TO: Sasha Daniels, Senior Counsel - Competition and Regulation, Spark New Zealand Trading Limited

FROM: Russell McVeagh (Craig Shrive, Sally Fitzgerald and Christopher Graf)

DATE: 24 September 2015

SUBJECT: Chorus submission on further draft UCLL and UBA pricing reviews

---

Introduction and executive summary

1. You have asked us to provide our views on certain legal issues discussed in Chorus' submission on the Commerce Commission's ("**Commission**") further draft pricing determination for the UCLL and UBA services.[1]

2. The relevant legal issues are:

   (a) whether the FPP price determined by the Commission should be backdated;

   (b) the application of ORC to all assets in the MEA model;

   (c) the use of FWA in the UCLL MEA model; and

   (d) the choice of UBA MEA.

3. In summary, our views are:

   (a) Backdating is not required as a matter of law. It is a matter for the Commission to exercise discretion consistently with the statutory framework and, in particular, the section 18 purpose.[2] The evidence we have reviewed supports the Commission's majority decision not to implement backdating as being the best way to give effort to section 18.[3]

   (b) The core legal requirement guiding the Commission's decisions regarding the MEA cost models is to ensure that only efficient forward looking costs are included. It is at risk of committing an error of law if it fails to apply that standard or makes decisions based on other considerations.

   (c) We remain of the view that the Commission is exposed to legal risk if ORC is applied to all assets in the UCLL cost model. Chorus (and the Commission) have not provided valid reasons for disregarding the Supreme Court's reasoning in the *Vodafone* decision.[4]

   (d) FWA must be included in the cost model to an efficient extent. It appears to us that the Commission has not applied that standard, and has instead followed a pragmatic approach based on Chorus' actual (inefficient) network.

---

[1] Chorus, *Submissions on further draft determination for UBA and UCLL services*, 13 August 2015.

[2] Section 18 of the Telecommunications Act 2001 ("**Act**").

[3] We acknowledge that there is evidence in favour of backdating. However, the weight to be given to the evidence is a matter for the Commission to determine, and is not a question of law.

[4] *Vodafone New Zealand Ltd v Telecom New Zealand Ltd* [2011] NZSC 138.

(e) The Commission's selection of UBA MEA is based on inconsistent reasoning and, arguably, fails to apply the section 18 purpose to its assessment of both layers 1 and 2 of the network an HEO would use to provide UBA services.

Backdating

4. Chorus considers that prices should be backdated because:[5]

(a) It is required by the Act:

(i) There is no basis to distinguish the Court of Appeal's decision that, as a matter of statutory interpretation, a price review determination relates back to the date of the initial determination.

(ii) A "purposive approach" to interpreting the Act requires (as held by the Court of Appeal) that the interim and final price "merge" when the final price is set, and to take effect from the same date as the initial determination.

(iii) Parliament has provided that the same review process would apply to Standard Term Determinations ("**STDs**"), which implies its intention for backdating to occur. Section 52 of the Act provides that the final determination is to specify only an expiry date, and not a commencement date. If the final pricing review determination was intended to take effect from the date of final determination (and not earlier), then this would have been expressly provided for in the wording of the Act.

(b) It is wrong to base any decision to backdate on whether such an outcome would demonstrably promote competition or any other "balancing act". The whole point of the review is to replace the IPP price, which has been established to be wrong. Moreover, there is clear legal precedent that the IPP is a preliminary or contingent price pending a more efficient FPP price being established. If the IPP price is allowed to stand for any period, then the Commission would be proceeding on the basis that section 18 would be met for that period, which cannot sensibly be the case.

(c) In order to give effect to section 18, the initial, inefficient prices should now be corrected. Any decision by the Commission not to substitute the review determination for the initial determination would undermine the section 18 purpose.

5. The following explains why we disagree with Chorus' arguments.

No legal precedent that backdating is required by the Act

6. The Act is silent on backdating. Chorus argues, therefore, that the scheme of the Act, as interpreted by the Court of Appeal (albeit in a different context), nevertheless *requires* backdating.

7. In our view, it would be wrong for the Commission to proceed on the basis that the Court of Appeal has held that, for an STD, an FPP price *must* be backdated.

[5] Chorus, *Submissions on further draft determination for UBA and UCLL services*, 13 August 2015, at paragraphs 282-288.

8. Rather, we agree with the analysis of Dr James Every-Palmer:[6]

(a) The Court of Appeal confirmed the High Court's decision to decline the declaration sought by Telecom. The (relevant) declaration sought was that a (non-STD) pricing review determination cannot include a commencement date earlier than the date of public notice of its making.

