.

56. Consistent with Trustpower's submission, Vodafone comment that *"All Capex that existed prior to December 2011 must not be allocated to UFB services. These costs are sunk and would have been incurred by Chorus regardless of whether it chose to participate in the UFB initiative or not"*. We agree. This is relevant to both calculation of financial losses and prevention of double-recovery between copper and fibre.

57. Investments made prior to this time were made (by definition) regardless of whether Chorus undertook UFB roll-out and therefore do not impact on the financial losses (if any) it incurred. We also agree with Trustpower's 'for the avoidance of doubt' statement that *"This may include any pre-2011 assets that have subsequently been used for FFLAS by Chorus"*.

58. Vodafone's submission also highlights the Commission needs to net out any tax benefits from financial losses. We agree with Vodafone's concern *"…that the Commission's proposed approach [to determination of financial losses] ignores a potentially significant tax benefit. If losses are actually incurred in any year an LFC will be able to use these losses to off-set its tax burden in other parts of its wider business. The Commission acknowledges this benefit exists, but fails to account for it"*. This provides an additional example of how the Commission's proposed approach would over-compensate Chorus and effectively lock an excessive profit stream into the RAB.

59. Vodafone provide another way of articulating the incremental cost approach recommending the calculation of financial losses should be *"set … so that the LFCs are economically indifferent to the investment (when the appropriate costs of capital and discount rates are taken into account). Indifference is a central concept in economics, and underpins the NPV=0 approach of the building block model that the Commission has proposed to apply"*. We agree. This will be the outcome if the Commission applies its real Financial Capital Maintenance principle to determination of financial losses.

60. Ultimately, whatever approach is taken to determination of financial losses, we agree with 2degrees that *"The burden of proof should be on Chorus to demonstrate the size [if any] of past financial losses"*.

DOUBLE-RECOVERY BETWEEN COPPER AND FIBRE NEEDS TO BE ADDRESSED TO AVOID EXCESSIVE PROFITS

61. We agree with 2degrees that *"Not addressing [double-recovery between copper and fibre services] would weaken the limits on Chorus' ability to extract excessive profits and result in failure to meet the Part 6 purpose (section 162(d))"* and while *"… this issue is more challenging than for LFCs' electricity and fibre services, or utilities that provide both*

electricity and gas network services (or gas distribution and transmission services) … it cannot be ignored".

62. Similarly, we agree with Spark that *"it is crucial that [past losses] not be overstated. Consumers will be forced to pay excessive prices for years to come and undermine the Part 6 framework. The Commission should ensure that it only actual losses incurred period is removed"*. Spark's views align with the views we expressed in our own submission about risk of over-compensation.

(a) In our submission, we offered some initial views on how to deal with double-recovery between Chorus' copper and fibre businesses. Some of Vodafone's comments directly illustrate the types of considerations we have advocated the Commission will need to take into account.

(b) Vodafone, for example, detailed that *"None of the [copper TSLRIC] models factored in a parallel fibre network, and certainty did not reduce copper costs on the assumption that another network would share the infrastructure costs. For example in the FPP, the Commission justified having no sharing on the basis of confidential Chorus data that indicated Chorus had been investing a significant amount in new ducts for UFB in 2012, 2013 and 2014 in comparison to average annual investment in ducts over the period 2005 to 2011"*. What this highlights is that the copper pricing determinations provided for full recovery of certain costs that may have subsequently been used for provision of fibre services, and these should be excluded from the fibre price determination.

63. We also agree with Vodafone's *"conclusion that … the copper prices were sufficient to cover the entire cost of the copper network. None of these costs need to be recovered from fibre revenues, as has been proposed by the Commission's cost allocation methodology"*.

64. In summary, to paraphrase Yarrow, this may be a challenging exercise, but it is not an exercise that is either infeasible or one that can be safely ducked.

THE ONLY USEFUL THINGS CHORUS HAS TO SAY ON DOUBLE-RECOVERY RELATE TO ITS VIEWS ON OVABAA

65. Chorus appears to have shifted its arguments away from claims double-recovery between copper and fibre couldn't exist in a Building Blocks setting, to latching onto the Commission's concerns about prevention or removal of double recovery being too difficult. None of Chorus' arguments are compelling or insurmountable.

