Vodafone Cross-Submission

New regulatory framework for fibre:

Cross-Submission on Fibre Regulation Emerging Views (Excluding Cost of Capital)

31 July 2019

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Executive Summary

Thank you for the opportunity to provide a cross-submission at this crucial consultation stage of the new fibre regulatory regime.

We are grateful for the additional time provided to cross submit on the cost of capital, given the vast amount of information provided in submissions. This cross-submission focusses on the following other critical issues.

- There is growing agreement that the Commission's proposed approach to implementing the losses calculation will result in a significant windfall gain for LFCs. We make the following observations on submissions:
    - Trustpower identify an important moral hazard faced by the LFCs. The confirmation that losses will become an asset in the new regime has weakened LFCs' incentives to be efficient. We are already starting to see this play out in practice.
    - Chorus' own statements are now supporting a different cost allocation methodology in the losses period, to account for the fact that fibre is a new emerging service relying on the existing copper infrastructure.
    - There is broad consensus across LFCs and RSPs that the benefit of tax losses must be accounted for in the regime.

- We agree with the concerns raised about information asymmetry and the need for thorough review of any forecasts provided by Chorus.

- Other RSPs have presented a strong case that pricing principles should be included in the new regime. Their concerns are based on practical problems that go beyond the theoretical arguments presented by Vogelsang and Cave.

- There is broad consensus that the industry must be engaged on quality metrics, and that the level of detail in current wholesale service agreements must be retained.

- The argument from Chorus that ICABS should not be included in the regime for DFAS services is anti-competitive, inconsistent with the Act, and likely unworkable.

- Finally, we note some process issues created by other submitters that the Commission must resolve.

Concerns are growing about the generosity of the losses

There is significant concern expressed by submitters that the Commission's approach to losses would result in double recovery. This is the most important issue for the Commission to consider in reaching the draft decision.

Vector's submission provides important insight. Vector bid alongside the LFCs for part of the UFB programme, so they have a credible view of how a rational firm would have approached the UFB investment. They note:

> *An incremental costs approach would be consistent with how Chorus would have considered the business case for UFB in 2011. It would have considered its incremental costs (that it otherwise would not have had to incur), and revenues, in determining whether to participate in UFB.*[1]

They also note that 'the copper prices at the time were set with a view to not discouraging future fibre investment'.[2] This echoes our view that the regulatory regimes for copper and fibre were established with an incremental cost approach in mind.

Other submitters like Spark and Vocus provided alternative approaches to avoid double-counting. These approaches must also be given serious consideration by the Commission. Simply avoiding this problem altogether, like proposed in the Emerging Views Paper, is not acceptable with such a wealth of practical and achievable options put before the Commission.

The losses create a moral hazard

Trustpower identify a troubling moral hazard problem created by the losses. Because LFCs now know that they will receive an asset to compensate for losses, they may be incentivised to act inefficiently from the date the Telecommunications (New Regulatory Framework) Amendment Act 2018 was passed and the start of 2022, when the new regulation will take effect.

We see this in practice today. Chorus are offering a rebate of up to $500 to some customers in Wellington and Auckland to switch to fibre. It beggars belief that it is

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[1] Vector, 'Submission to Commerce Commission on the Fibre Regulation Emerging Views Paper', 16 July 2019, para 28.

[2] Ibid para 36

efficient to offer such a significant incentive for a product that Chorus claims is already being sold at below cost.

From a customer's perspective this incentive is simply a ruse. They get a large rebate now, but unbeknownst to them, the rebate is included in the losses to be paid back later, at an interest rate equivalent to the WACC. Practically, it is equivalent to consumers taking out a loan at a higher rate (WACC) than the typical household lending rate (mortgage rate).

From Chorus' perspective, they can afford an otherwise unsustainable discount, safe in the knowledge they can add it to their losses and recover it later. Nothing about the level of fibre uptake suggests such extreme measures are necessary.

We, therefore, support Trustpower's submission that the Commission must assess the efficiency of losses incurred after the Amendment Act was passed. This signal should provide the correct incentives on the LFCs to act efficiently.