(b) Accordingly, the Court of Appeal did not decide, nor, importantly, was it required to decide, that the Act requires backdating in every case. Had it done so, the subsequent approach of the High Court and Court of Appeal in appeals arising out of the setting of the IPP, to deliberately avoid expressing a view on the issue, would be at odds with the Court of Appeal having made such a determination.[7]

9. In addition, the High Court had found that the Commission has the power (but not an obligation) under section 52 to decide that it was appropriate for a pricing review determination to apply from a date other than the inception date of the section 27 determination.[8] That express and clear finding contradicts a legal *requirement* to backdate to the inception date of a section 27 determination. The Court of Appeal did not overturn or otherwise say anything to contradict this positive finding by the High Court.

10. We do not disagree that the Court of Appeal's (and the High Court's) reasoning supports backdating in the circumstances of that particular case. Again, however, this was in the context of declining the declaration sought by Telecom.[9] It is quite different to a finding that backdating is automatic or legally required in every case.

2006 CA decision considered materially different circumstances

11. In our view, the circumstances now being considered by the Commission are materially different to the facts and statutory/regulatory context that were considered by the Court of Appeal (now some nine years ago). In accordance with the statutory requirement that legislation must be interpreted "as applying to circumstances as they arise",[10] a court would need to consider afresh whether the Act, in particular section 18, requires backdating of an FPP price, in the circumstances then before the court.

12. A key distinguishing factor in the present case from that before the Court of Appeal in 2006 is that the Commission is considering backdating of an STD price, under new statutory provisions. That is important. STDs did not exist at the time of the Court of Appeal decision. Key differences are that STDs:

(a) apply to multiple parties, who may change over time; and

(b) do not have an expiry date, and therefore do not establish a price for a specific period.[11]

---

[6] James Every-Palmer "FPP determination: Issues re service description and the modern equivalent asset" (12 March 2014) at paragraphs 6-10.
[7] See *Chorus Ltd v Commerce Commission & Ors* [2014] NZHC 690 at [42] and *Chorus Ltd v Commerce Commission* [2014] NZCA 440 at [26].
[8] At [31].
[9] Which was that "a pricing review determination ... *cannot* include a commencement date earlier than the date of public notice of its making" (emphasis added).
[10] Interpretation Act 1999, s 7.
[11] The fact that section 27 (and pricing review) determinations were required to have an expiry date, and therefore set the price to be paid for a specified period, was an important feature of the Court of Appeal's and High Court's reasoning, as discussed below.

13. Chorus seeks to argue that these differences are immaterial, because the specific features of section 27 determinations were not relevant to the Court of Appeal's decision. We disagree. To the contrary, it is clear that the Court of Appeal (and High Court) was influenced by the following key features of section 27 determinations:

(a) in the first instance, as required under section 22(1)(c), prices and other terms of access had been subject to negotiations, or attempted negotiations, between the access provider and the access seeker;

(b) the access seeker could apply for the price (and other terms of access) to be determined by the Commission, for a specified period. The application must specify the price period sought, although this could be varied by the Commission in the final determination; and

(c) either the access seeker or access provider could apply for a pricing review.

14. In those circumstances, it is clear that a key part of the Court's reasoning was to avoid a perverse or absurd outcome that Parliament could never have intended.[12] That is, the section 27 determination had expired *before* the pricing review decision was made, and therefore the pricing review would be rendered ineffective and redundant if it could not be backdated. The Court of Appeal stated that:[13]

> The observation might be made that because the Act requires the determination on a review application, **Telecom's argument envisages a mandatory statutory process involving considerable delay and expense in order to produce a formalised futility.** Unlikely though it may be that such a result is within the statutory purpose of Part 2, as explained in s 18, we will of course examine the structure of Telecom's argument later in this judgment.
>
> [Emphasis added]

15. This was consistent with observations made by the High Court:[14]

> Telecom asserts that the three pricing review determinations when made will only take effect from the dates of delivery. As an inevitable consequence, **they will be ineffective and of academic interest only** for the two terms of supply which have already expired and of **limited effect for the one remaining alive. That result may be startling, even heretical, to Parliament and those like the Commission and TelstraClear who adhere to the purposive school of statutory interpretation.** However, Telecom submits that judicial endorsement of the contrary proposition, namely that a pricing review determination may take effect from the same date as the s 27 determination (what it describes as backdating) and thus through an expired term, is equally repugnant in that it is contrary to the terms of the statute and offends the prohibition on retrospectivity. These two extremes set the parameters for argument.
>
> [...]
>
> The Courts have long adopted a purposive approach to interpreting legislation, to avoid an absurd result – one that is "unworkable or impracticable, inconvenient, anomalous or illogical, futile or pointless, artificial, or productive of a disproportionate countermischief".
>
> [Emphasis added]

---

[12] At [19H]. See also the judgment of Harrison J at [3], [5], and [57].
[13] *Telecom New Zealand Ltd v Commerce Commission* CA75/05, 25 May 2006, at [19].
[14] *Telecom New Zealand Ltd v Commerce Commission* HC Auckland CIV-2004-404-005417 at [3], [23].