66. Chorus, first, argue *"The sharing of assets is substantial"*. This is a reason why dealing with double-recovery is important. The more sharing the higher the risk and size of any double recovery.

67. Chorus go on to argue *"the valuations of the assets are not consistent (i.e. one is based upon (past) actual cost and a calculation of economic recoveries, whereas the other reflects the replacement value but of a hypothetical and highly optimised network)"*. We

acknowledge this adds some complexity but fundamentally it does not matter. As long as the Commission identifies that a particular cost or asset was set to be recovered under the copper (UBA and UCLL) pricing, or a proportion of the cost or the asset, it can make adjustments to the fibre determination to reflect this e.g. if half of an asset was assumed to be shared by copper then that half should be excluded from the fibre determination, irrespective of the valuation methodology used. We detailed the steps the Commission should take in our submission.

68. Chorus then argue *"The regulated prices for copper services (where they remain) are locked in. This means we are unable to revise copper prices to remedy an incorrect assumption when setting the FFLAS revenue cap about the costs that are recoverable from copper services"*. This begs the question, so what? This simply means any adjustment to avoid double-recovery will need to be through lower (than otherwise) fibre prices, rather than adjusting (re-opening) the copper price determinations.

69. Chorus try to muddy the waters further by commenting that *"In addition, the quantum of shared costs that can be recovered from copper is very hard to observe. … the price for copper services reflected the average cost across the whole of the copper network"*. Ensuring there is no double-recovery can be done at an aggregate, whole-of-business level, so cost variation across the copper network can be ignored.

70. Chorus final argument is that *"… the setting of the FPP prices implicitly assumed that the unit cost of copper services will decline in proportion to the number of consumers served (price is independent of consumer numbers). However, there are substantial fixed costs associated with copper services, which in turn means that the contribution to shared costs from copper will also fall as consumers migrate"*.

71. There are many assumptions the Commission made in the copper pricing determinations which may or may not reflect actual outcomes. For example, we understand there has been substantially more sharing between copper and fibre than the Commission had assumed (so the TSLRIC price was higher than it should have been).

72. TSLRIC is intended to reflect a hypothetical efficient business not Chorus' actual business. Chorus line of argument would take us down the path of re-litigating/re-opening the copper price determinations. This would be unhelpful and Chorus' comments should be disregarded.

ABSENCE OF EVIDENCE FROM CHORUS REINFORCES THAT WACC PERCENTILE SHOULD BE MAINTAINED AT MID-POINT

73. Chorus relied on a report from HoustonKemp to support an uplift in WACC. It appears Chorus and HoustonKemp learnt nothing from the High Court decision on Part 4 WACC percentile and the Commission's subsequent review of the Part 4 WACC percentile for electricity and gas. Specifically, the Commission was criticised by the Court for over reliance on subjective judgement rather than evidence in making its original WACC percentile decision. Chorus and HoustonKemp effectively are asking the Commission to

make the same mistake with fibre. The Chorus and HoustonKemp submissions are based entirely on assertions with no quantified or supporting evidence and provide no legitimate basis for granting Chorus a WACC percentile above mid-point.

74. According to Chorus *"Houston Kemp concluded there is a strong qualitative case for a cost of capital uplift"*. If this is true, the *"strong qualitative case"* was omitted from HoustonKemp's WACC percentile report.

75. All HoustonKemp's report managed to do was detail that Chorus intended to undertake some level of, commercially-confidential, investment in the future (chapter 3). The High Court quotation citied by HoustonKemp applies equally to HoustonKemp's own report on WACC percentile:[4]

> *"No supporting analysis was provided by the Commission. Indeed, the propositions advanced for choosing a point higher than the mid-point seemed to be considered almost axiomatic. This extended to a strongly expressed, but unsupported, view of the benefits of dynamic efficiencies deriving from investment, without apparent regard to the nature of the investment."*

76. It is all very well for Chorus to claim *"We did not see any evidence demonstrating that the asymmetric consequences of under-investment in electricity and gas distribution businesses are greater than the asymmetric consequences of under-investment in FFLAS"*, but the reality is there has been substantive quantitative evidence produced to demonstrate an above mid-point WACC is justified for electricity and gas, and this is not the case for fibre.

