Proposed Amendments to Fibre Input Methodologies: draft decisions Reasons paper

Commerce Commission Consultation

2degrees submission, 8 July 2021

Introduction

2degrees welcomes the opportunity to submit in response to the Commerce Commission's Reasons Paper *"Proposed Amendments to Fibre Input Methodologies: draft decisions*", 27 May 2021, and to provide cross-submissions in relation to the *"Amendments needed in order to implement the proposed approach to determining Chorus' initial PQ RAB"*.

2degrees support a number of IM changes prior to the first statutory IMs review:

- We support the Commission making changes to the Input Methodologies (**IMs**) to allow for a draft Regulatory Asset Base (**RAB**) to be adopted for PQP1 and for the IMs to include a wash-up mechanism.
- We also support amendments to correct for errors. We acknowledge "As the fibre IMs are new, there was a greater chance of [correction for error] being necessary prior to the first reset (as was the case with the IM amendments ahead of the second default price-quality path reset (DPP2) for electricity distribution businesses (EDB))".
- We agree with the Commission that it can introduce new IMs outside the statutory IM review process.

However:

- We do not support the adoption of an 'unlimited' wash-up, as the Commission has proposed, which is in contrast with the approach it adopted under Part 4 of the Commerce Act.
- We consider the consideration of a Pricing Input Methodology, which may apply from PQP2, would meet the criteria to be considered outside the statutory IM process (i.e. it would both help promote competition and improve certainty).

We support amendment of the IMs to allow for a draft RAB to be adopted for PQP1

We do not agree with Chorus' position that the "Proposed amendments to process for determining initial RAB are unjustified, reduce certainty, and are inconsistent with the Act".

While Chorus claims "Certainty … is undermined if the rules are constantly subject to change, or if the Commission changes the rules in a significant way at a late stage to accommodate its desired approach to setting price-quality paths" it is clear the proposed amendments are justified and reflect the circumstances specific to transitioning to the new Part 6 fibre regime. The Commission adopting a process that will better ensure a robust RAB, that protects the long-term interests of end-users, does not undermine certainty.

We also disagree with Chorus' view "No … compelling and urgent rationale has been offered" and that "The only justification the Commission has offered for this change is

that it has run out of time to complete the exercise that Parliament originally intended it should complete by 1 January 2020 and then extended for a further two years to 1 January 2022". It is clear from the observations provided by the Commission and stakeholder submissions that the RAB values Chorus has proposed do not provide a suitable basis for the Commission to determine a final RAB value in time for the price-quality reset.

While we agree with Chorus "some form of transitional initial RAB is unavoidable", 2degrees continues to support amending the IMs to provide for Chorus' fibre RAB to initially be determined on a draft basis for the 2022 PQP1 with the RAB finalised prior to PQP2, and (forward-looking) wash-up applied to adjust for the difference in PQP2.

We also support the related proposals to amend "the Cost of Capital fibre IM to specify that the transitional initial PQ RAB inputs to the "term credit spread differential allowance" and "term credit spread differential" for PQP1 would be determined, in part, on "relevant estimates of historic values", rather than "relevant actual values"" and "the Capital Expenditure fibre IM to change the date by when we must determine a "base capex allowance" and "connection capex baseline allowance" for PQP1".

We agree with the Commission that it "do[es] not have sufficient time to complete the required scrutiny in 2021" and "at the time of determining the PQ path, scrutiny of unallocated asset values may not have been completed and the final cost allocators that will be applied to determine the actual initial PQ RAB asset values will not yet be available. Transitional assumptions are therefore needed to obtain an estimate of the initial PQ RAB". We also agree the Commission's proposed approach "will enhance certainty, consistent with s 174, about the requirements for calculating the transitional initial PQ RAB. We consider our proposed approach is preferable to other ways of managing uncertainty that might risk a material under- or over-statement of Chorus' initial PQ RAB (for instance, not carrying out any scrutiny of Chorus' initial PQ RAB proposal prior to determining PQP1)".

We do not support 'unlimited' wash-up

2degrees supports the wash-up mechanism being included in the IMs.