Chorus are confused about how costs should be allocated to a new service

Chorus has multiple views on how a workably competitive firm would allocate cost, which appears driven by taking a position that most advantageous in a particular situation, rather than the commercial reality. This demonstrates why they need to be kept on a tight leach for this crucial decision. The Commission must specifically dictate how cost allocation should be applied, especially during the losses period.

At paragraph 75, Chorus asserts that in a competitive market, when a new network is built, the costs of existing assets are embedded into the price of the new network. They attempt to demonstrate this point by using the example of the transition from 3G to 4G technology in the mobile market. In this market the mobile companies incurred significant cost to upgrade to the newest technology, but competitive pressures meant we did not increase prices, despite offering a significantly improved service.[3] We support an allocation method that results in the same outcome for fixed line technology. This is best achieved in the Part 6 fibre regime by not allocating any copper/fibre shared costs to fibre during the losses period.

However, Chorus then go on to contradict themselves at paragraph 104-106 where they argue that it is efficient for shared costs to remain on the existing network when

[3] Vodafone initially charged a $10 premium to use 4G, however this quickly become unsustainable in a competitive market and was dropped.

a new service is built. They use this to justify having the OVABAA allocation method available to them for fibre services. They note that:

> *there is a risk that ABAA could make the provision of an unregulated service uncommercial and unprofitable even if it is efficient.*

This exact effect is at play in the transition from copper to fibre services during the losses period. If the ABAA allocation method is applied it will make the fibre services appear unprofitable, despite being economically efficient. We know the fibre prices were economically efficient because they were agreed in a commercial contract with the Crown. It would have been irresponsible for the LFCs to agree to prices below the incremental cost level.

The only way the LFCs could have reasonably agreed to prices below cost is if they were aware that any losses would be compensated for in the future fibre regulatory regime. If this was the case then it will have a significant impact on the level of risk LFC investors were taking on, and as a consequence the expected cost of capital.

We do not support retaining shared costs in the fibre asset base if an LFC branches out into a new service (for example, mobile). This would significantly harm competition by giving the LFC a lower cost base than its competitors, so is in conflict with the requirements in s166(2)(b). Chorus claim that there is no impact on competition because the new business still has to recover incremental costs. However, costs in the telecommunications sector are usually compared on a long run incremental cost basis. Long run incremental costs include many of the fixed costs that would be inappropriately allocated using an OVABAA approach.

Broad consensus that tax benefits of losses must be accounted for

There is broad support across the entire industry that the tax benefit of any losses must be accounted for. This is particularly critical during the losses period. This is also acknowledged by the LFCs despite it potentially reducing their overall revenue allowances. This makes it even more baffling that the Commission's emerging view ignored this benefit.

A smaller residual concern remains as to how the time value of money should be applied to the tax benefit from losses. In a workably competitive market, any time value of money benefit would be passed on to end-users, and this same approach must be applied to the LFCs.

The LFCs requested that the tax benefit be carried forward until it is used to offset future tax costs of fibre services. This assumes that fibre is a stand-alone business, which is inconsistent with many other assumptions in the regime. If the tax benefit was able to be absorbed by another part of the LFCs business, it must be applied as such in the regime, and treated as a revenue item in the year incurred.

However, there may be some cases where the other parts of an LFC's business cannot fully absorb the tax benefit. In these cases the time value of money benefit of transferring the tax benefit into future years must be accounted for. The same discount rate should be applied as elsewhere in the regime, which under the Commission's current assumptions is the full WACC rate.

Submitters raise a critical information asymmetry problem

We agree with the concerns raised by Vocus and 2degrees that it will be challenging for the Commission to assess any forecasts provided by Chorus for the initial setting of the revenue cap. It is critical that the Commission either develop their own forecast independent of Chorus, or have Chorus' forecasts thoroughly reviewed by an independent assessor.

We also strongly oppose Chorus' suggestion that the entire price-quality path be set on a "propose-and-approve" mechanism. The information asymmetry between the Commission and Chorus at this early stage of the regime makes this approach entirely inappropriate. While forecasts from Chorus may be appropriate for some parts of the model, these must all be independently assessed by the Commission on their own right. The Commission must then be responsible for putting the model together itself and determining a maximum revenue allowance.

