



## Fibre Input Methodologies: regulatory processes and rules draft

Cross submission | Commerce Commission

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## Executive Summary

The purpose of input methodologies is to promote certainty for regulated fibre service providers, access seekers, and end-users in relation to the rules, requirements, and processes applying to the regulation, or proposed regulation, of fibre fixed line access services.<sup>1</sup> When the Commission is consulting on the Regulatory Processes and Rules (**RPR**) that it will use to set Price-Quality and Information Disclosure requirements it must do so with this purpose in mind.

The proposed RPR input methodology (**IM**) addresses matters such as when an amendment to a price quality path might be entertained by the Commission, what costs are passed directly to customers rather than through the BBM model and how efficiency gains are to be shared between providers and end users over time.

### The wash-up mechanism

The Commission is required by the Act to apply a “wash-up” in price quality determinations to capture any under or over-recovery of costs in the previous period<sup>2</sup> and submitters have asked the wash-up mechanism be specified in an input methodology.

We agree that specifying the wash-up mechanism is important, particularly as the Commission has discretion to specify the wash-up methodology and the approach will influence the allocation of risk between LFCs and end users and incentives faced by fibre providers. For example, the cost standard used to calculate the gap (i.e. incurred versus forecast), the approach to model parameters such as demand and CPI and whether a cap on the wash-up amount is applied will determine whether key risks are born by LFCs or consumers. However, we appreciate that the Commission is not required to apply the wash-up mechanism until the end of the first regulatory period and may not have sufficient information to set the methodology until the price-quality determination process. LFCs may also use more accurate forecasts in pricing proposal if it is uncertain who bears the forecasting risk.

Our principle concern is that key decisions relating to the allocation of risk between LFCs and consumers (such as the wash-up) have become disconnected from specification of LFC return. For example, the draft IMs set very specific WACC values, yet these values imply an allocation of risk that has yet to be determined. We propose that the Commission align key related decisions by either (1) setting out the wash-up mechanism in the RPR IM; or (2) not set specific WACC values such as the asset beta in IMs, but rather set out the principles it will apply to ensure aligned allocation of risk and return (returning to both wash-up and WACC parameters in the price-quality determination process).

### Pass-through

Chorus and electricity distribution companies have asked that the Commission determine rates to be a pass-through cost as it is in the Part 4 context. While we accept the principle of pass through, it is unclear how the Commission might allocate shared costs such as rates and TDL between Part 6 regulated and other services for pass-through purposes. Therefore, if the Commission chose to consider these pass-through costs, it will need to determine how these allocations will occur.

### Proposal and evaluation process

We agree with Two Degrees that early guidance on the proposal/evaluation process would be helpful. Chorus' submission highlights that it is already making assumptions relating to its proposal and, with the short time available for the price-quality determination process, it may be difficult to change course if these assumptions prove to be incorrect.

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<sup>1</sup> Section 174, Telecommunications Act 2001

<sup>2</sup> Section 196, Telecommunications Act 2001

## Introduction

1. Thank you for the opportunity to comment on submissions on the draft Regulatory Processes and Rules Input Methodology.
2. The Commission set out its proposed approach to the specification and definition of price, and circumstances in which a price-quality path may be reconsidered within a regulatory period.
3. We discuss submissions on the proposed wash-up, pass through and proposal/evaluation below.

## Specification of the wash-up mechanism

4. Several submitters sought further clarification of how the wash-up will apply. For example, Chorus recommends that washup mechanism principles be set in the IM. Chorus asks that the Commission set out which of the inputs to the allowable revenue calculation will wash-up – i.e. allowable revenue or ex post allowable revenue, some building blocks, allocations, foreign exchange rates and CPI – and over how many periods the wash-up will occur<sup>3</sup>. Enable, 2Degrees and Vocus all recommend that the Commission provide guidance on how the washup will apply.
5. The submissions highlight the breadth of options available to Commission in determining the wash-up methodology. For example, Chorus' outlines its concerns that the washup methodology may wash-up only some model parameters, or that collars and caps may apply<sup>4</sup>. Vector highlighted practical issues associated with the wash-up of actual and ex ante forecast revenues and treatment of inflation.
6. We agree that the wash-up mechanism is important, particularly as the wash-up effects the allocation risk between providers and end-users within the regulatory model and incentives the Commission seeks to embed in the regime. The Commission has discretion in how it applies s196 provided it is consistent with the purposes of the Act.
7. Accordingly, we agree that the Commission would ideally specify the wash-up mechanism in the RPR IM. If it does not do so now, it will need to set out how the wash-up will apply at the same time as it finalises specific WACC settings. However, we appreciate that the Commission is not required to wash-up revenues until the end of the first regulatory period and may not be able to determine a wash-up methodology ahead of starting the price-quality determination process.
8. Key information that would enable the Commission to set the wash-up methodology will likely only be available through the PQR proposal process and, without that information, it would be very difficult for the Commission to specify a methodology that it can be confident supports the purposes of the Act. For example, the Commission will not know where material risks and incentives lie and what trade-offs it is implicitly making.
9. Input methodologies seek to promote certainty for regulated firms, access seekers and end-users amongst other things. Chorus notes that, in doing this, the Commission should seek the right balance between providing certainty and flexibility<sup>5</sup>. However, in finding that balance, the Commission can only provide certainty in an IM where it can be confident that application of the IM through a price-quality determination will likely result in outcomes that support the purposes of the Act.
10. Deferring specification of the wash-up may also - in our context where there are significant information asymmetries and key information will not be revealed until late in the process -