16. Such concerns obviously do not arise in relation to an STD. The STD must *not* have an expiry date (section 30Q). The pricing review determination will therefore be fully effective on a prospective basis.

17. The Court of Appeal was also influenced by the view that the "obvious function of the price determination regime is to fix the price for a period of time relevant to the application, not to fix the price for part of that time and another price for another part". The High Court found that section 20, which gives an access seeker the right to apply for price terms to apply "during the period of time specified in the application", was important. A critical part of the High Court reasoning, which the Court of Appeal agreed with, was that a review of the "price to be paid" under section 42 "could only relate to the price fixed by the s27 determination for a defined period".[15]

18. These considerations are of much less relevance to STDs. First, there is no equivalent of the words used in section 20. Second, there is no application made for a price to be paid for a defined period. And, as demonstrated by the history of UCLL in particular, the price under an STD *will* change over its duration - whether or not there is an FPP review.

19. Finally, we consider that in the present circumstances, different as they are to those considered by the High Court and Court of Appeal in 2005/2006, a decision by the Commission not to backdate is arguably consistent with the Court of Appeal's approach of focussing on achieving an efficient outcome in the circumstances.[16] The Court of Appeal wished to ensure the most efficient price applied for the entire fixed period of the section 27 Determination. In the absence of a fixed period under a STD, which has been (and will be) subject to different prices over different periods, focussing on efficiency considerations appropriate to the different circumstances at hand, as the majority of the Commission has done, is appropriate.

No clear Parliamentary intent

20. Chorus argues that Parliament intended the Court of Appeal decision to apply to STDs, because it was silent when it had the opportunity to clarify the position when it included STDs in the Act That is not a tenable proposition: it is a not a sound principle of statutory interpretation that Parliament's intent can be divined from its silence:

    (a) Section 5(1) of the Interpretation Act 1999 provides that "the meaning of an enactment must be ascertained from its text and in the light of its purpose." Among other things:

    > This provision makes it clear that the task is to interpret the words of the Act not to create new words in order to give effect to legislative intention.[17]

    (b) Or, more generally:

    > "We must look for the intention of Parliament ... But we can only take the intention of Parliament from the words they have used in the Act".[18]

21. In our view, Parliament's silence cannot reasonably be interpreted as requiring backdating in every case. The better view, in light of established principles of statutory

---

[15] At paragraph [23].
[16] *Telecom New Zealand Ltd v Commerce Commission* CA75/05, 25 May 2006, at [35].
[17] *Union Motors Ltd v Motor Spirits Licensing Authority* [1964] NZLR 146, 150 (SC). The case concerned the interpretation of section 5(j) of the Acts Interpretation Act 1924 - which is the same as the current section 5(1).
[18] (*Inland Revenue Commissioners v Hinchy* [1960] AC 748 (HL) at 767 per Lord Reid) - cited in *Burrows and Carter on Statute Law in New Zealand*, Fifth edition, at p. 201.

interpretation, is that when STDs were introduced into the Act in 2006, Parliament would have expressly required backdating in all cases, irrespective of the particular circumstances facing the Commission (or a court, as the case may be), if that was the outcome it wanted.

22. Accordingly, the Commission's (and a court's) task will be to establish Parliament's intent by examining the scheme of the Act. In our view, there are features of the statutory scheme governing STDs that count against any interpretation that backdating is required.

23. For STDs, the Act includes specific provisions dealing with price, where there are no comparable provisions for section 27 determinations. That is, there is evidence that Parliament consciously implemented different requirements for STDs (despite Chorus' arguments to the contrary). Relevant provisions include:

    (a) Section 30P(1), which specifies that the section 30M STD must include the price determined in accordance with the FPP in a final pricing review determination made under section 51. The Commission also has the power to include an updated calculation of the section 51 determination price. These provisions count against Chorus' argument that the IPP and FPP determinations "merge" once the FPP price is set. Section 30P treats the section 51 final pricing review determination as being separate to the section 30M determination.

    (b) Section 42(1A), which provides that there can be no review of a section 30M determination price when that price was included in the determination pursuant to section 30P(1)(a) (where the price included in the section 30M determination is the FPP price in a determination under section 51). This reinforces that an FPP price determination is separate to the section 30M STD.