This concern is not just theoretical. Chorus have a history of over-forecasting whenever they get the opportunity. As highlighted by Vocus and 2degrees, Chorus' initial estimates for both TSLRIC and the TSO have generally been considered opportunistic. Chorus must not be given this opportunity again.

There are a number of options open to the Commission to mitigate this information asymmetry concern, including:

- extensive use of a contingent project mechanism, where the revenue cap is only adjusted once a forecasted project begins (along with appropriate quality metrics to minimise gold-plating);

- use of an independent consultant to assess a reasonable expenditure for Chorus during the first period;
- use of an independent verifier to assess any proposals sought from Chorus; and/or
- applying incentive mechanisms, like menu regulation.[4] The Commission has generally shied away from this mechanism in Part 4 because of its complexity. However, Chorus is a large and capable organisation that is well suited to this sort of approach. The details of this regime don't need to be in the IMs, giving the Commission sufficient time to develop it ahead of the first regulatory period beginning in 2022.

There is a strong rationale for pricing principles

A number of RSPs raised concerns with the proposed lack of oversight by the Commission of LFCs approaches to pricing. We share these concerns.

The paper from Vogelsang and Cave[5] missed a number of key issues. Most of these have been covered in submissions. To that list we add:

- price shocks need to be minimised at a product level;
- an explicit requirement is needed to stop foreclosure of competition;
- requiring a single price between the specified hand-over point and the end-user;
- short term discounts must be eliminated; and
- equivalence of inputs and non-discrimination rules must be embedded into the Part 6 regime.

As noted by Spark, consumers on speeds other than the anchor products run a real risk of suffering a significant price shock following 2022. The generous approach the Commission is proposing to apply to the losses, along with the long list of WACC uplifts proposed by the LFCs and their investors could result in a significant increase to the LFCs' revenue after 2022. This burden would all fall on the non-anchor products (or across all products for LFCs). Even if the Commission smooths the

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[4] For an explanation of menu regulation see: https://comcom.govt.nz/__data/assets/pdf_file/0010/63001/ENA-submission-on-process-and-issues-paper-14-04-23-Frontier-Output-2-report-stc.PDF

[5] Vogelsang, I & Cave, M, 'Pricing under the new regulatory framework provided by Part 6 of the Telecommunications Act' 16 May 2019.

aggregate revenue cap for Chorus, it is likely that non-anchor product users could face significant price increases for several years on end. For LFCs there is no mechanism to smooth the revenue path so these price shocks may be felt immediately for all products.

Vogelsang and Cave assume that there is no need for an explicit prohibition against foreclosing competition because of the existing equivalence of inputs rules in the Fibre Deeds. While we agree that the correct interpretation of these rules would stop foreclosure, this is not what we are seeing in practice. All the LFCs have recently released pricing for the layer 1 product, and they all exceed the current layer 2 prices completely foreclosing that market. If there is any doubt that the existing requirements in the Fibre Deeds do not stop foreclosure, the new regime must make this requirement explicit.

Another problem revealed by the proposed layer 1 prices is the tendency for the LFCs to break fibre prices into as many components as possible. In the case of the layer 1 access, all LFCs have chosen to break the price into the feeder fibre and the distribution fibre. This creates a serious competition and discrimination problem. The full service price will be different depending on how many customers each RSP has connected to a particular feeder fibre. We believe this breaches the non-discrimination requirement in the Deeds. However, if this is not correct, this requirement must be included as a pricing principle.

At this stage of fibre deployment and uptake, it is time that the LFCs focus on running a top quality network and stop directly advertising to customers, or offering short term discounts, or other incentives. These discounts are intended to shift customers on to certain products to suit the LFCs priorities. These are often not aligned to consumer's interests.[6] It also allows the LFCs to effectively adjust prices without proper industry consultation.

Finally we note the support from Vector for the layer 1 pricing rules (equivalence of inputs and non-discrimination) to be embedded into the Part 6 regime. Ignoring these rules because they are set under a different part of the Act will only lead to a disjointed approach from the Commission. As noted by Spark, clarifying the unbundling requirements in the IMs also provides the certainty needed to support investment into fibre unbundling.