77. We see no basis for Chorus to *"expect the Commission will set the service-specific cost of capital for FFLAS at an appropriate point above 67th percentile of the cost of capital range"*.

78. We are not really sure what Chorus means by the claim *"In the time available, we have not attempted to quantify these costs or the appropriate uplift that should be applied"*. Chorus and everyone else knew that WACC uplift would be an issue from when it was determined Chorus' fibre business would be subject to price control. This was well before the new telecommunications legislation was even introduced at bill stage.

79. We note Transpower provided quantified evidence on WACC percentile as part of the Part 4 WACC percentile review, within a much more constrained consultation timeframe. Likewise, the quantified evidence the Commission provided as part of the WACC percentile review was produced within a condensed time-frame, with many submitters questioning (incorrectly as it turned out) whether the Commission had given itself enough time to conduct the review. Both went considerably further than Chorus' indication it is *"… investigating how … quantitative analysis can be done and we expect to be able to put forward a framework for analysis as part of the Commission's draft decision consultation process"*.

[4] WELLINGTON INTERNATIONAL AIRPORT LTD & ORS v COMMERCE COMMISSION [2013] NZHC [11 December 2013] at [1462].

80. Ultimately, there is an element of 'Peter and the Wolf' with Chorus' threats that if it doesn't get an above mid-point WACC it won't invest or will restrict its investment. These arguments have been made time and time again by regulated suppliers, while they continue to invest in their networks. If the WACC percentile decision will impact Chorus' investment decisions it should be able to provide evidence of this.

81. In summary, Chorus and HoustonKemp provide no meaningful basis for the assertion that *"The negative consequences [of under-investment due to setting WACC at midpoint] to consumers are real, and outweigh the potential negative consequences to consumers of over-estimating cost of capital"*.

82. We yet again find ourselves needing to reiterate the High Court statement *"Where a proposition is simply asserted … we give it little or no weight"*.[5]

HOUSTONKEMP FAIL TO DISTINGUISH FIBRE FROM COPPER AND AIRPORT WACC PERCENTILE PRECEDENT

83. HoustonKemp attempt to distinguish between copper precedent and fibre, with the observation there wasn't a *"direct"* WACC-investment under TSLRIC because prices didn't depend on actual costs or Chorus' investment.

84. While this is a valid reason for rejecting above mid-point WACC in relation to copper, that may not necessarily apply to fibre, it should be recognised there were a range of reasons for selecting a mid-point WACC for copper. Many of the reasons cited during the copper pricing determination also apply to fibre. The Commission's Emerging Views Paper highlights there are also fibre-specific regions for applying a mid-point WACC to fibre.

85. HoustonKemp also note one of the reasons the Commission rejected an above mid-point WACC for airports was that *"Airports are only subject to [information disclosure] – this means that the regulated WACC is not as strong a binding constraint on the airport's pricing and investment decisions"*.[6]

86. HoustonKemp has only asserted there is a strong link between Chorus' WACC and investment decisions and has not provided any real evidence to support this. As such, HoustonKemp has failed to demonstrate Chorus' UFB business's circumstances are distinguishable from airports or a different decision on WACC percentile is warranted.

AUSTRALIAN INVESTORS MIS-UNDERSTAND NZ WACC PERCENTILE PRECEDENT

87. The submissions from Paradice Investment Management, Ubique Asset Management, TelstraSuper et al were notable for their homogeneity, including repetition of the same factual errors in each of the submissions.

[5] WELLINGTON INTERNATIONAL AIRPORT LTD & ORS v COMMERCE COMMISSION [2013] NZHC [11 December 2013] at [1745].
[6] Commerce Commission, Input methodologies review decisions | Topic paper 6: WACC percentile for airports, 20 December 2016, page 32, paragraph 136.