We consider the wash-up mechanism is something that should not vary over-time and therefore it is appropriate to include it in the IMs. We reiterate "Including a wash-up in the IMs would aid regulatory certainty and promote the long-term interests of end-users" and "we consider the wash-up mechanism should be included in the IM as it is under Part 4 of the Commerce Act".[1]

However, we do not support the wash-up mechanism being set to permit 'unlimited' wash-up, which is in contrast to the Commission's approach under Part 4 of the

[1] https://comcom.govt.nz/__data/assets/pdf_file/0029/217982/Two-Degrees-Submission-on-Fibre-input-methodologies-Regulatory-processes-and-rules-draft-decision-29-May-2020.pdf

Commerce Act, which applies to electricity distributors, Transpower and gas networks. We also do not consider that the Commission has provided reasonable grounds why 'unlimited' wash-up would be to the long-term benefit of end-users. We reiterate "We are concerned by Chorus' suggestion it should be able to operate an unconstrained wash-up for under-recovery. We consider that the Regulatory Rules and Processes IM should include the wash-up mechanism and should include specific limits on the extent of wash-up that is permissible. We note there is precedent for this under Part 4 that the Commission can draw on".[2]

We agree, for example, with the Commission's concern that "the wide scope of this wash-up – specifically the inclusion of an unlimited accounting for undercharging – could in some circumstances harm workable competition from FWA providers in access markets".

While it may be the case Chorus' cashflow incentives would limit the extent to which it would be likely to undercharge, there are reasons and circumstances under which Chorus might undercharge, not all of which are under Chorus' control.

By way of example, the Christchurch earthquakes resulted in Orion under-recovering its allowed revenue, but the Commission did not permit Orion to recover the full level of under-recovery. The Commission was very clear it did not allow full recovery of revenue foregone because:

- "Sharing of risks and costs provides incentives to manage risks"; and
- "Demand risk normally borne by suppliers in competitive markets".[3]

The Commission commented that "While it is clear that specific repair and replacement expenditure benefits consumers, it is less clear that compensating for a reduction in demand benefits consumers" and "allowing claw-back for additional net costs incurred after a catastrophic event helps strengthen regulated suppliers' incentives to invest in restoring their networks … Consumers benefit from this expenditure because it helps directly mitigate any deterioration in quality of service … In contrast, as noted by Professor Yarrow …, reduction in demand has no such direct or immediate implication for the quality of service provided to consumers".[4]

The Commission also noted:[5]

> "To the extent the submission is that demand risk following a catastrophic event should not be borne by Orion at all, we disagree. … the period for which a supplier is exposed to demand risk as a result of a catastrophic event is limited to the time between the event and the next reset of the path.

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[2] https://comcom.govt.nz/__data/assets/pdf_file/0030/173496/2degrees-Fibre-Regulatory-Processes-and-Rules-submission-9-September-2019.pdf
[3] https://comcom.govt.nz/__data/assets/pdf_file/0024/63159/Briefing-for-Orion-CPP-final-decision-29-November-2013.pdf
[4] https://comcom.govt.nz/__data/assets/pdf_file/0023/63158/Final-decision-for-setting-the-customised-price-quality-path-of-Orion-New-Zealand-Limited-29-November-2013.pdf
[5] https://comcom.govt.nz/__data/assets/pdf_file/0023/63158/Final-decision-for-setting-the-customised-price-quality-path-of-Orion-New-Zealand-Limited-29-November-2013.pdf

"Demand is reforecast at the time a price-quality path is reset, therefore, demand risk is 'recalibrated' over the next regulatory period. This is a construct of the regulatory framework, which balances incentive properties against other objectives. …"

And that:[6]

"B3 In our view, the financial impact of the earthquakes should be *shared* between Orion and its consumers. Imposing the entire financial impact of the earthquakes on consumers is not consistent with the Part 4 purpose because:

B3.1 it is unusual for consumers to bear *all* the costs and risks of catastrophic events in a workably competitive market. Workably competitive markets tend to manage risks efficiently, by allocating identified risks to the party best placed to manage them;

B3.3 regulated suppliers (and their investors) are generally better placed to manage the risks of catastrophic events than consumers; [244] and

B3.3 from a forward-looking perspective, allocating all the costs and risks of catastrophic events to consumers would reduce the incentives for suppliers to manage these risks efficiently (ie, create a moral hazard). [245]

If the proposed fibre wash-up mechanism had applied to Orion it would have been able to fully recover its foregone revenue. There is no obvious reason for treating Chorus differently to Orion or other electricity networks under Part 4 Commerce Act or vice versa.