    (c) Section 30P(2) provides that an STD "may also include any other terms concerning the price for the service that the Commission considers relevant". This appears to give the Commission power to determine the date upon which an FPP price takes effect (in addition to section 52, which Harrison J stated (at [31] of his Honour's judgment) allowed the Commission to determine the starting date for an FPP price). Interpreting the Act as *requiring* backdating in all cases would be inconsistent with these broad powers.

24. In summary, a key part of the High Court's (and Court of Appeal's) reasoning was that the pricing review determination extinguishes and replaces the section 27 determination on price, because it was a review of a price that was to be paid for a fixed term.

25. The same cannot be said for STDs, where the Commission must separately determine how the pricing review determination is to be incorporated into the STD (under section 30P), in circumstances where the initial price under an STD is available indefinitely to all parties who wish it to apply (that is, it is not a price applied for by an access seeker for a fixed term).

No other factors support backdating as a legal requirement

26. We have considered whether there are any other factors, including those raised by Chorus, which could support a "purposive interpretation" that backdating is legally required in all circumstances. In our view, there are none. In particular:

(a) It is not correct that the IPP price is "wrong" and should therefore be replaced as though it never existed. As noted by the Court of Appeal, "a section 51 determination does not supplant a s 27 determination because the latter is wrong".[19] According to the Act, an IPP price is legally enforceable - it could have remained the legally enforceable price. It is not in the true sense reviewed under an FPP process - the Act provides an entirely different mechanism for setting the FPP price (*if* a party triggers the FPP process).

(b) Although the Court of Appeal has stated that an FPP price should be treated as being more efficient than the IPP price, it is not correct that the IPP is in itself inefficient or inconsistent with section 18. The very fact that Parliament chose to include an IPP process in the statutory framework, which contains section 18, is indicative that Parliament considered a price based on the IPP would be efficient (and consistent with the section 18 purpose). And the Commission's determination of the IPP, which involved benchmarking against only overseas comparators utilising a TSLRIC model (producing a sample which was then narrowed further for comparability), was approved by both the High Court and Court of Appeal as having been determined in accordance with section 18.[20] It is therefore undeniably an efficient price in and of itself.

(c) Indeed, when devising the two-step regime, it was hoped that a robust IPP process and price would avoid the need for FPPs altogether. The very reason for having a binding IPP during an FPP process is that it was known the FPP price could be complex and lengthy. In summary, having an IPP price quickly available through a shorter and more cost effective process was in and of itself efficient.[21]

(d) We have not identified any compelling economic evidence that backdating is necessary to give effect to section 18. Indeed, there is economic evidence before the Commission that it would be inconsistent with section 18.[22]

(e) In this context, we disagree with Chorus' (and the Sapere report's) view that the time inconsistency in the Commission's approach will undermine market incentives and the assurance process by sending the wrong signal to affected parties and/or investors. By contrast, our view is that:

(i) The Commission is simply, and appropriately, making its decision in light of all the circumstances that exist at the time of that decision.

---

[19] *Telecom New Zealand Ltd v Commerce Commission* CA75/05, 25 May 2006 at [15].
[20] *Chorus v Commerce Commission* [2014] NZHC 690 (8 April 2014); *Chorus v Commerce Commission* [2014] NZCA 440 (8 September 2014).
[21] Ministerial Inquiry into Telecommunications, Final Report, 27 September 2000, at p. 68.
[22] DotEcon, *Submission on behalf of Spark and Vodafone on further draft determination for UBA and UCLL services*, 13 August 2015; Network Strategies, *Submission Submission on behalf of Spark and Vodafone on further draft determination for UBA and UCLL services*, 13 August 2015; WIK, *Submission on behalf of Spark and Vodafone on further draft determination for UBA and UCLL services*, 12 August 2015.

(ii) We agree with the majority of the Commission that the rationale of having FPP prices in the market earlier is contrary to the statutory scheme that, among other things, provides that the IPP is legally binding. The Commission has noted that:[23]

> A draft is intended to allow parties to give views that inform the final decision: it is not a quasi-final decision itself, and may be significantly amended.

(iii) If draft FPP prices were to have price signalling status, this would constrain the Commission's statutory obligation to properly consult and otherwise act with an open mind, and put pressure on the Commission not to vary its draft position when it makes the final decision. The Commission would be at risk of inviting allegations of pre-determination in relation to each final decision.

Section 18, TSLRIC and Efficiency

27. Our views on the relevant MEA cost model legal issues discussed in the following sections are underpinned by our assessment of how TSLRIC should be interpreted and applied consistently with section 18 of the Act.