88. The Australian investors all seem to be under the impression above mid-point WACC applies to all other regulated industries e.g.:

(i) According to TelstraSuper they were *"… surprised the Emerging Views paper suggested the WACC for Chorus would be kept at the 50th percentile, while other regulated industries in New Zealand have apparently been set at the 67th percentile"*.

(ii) Ubique Asset Management commented *"The Emerging Views Paper also proposes that there will be no adjustment from the 50th percentile for CNU's WACC. All other regulated utilities (electricity distribution networks, gas networks, airports) in New Zealand have their WACC set at the 67th percentile to avoid the risk of under investment"* [emphasis added].

(iii) Paradice Investment Management commented that *"…the decision not to apply an uplift to the 50th percentile for Chorus' WACC … is inconsistent with the treatment of ALL other regulated utilities within New Zealand that have their WACC set at the 67th percentile. It is unclear to us as to why Chorus would be singled out for differential treatment and it discourages the company from investing in areas that are beneficial to the consumer, such as higher network capacity, 5G backhaul and increased redundancy overlays"*.

(iv) Investors Mutual (IML) commented *"The WACC should be set at the 67th percentile … investors in the fibre networks reasonably expect to be treated in a like manner to other regulated assets in New Zealand"*.

89. We question why none of these sophisticated investment companies appear to be aware of airports and telecommunications precedent where above mid-point has never been adopted, and why these precedents haven't shaped their expectations.

ENA COMMENTS ON WACC PERCENTILE SHOULD BE SEEN AS AN ATTEMPT TO RELITIGATE PART 4 DECISIONS

90. ENA submitted the Commission should apply an uplift to WACC. We do not agree with any of the reasons ENA provided:

(i) ENA's claim *"use of a WACC percentile has been an enduring feature of the regulatory landscape in New Zealand since at least 2003"* ignores that an uplift has only ever been applied to regulated suppliers in electricity and gas, and not to airports or telecommunications.

(ii) We are not aware of any reasonable basis for assuming there would be a WACC uplift *"in the financial models underpinning the bids Chorus and other LFCs made in securing the contracts with CFH"*. The new regulatory regime for fibre had not been established at the time the UFB tender occurred, and price control only applies to Chorus. Chorus should not be compensated for making cavalier

assumptions like this about how lenient (generous) the Commission will be in its price-setting.

(iii) While ENA make the general comment that *"Given the similarities in the legislative frameworks for the regulation of electricity, gas and specified airport services under Part 4 and FFLAS services under Part 6, regulatory certainty will be promoted with consistent approaches to IMs, where appropriate"* their submission fails to consider or acknowledge industry-specific differences which may justify different WACC percentiles in different industries. This was well canvassed in submissions on WACC as part of the copper (UBA and UCLL) price determinations. Aurora and Transpower provided more robust perspectives on telecommunications versus energy during the respective Part 4 WACC percentile review and copper pricing determinations

(iv) The ENA comments appear to be a back-door attempt to relitigate the Commission's decision to lower the WACC percentile under Part 4 from 75th to 67th percentile: *"From the ENA member perspective there has already been an erosion of regulatory confidence with the reduction in the percentile from the 75th to 67th …"*.

CHORUS' ADVOCACY OF UNCONSTRAINED WASH-UP IS UNTENABLE

91. Chorus' claims its *"… interpretation of the Act is that a symmetric, unconstrained wash-up is to be applied to FFLAS for RP1"*. Chorus did not substantiate this claim.

92. Vocus does not support unconstrained wash-up.

93. We consider Part 4 Commerce Act provides appropriate precedent for wash-up rules. This includes the treatment of voluntary under-recovery.

94. Chorus' position would provide no surety against price shocks. At the extreme, it would mean Chorus could set fibre prices at whatever level it wanted in the first regulatory period (from zero, with recovery in the next regulatory period, or double or more than the Commission's price determination). This is clearly untenable and not envisaged by the legislation.