[6] For example they may be used to shift customers off the anchor products and expose them to the full risk of price changes.

There is strong support for an industry involvement in setting quality standards

Many submitters, including Spark and Chorus acknowledge that it is important for industry to be engaged in setting the quality standards. This will help iron out any issues before it is presented to the Commission, simplifying the process, and improving the outcome. It will also allow a continuation of the level of detail set out in the Wholesale Service Agreements.

However, we also appreciate Spark's concerns that the existing SLAs may become out-dated during the first regulatory period. Much of the existing SLAs are focussed on improving the customer install experience. This will become a smaller issue as time goes on, and performance metrics will come to the fore.

Beyond the metrics raised by Spark, the Houston Kemp report submitted on behalf of Chorus[7] provides a good summary of quality metrics that may become important. This includes resilience, asset management, and capacity management. These are all easily measurable, and as noted by Houston Kemp, are areas where without any quality metrics Chorus may choose to under-invest.

All fibre services must be covered by the regime

Chorus have attempted to argue that ICABS services should be removed from the regime for DFAS products. This is an obvious ploy to hurt mobile and fixed wireless competition. It is also inconsistent with the Act, and is unworkable.

The Act requires that all fibre services (including DFAS) cover everything from a 'specified point of interconnection' to the 'end users premises, building or other access point'. Where a DFAS service terminates at a specified point of interconnection, then no ICABS is necessary. Where it terminates somewhere else, there is a need for ICABS to reach the point of interconnection, and therefore must be within the regime. It is broadly accepted that this logic applies to layer 2 services, so we are unsure why it would not apply to DFAS services.

If the interpretation above is incorrect, it raises a significant issue. The LFCs may choose to turn every exchange into a hand-over point, and then artificially bump up the price of the ICABS service. This may help them reduce regulatory costs and

[7] Houston Kemp Economists, 'WACC uplift – asymmetric consequences of under-investment: A report for Chorus", 15 July 2019.

increase non-regulated revenue, increasing their profit within a given regulatory period. However, end-users are worse off. RSPs will either have to buy the inflated ICABS product, or build their own backhaul. Either way there are more costs for end-users to bear. If the Act does not otherwise cover off this risk, it needs to be picked up as a specific quality standard to avoid any anti-competitive behaviour.

Some concerning process issues are starting to arise

We are concerned with a number of process issues that have now started to raise their heads.

- **Timeframes for responding.** We are grateful for the Commission's extension to the cross-submission timeframes on the cost of capital. However, we expect that the LFCs will continue to provide a significant amount of material in future consultations. Given the information asymmetries between LFCs and RSPs, there must be much longer given for the cross-submission process for us to effectively engage. For the draft decision we expect that at least four weeks will be needed to comprehensively cross-submit.

- **Withholding of key non-commercial information.** Chorus and its experts withheld significant amounts of key information, even where no commercial confidentiality could apply. For example Oxera withheld their estimate of the WACC uplift for the risk of asset stranding, and even withheld some of the information they considered in making their estimate. As an expert estimate, we cannot fathom why this can be considered commercially confidential, particularly when no attempt was made to justify the sensitivity of this information.

- **Misuse of the cross-submission process.** The submission from Enable and Ultra-Fast Fibre (UFF) notes that

  > *The fact that we have not commented on other aspects of the EVP in Part I does not mean we necessarily agree with those views; we propose to deal with other relevant issues in the cross-submission process*[8]

  This is a clear misuse of the cross-submission process. As the Commission recently clarified "[t]he purpose of cross-submissions is for parties to respond

[8] Enable Networks Limited and Ultrafast Fibre Limited, 'Submission on NZCC Fibre Regulation Emerging Views: Technical Paper', 16 July 2019, Para 1.2.

directly to other parties' submissions. Cross-submissions are not for presenting new information".[9]

If Enable and UFF submit any new information in cross-submissions this must either be dis-regarded by the Commission, or a further cross-submission timeframe allowed for other parties to provide their views on the new information.

[9] Commerce Commission, "Vocus' request to reconsider timeframes for the Mobile Market Study', Email sent from regulation.branch@comcom.govt.nz, 5 July 2019.