28. In our view, the Act requires the Commission to apply TSLRIC so that only efficient forward-looking costs of providing the regulated service(s) are included in the determined price. Specifically:

(a) Parliament has chosen TSLRIC as the methodology that will best give effect to section 18;

(b) we agree with the Commission that the definition of TSLRIC itself provides limited practical guidance on the choices it needs to make in relation to its cost model;[24]

(c) however, in the context of regulating a monopoly service, section 18(2) guides the Commission to ensure that only efficient costs are included in its cost model;

(d) consistent with the observations of the High Court in the Merits Review proceedings,[25] the focus must be on setting a price that allows recovery of efficiently incurred costs - as that in itself will be sufficient to promote all forms of efficiency, including dynamic efficiency.

(e) what is an efficient cost will be an evidential matter in each case. The Commission will need to exercise judgement to choose the best evidence of efficient costs;

(f) but it must exercise that judgement in the correct legal context/in response to the correct legal test. It cannot apply a different standard, allowing for example considerations only relevant to a Return on Investment (ROI) type approach (where the focus is on providing a fair return on *actual* investment). The test

[23] Commerce Commission "Further draft pricing review determination for Chorus' unbundled copper local loop services" 2 July 2015, paragraph 888.
[24] Commerce Commission, *Further draft pricing review determination for Chorus' unbundled copper local loop service*, 2 July 2015, at paragraph 92.
[25] *Wellington International Airport Ltd and others v Commerce Commission* [2013] NZHC (11 December 2013), at [14], [18].

applied in each case must be whether the costs included are efficient forward looking costs.

29. We are therefore concerned with the Commission's suggestion that the cost modelling choices it makes may not impact on the requirement to "promote competition" under section 18, as it is difficult to see how different prices will impact on competition.[26] In our view, the Commission must promote competition (under section 18) by setting a price based on efficient forward looking costs of providing the regulated service.

30. A focus on identifying efficient costs when applying TSLRIC is consistent with the intent expressed in the Fletcher Inquiry report. In the context of designating interconnection services, the Inquiry stated:[27]

> It is important that interconnection is priced efficiently so that other providers are faced with the appropriate incentives to decide whether to build their own network or merely resell access to another's network. Further, if interconnection prices do not accurately reflect costs, perverse incentives can be created, as has been the case in the 0867 dispute.
>
> In the Inquiry's view, **the efficient costs of call origination and call termination are the costs that would be incurred by an operator using the most efficient means at any point in time to provide the service**. This approach, widely supported by leading academic research and best practice regulation, is sometimes referred to as calculating prices on the basis of 'forward-looking costs'. Such costs would include the direct costs of providing the services, including a cost of capital return on the capital costs, as well as a share of common costs that are related to supplying the services in the long term (i.e. the total service long-run incremental cost - TSLRIC) of an efficient operator.
>
> [Emphasis added]

31. In light of the above, approaches that seek to define additional standards or criteria for applying TSLRIC are in our view incorrect, because they risk TSLRIC being applied inconsistently with section 18. In particular:

    (a) Chorus' view that "conventional" or "classical" TSLRIC must be applied has no basis under the Act. If it is applied in a way that means inefficient costs are included in the Commission's model, then it is inconsistent with section 18 of the Act; and

    (b) similarly, it is incorrect to choose an approach on the basis that it will promote competition by, for example, competitive bypass or unbundling. When regulating a monopoly service, the Commission should focus on promoting competition (and efficient build/buy decisions) by ensuring efficient cost based prices for the monopoly input.

Asset valuation

32. Chorus provides various reasons why it supports the Commission's choice to apply Optimised Replacement Cost ("**ORC**") to *all* assets in the MEA, and the Commission's decision not to value re-useable assets at historic costs.[28]

[26] Commerce Commission, *Further draft pricing review determination for Chorus' unbundled copper local loop service*, 2 July 2015, at paragraphs 161-163.
[27] Ministerial Inquiry into Telecommunications, Final Report, 27 September 2000, at p. 65-66.
[28] Chorus, *Submissions on further draft determination for UBA and UCLL services*, 13 August 2015, at paragraph 178.

33. In particular, Chorus supports the Commission's preliminary decision not to be guided by the Supreme Court's judgment in *Vodafone New Zealand Ltd v Telecom New Zealand Ltd.*[29] We have previously explained why we think the *Vodafone* case is relevant and would influence a Court's consideration of the lawfulness of the Commission's choice of asset valuation.[30]

34. To reiterate, it is not suggested that the *Vodafone* decision is legally binding. We accept that the statutory context was different in that case. The same is true for the Court of Appeal's backdating decision. Rather, for both decisions, the relevant question is whether a court would find the reasoning to be persuasive in assessing the lawfulness of the Commission's decisions' under the final pricing review.