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<sup>3</sup> Chorus submission at paras 10.2 and 42.

<sup>4</sup> Chorus at 42.

<sup>5</sup> Chorus at 2.

encourage regulated firms to propose more accurate price-quality parameters or forecasts. For example, LFCs are more likely to reveal true forecast expectations where it is uncertain whether forecasting risk will sit with the regulated firm or consumers.

11. Our principle concern is that the current approach risks decisions across IMs and the price-quality determination being disconnected, and that this undermines the regulatory process and outcomes required by the Act. For example, the Commission proposes to set specific WACC values in IMs that imply a specific allocation of risk between provider and end users and planned incentives, yet submissions highlight that key factors for the allocation of risk and incentives have yet to be determined. The current approach risks predetermining decisions that are properly made when considering proposals in the price-quality process, i.e. this is when key information that properly enables risk faced by LFCs to be aligned with WACC settings is available to the parties.
12. Accordingly, we recommend that the Commission aligns related decisions by either:
  - a. Specifying the wash-up mechanism in the RPR IM as requested, ensuring the allocation of risk and incentives through the wash-up is appropriately aligned with WACC parameters, or
  - b. Not set specific WACC values such as the asset beta in the WACC IM, but instead set out the WACC methodology and principles it will apply to assure that risk, incentives, and return are aligned across the regulatory settings. For example, the Commission would retain the flexibility to modify the benchmark firms or select a low asset beta within the benchmark range where the wash-up methodology results in risk predominantly falling on end-users.

The Commission could then set an aligned wash-up methodology and specific WACC parameters informed by the first price-quality review process. The approach would appropriately balance the certainty of setting out the WACC methodology with the flexibility to align specific WACC values with decisions made in the P-Q process.

## Pass-through

13. Chorus<sup>6</sup>, ENA<sup>7</sup> and Vector<sup>8</sup> all propose that the Part 6 approach to pass-through be aligned with that applied by the Commission to Part 4 regulated firms.
14. However, there are differences between Part 4 firms and Part 6 fibre network providers and the Commission should be cautious in adopting Part 4 settings. For example, as 2Degrees note, it will be necessary to identify the fibre related portion of the TDL for the pass-through. Further, the Commission highlights in the draft that there may be shared elements of the levies that would need to be allocated between Part 6 fibre and other businesses. Rates are applied to infrastructure that is shared between Part 6 regulated and other services.
15. While it is an empirical matter whether the shared levy costs are material, it is open to the Commission to choose a different Part 6 approach that doesn't require it to revisit Part 4 settings. In this case, the approach needs to take in to account the shared costs.

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<sup>6</sup> Chorus at 25.

<sup>7</sup> ENA submission 29 May 2020.

<sup>8</sup> Vector at 6.

## Proposal and evaluation proposal

16. 2Degrees reiterates its submission that Chorus proposal/evaluation process should be in the rules<sup>9</sup>.
17. We agree with 2Degrees that early guidance on the proposal/evaluation process would be helpful. We support the Commission providing early guidance on how the proposal/evaluation process will work.
18. Chorus' submission highlights that it is making assumptions relating to its proposal and, with the short time available for the price-quality process, it may be difficult to change course if these assumptions prove to be incorrect. For example, Chorus notes its working assumption is that it will propose revenue smoothing via altered depreciation in its expenditure proposal<sup>10</sup>. It is unclear that this should be the case and, if it is, what supporting information such as unadjusted depreciation would be required.

**[END]**

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<sup>9</sup> 2Degrees at page 4.

<sup>10</sup> Chorus at 10.3.