35. We now address the reasons provided by Chorus (and the Commission) to support their view that the *Vodafone* case has no bearing on the Commission's decision to use ORC when applying TSLRIC.

Different statutory context

36. Chorus argues that the statutory context considered by the Supreme Court in *Vodafone* is fundamentally different to the statutory task the Commission is required to undertake to set prices in accordance with TSLRIC.

37. It is true that the statutory contexts are different. However:

(a) The Supreme Court was focussed on the requirement that only efficient costs be included in the relevant cost model. In our view, it is not credible to say that the task before the Commission now is so materially different to its task in the TSO case (namely, identifying efficient costs of providing a service - or, identifying the costs that would be incurred by an efficient service provider), that the guidance provided by the Supreme Court is to be disregarded.

(b) We note that the Commission has itself acknowledged substantial similarities between the approach to asset valuation in a TSO and TSLRIC context:[31]

> The first common issue between the TSO and TSLRIC is the construction of a core network model. [...] In building this model, the Commission has been required to consider and make decisions on a range of issues relating to the design of the core network that also need to be addressed when building a TSLRIC model.
>
> The other common area between the TSO and TSLRIC is the economic approach to asset valuation, treatment of depreciation, and the cost of capital of telecommunications assets.

(c) Importantly, the Supreme Court drew on and was guided by precedent and commentary from different regulatory settings - therefore, in the context of the principled approach it took, it did not consider that differences between the statutory terms or the regulatory models being considered drove fundamentally different results:

(i) The Supreme Court directly relied on and approved the Australian Competition Tribunal's conclusion, in *Application by Telstra*

---

[29] [2011] NZSC 138.
[30] See our advice dated 20 March 2015.
[31] Commerce Commission *Implementation of TSLRIC pricing methodology for access determinations under the Telecommunications Act 2001: Principles Paper*, 20 February 2004 at paragraph 39-40.

Corporation Ltd, that the use of a replacement cost methodology in the context of a TSLRIC exercise would not promote the long-term interest of end-users - a legislative purpose akin to section 18.[32] Obviously, and as in the *Telstra* case, the Commission must apply TSLRIC now.

(ii) The Supreme Court was also influenced by a David Johnstone article: *Replacement Cost Asset Valuation and the Regulation of Energy Infrastructure Tariffs - Theory and Practice in Australia".*[33] Clearly energy sector regulation is a different context to the unique telecommunications provisions before the Supreme Court at the time.

(iii) The Supreme Court also noted that revaluation of legacy assets had also been disapproved in the United States, referring to the FCC "Report and Order in the Matter of Federal-State Joint Board on Universal Service (FCC 97-157, Washington DC, 1997). That decision concerned the adoption of "forward looking economic cost" models (ie akin to the TSLRIC approach now required).

(d) Chorus argues, by reference to the Commission's discussion paper of 2004, that applying ORC is consistent with overseas precedent. We agree that overseas precedent can be persuasive, but the Supreme Court has established that the 2010 Australian Competition Tribunal *Telstra* decision, which rejected the use of ORC under TSLRIC, is most persuasive.

38. Chorus and the Commission have not addressed the point that the Supreme Court was clearly influenced by precedent from different jurisdictions, considering different statutory tests. We think this is an important point, as it reinforces our view that the Supreme Court was of the view that the principle of only including efficient costs in a cost model was a common requirement across economic regulation, despite differing specific statutory contexts.

Different cost model

39. We do not agree with Chorus' (or the Commission's) view that the requirement to apply TSLRIC either requires, as a matter of law, the application of ORC asset valuation methodology or means that the *Vodafone* principles do not apply. We understand the argument Chorus is making to be that the Supreme Court noted that the efficient service provider "is supposed to be a proxy for a firm which will continue to employ old assets";[34] however, the Commission's application of TSLRIC requires an assumption that the efficient service provider will build a new network "from scratch".

40. In our view, such an argument is misconceived. Rather:

(a) The Supreme Court's comment reflected that the task then at hand was to identify efficient costs of providing a real world service - which would be provided over legacy assets. The same situation applies to the provision of UCLL and UBA. We do not think the Court's comment reflects a view that the cost model was limited to employing old assets. For example, the Supreme Court also found that it was an error of law for the model not to replace legacy assets with mobile technology where that was more efficient.

---

[32] *Application by Telstra Corporation Ltd* [2010] ACompT 1 at [238]-[246].
[33] University of Bath School of Management CRI International Series 8, 2003.
[34] At paragraph 70.

(b) In any event, it would be incorrect to say that *Vodafone* is wholly irrelevant because of the way the Commission has *chosen* to implement TSLRIC (that is, assuming the efficient operator builds a network from scratch). The law should guide the choice of model (the use of which will need to be consistent with the legal "boundaries" of the exercise of that choice) - the choice of model should not dictate whether the law is applicable. The latter approach puts the cart before the horse. The correct question is whether the Commission's choice of model is lawful when considered in light of section 18 and the *Vodafone* principles, as set out by the Supreme Court. That is, the relevant legal requirement is for the Commission to establish a model that only includes efficient forward looking costs of providing the regulated service. That legal requirement constrains the Commission's choice of model - including asset valuation.

(c) Accordingly, to the extent that the Commission's adoption of an ORC approach to asset valuation causes it to include efficient costs in the MEA, that is inconsistent with section 18. Previous cases indicate that is capable of giving rise to an error of law.

41. Furthermore, in our view:

(a) The TSLRIC model does not in itself dictate the choice of asset valuation methodology. The Commission has itself correctly recognised that there are a range of asset valuation methodologies consistent with forward-looking costs and TSLRIC.[35]

(b) Applying a "conventional" TSLRIC approach to determine the choice of asset valuation will be an error if it means that inefficient costs are incorporated into the Commission's model.

42. Finally, we disagree with Chorus' assertion that the Court of Appeal's recent characterisation of the TSLRIC model assists in this case.[36] The Court of Appeal description of TSLRIC is simply a (non-controversial) observation of what TSLRIC entails. It does not guide the choice of asset valuation methodology under TSLRIC.

Fixed Wireless Access

43. Chorus argues that FWA should not be included in the MEA because:[37]

(a) it is not capable of meeting either the "full" or "core" functionality of the UCLL service, which at a minimum requires the ability for the service to be unbundled (at layer 1);

(b) it is inconsistent with the Act and an orthodox application of TSLRIC (which requires the Commission to set a price for *the service* that Chorus is required to provide based on the TSLRIC cost of providing *the service*); and

---

[35] Commerce Commission *Implementation of TSLRIC pricing methodology for access determinations under the Telecommunications Act 2001: Principles Paper*, 20 February 2004 at paragraph 39-40. Commerce Commission "Further draft pricing review determination for Chorus' unbundled copper local loop services" 2 July 2015, at paragraph 1218.

[36] *Chorus v Commerce Commission* [2014] NZCA 440 at [30].

[37] Chorus, *Submissions on further draft determination for UBA and UCLL services*, 13 August 2015, at paragraph 40.

(c) the Commission cannot optimise away the regulatory obligations that the HEO is required to perform (ie to provide a point-to-point unbundleable layer 1 service).

44. We disagree. As set out in our opinion of 30 April 2014, the Act does not dictate the Commission's choice of MEA. The Commission must exercise judgement and discretion to determine which MEA is likely to provide the best evidence of efficient forward looking costs over the long run. There are a multitude of decisions that the Commission must make when applying TSLRIC, on which the Act provides no express guidance. Therefore, it would be strange to interpret the definition of "TSLRIC" as providing very specific guidance on one specific matter.

45. Consistent with our view that the Act does not place any specific constraints on the choice of MEA, the Act does not require the HEO to be subject to the same regulatory obligations as Chorus. Rather, as the Chief Justice summarised in the *Vodafone decision* (discussed further below):[38]

> What was required was an assessment of the network that would have been used by an efficient service provider. Any cost incurred which was not one that would have been incurred was avoidable and, on the definition of net cost, should have been eliminated from the assessment.

46. Further, and even if it was correct that the HEO should be subject to the same regulatory obligations as Chorus, it does not follow that the *whole* network needs to be unbundleable. Chorus' obligation under the Act is to provide UCLL on the lines requested by access seekers (not to ensure it is available over the entire network). Although an evidential question, we anticipate that an HEO would wish to determine the extent to which layer 1 unbundleability would likely be requested on its network, and build accordingly (ie not include unbundleability where it was reasonable to assume it will never be required).

47. Although the Commission must exercise judgement when determining the appropriate extent of FWA, the *Vodafone* decision demonstrates that an error of law will be committed if its decision is inconsistent with the applicable statutory framework. In this context:

(a) Section 18 requires the Commission to incorporate FWA in the model to the extent that it is efficient to do so. Under the Commission's construct, the question is to what extent an HEO would use FWA to build its network.

(b) The Commission appears to have disregarded this requirement by limiting FWA to Chorus' actual voice only and low speed lines. The Commission has not sought to establish that this approach provides a reasonable input for the estimation of efficient costs. It appears to simply be a pragmatic choice. This is at odds with the legislative requirements and the Commission's view that the HEO would choose the most efficient network technology. In other words, the Commission has not asked itself the right question when exercising judgement on the extent to which the MEA should include FWA.

(c) The Supreme Court's reasoning on the "new technologies issue" in *Vodafone* is highly relevant:

[38] *Vodafone New Zealand Ltd v Telecom New Zealand Ltd* [2011] NZSC 138, per Elias CJ, at [9].

(i) although the Commission had included some mobile technology in its model, it has not asked itself, what is the efficient extent to which FWA ought to be included (and so erred in law);[39] and

(ii) not asking itself the correct question, as required by the Act, is particularly problematic when the Commission's model already includes inefficient costs by using ORC.[40]

48. In our view, applying TSLRIC consistently with section 18 requires the Commission to follow a robust approach by including FWA to the extent it would be used by an efficient operator acting rationally. We have reviewed Network Strategies' report, 'Response to submissions on revised draft determination', which provides evidence that the approach adopted is inconsistent with that of an HEO. Accordingly, in our view the Commission is at risk of exercising its discretion within the framework of the wrong legal test.

MEA for UBA

49. Chorus argues that the UBA MEA must be delivered over Chorus' existing FTTN/Copper network because:[41]

(a) such an approach is "mandated by the structure and purpose of the Act"; and

(b) it ensures appropriate relativity between the Layer 1 and 2 designated services, as required by the Act.

50. As set out in our advice of 30 April 2014, our view is that the Act does not dictate a particular approach to the UBA MEA model. However, it would be consistent with the scheme of the Act to conceptualise UCLL and UBA as being provided over the same network, as it is in the real world. Indeed, such an approach will better ensure that inefficient costs are not included in the UBA modelling.

51. Chorus has not sought to elaborate (substantially) on the views that we took into account when forming our 30 April 2014 views, and therefore we do not elaborate on our reasoning here

52. There remains a separate issue of whether the Commission has applied the correct legal test when choosing the UBA MEA.

53. Chorus (in the alternative) supports the Commission choosing to use Chorus' existing network, on the basis that it will better promote efficient build or buy choices. The Commission selected an underlying copper access network because it will likely better allow for competition through unbundling where it is efficient. That is because decisions regarding unbundling are made in respect of the existing copper network, so the Commission's choice of MEA will better align efficient build/buy decisions with those made in the real world.

54. It is correct that relativity (and the promotion of unbundling) is a relevant consideration under the Act. However, it cannot override the primary legislative requirement to ensure that only efficient costs are included in the Commission's model. This primary requirement plainly extends to the Commission's choices for both layers 1 and 2 of the network an HEO would use to provide UBA services.

---

[39] See Elias CJ at [9] to [14];
[40] See [75].
[41] Chorus, *Submissions on further draft determination for UBA and UCLL services*, 13 August 2015, at paragraph 147-150.

55. We therefore agree with the Commission's view that:[42]

> ... we find that relativity guides us less towards attempting to promote unbundling, and more towards the efficiency aspects of the section 18 purpose statement. We consider that we should be neutral towards the promotion of unbundling, and allow for unbundling to occur to the extent that it is efficient.

56. However, it appears that the Commission has failed to apply its own view, and in our view the correct approach under section 18, when making its choice of UBA MEA:[43]

> We consider that a MEA for the UBA service that presupposes an underlying copper access network will likely better allow for competition through unbundling where it is efficient. This is because decisions regarding unbundling are made in respect of the existing copper network, and so a MEA for the UBA service that utilises an underlying copper access network better aligns efficient build/buy decisions with those made in the real world, compared to the case with an alternative MEA built over an optimised access network.

57. Had the Commission applied the correct approach under section 18, we note that evidence before it, prepared by WIK Consult GmbH, suggests that efficiency considerations would require the adoption of FTTH for the underlying network an HEO would use to provide UBA services.

58. In our view, the Commission's reasoning is subject to the following errors:

(a) It has failed to properly apply section 18 to its choice of MEA, and has instead applied reasoning that, on its own analysis, is not what section 18 requires when properly interpreted.

(b) It has failed to apply a consistent legal approach to its selection of MEAs for UCLL and UBA. If the Commission was to consistently apply its approach to the MEA for the UCLL to the UBA service, then it would build the hypothetical network from scratch, on a blank/clean slate, with the assumption that all assets within the legacy network no longer exist and modern efficient technology is used.[44] In the case of UBA, there is no legal basis to consider that does not extend to both layers of the network utilised to provide the service.

---

[42] Commerce Commission. *Further draft pricing review determination for Chorus' unbundled copper local loop service*, 2 July 2015, at paragraph 259.
[43] Paragraphs 293 and 294 of UBA revised decision.
[44] Commerce Commission. *Further draft pricing review determination for Chorus' unbundled bitstream access service*, 2 July 2015, at paragraph 175.