The adoption of 'unlimited' wash-up effectively allocates all revenue risk to end-users.

The Commission also suggests the proposed approach of permitting unlimited wash-up is "the least complex and most transparent way of implementing the wash-up" and "This should reduce compliance cost and the risk of unintended outcomes". The Commission has not identified what complexity issues have arisen from the alternative approaches they use under Part 4 of the Commerce Act where there are limits on the extent to which wash-up could occur, or what the potential negative "unintended consequences" may be. We are concerned about consequences, including unintended consequences, of not adopting the approach under Part 4 of the Commerce Act.

We reiterate it is "important for the Commission to be clear and transparent about where it exercises judgement. This includes the reasons for following and deviating from Part 4 of the Commerce Act …" and "Being clear about when previous precedent is not being used will be just as important as being clear about when previous precedent is being used".[7]

We consider the Part 4 precedent is directly relevant to this issue. Prior to making a final decision on the approach to wash-up, the Commission should have regard to the approaches adopted under Part 4 of the Commerce Act and determine whether

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[6] https://comcom.govt.nz/__data/assets/pdf_file/0023/63158/Final-decision-for-setting-the-customised-price-quality-path-of-Orion-New-Zealand-Limited-29-November-2013.pdf
[7] https://comcom.govt.nz/__data/assets/pdf_file/0022/111982/Two-Degrees-Submission-on-new-regulatory-framework-for-fibre-18-December-2018.PDF

there is reason why a different approach is justified and to the long-term benefit of end-users.[8].

The Commission is able to re-open other elements of the IMs outside of the IM review

We agree with the Commission there isn't "a firm rule against introducing new IMs outside the IM review".

There are other elements of the IMs that merit review prior to the IM statutory review.

We recognise section 195 required that the Commission must set PQPs on the basis of a revenue cap for each regulatory period that starts before the reset date, but it can invoke section 181(1) provisions to determine whether a price or revenue cap should be specified in the IMs in time for the following regulatory period if it precedes the timing of the statutory review of the IMs. L1 Capital has commented that "The revenue cap means there is no incentive to invest further in fibre take up or penetration – our recommendation in the absence of a better regulatory regime would be to minimise future investment while it earns a returns [sic] well below cost of capital".[9] This is consistent with submissions by RSPs on this topic.

While the Commission has stated "extending the IMs to cover an entirely new topic would in most cases be a fundamental change; one that needed to be considered in light of the scheme of the IMs as a whole, rather than in relative isolation" the matter of a potential Pricing Input Methodology can be considered an exception.

A Pricing Input Methodology would meet the criteria that the Commission "would only add new IMs if we thought that there was a gap in the mandatory IMs that meant that as a package they did not: … best give, or are likely to best give effect to s 166(2)(a) and s 166(2)(b) (where relevant); or … promote sufficient certainty to achieve the purpose of IMs in s 174". A Pricing Input Methodology would both help promote competition and improve certainty.

The Commission has detailed why circumstances and the legal requirements for PQP1 mean it hasn't adopted a Pricing Input Methodology at this time, but those reasons do not necessarily apply to PQP2 or beyond.

As we have noted previously, "If pricing principles are not adopted for the first regulatory period, it will be important to ensure they are considered before the second regulatory period. Under Part 6 the Commission is able to introduce new IMs at any time, so a decision not to introduce Pricing Principles before the first price-quality determination does not exclude their introduction in the future".[10]

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[8]While the Commission has suggested a difference in approach to Part 4 of the Commerce Act on the basis that some regulated suppliers are trust-owned and may not be commercially incentivised to fully recover their revenue allowance, this argument doesn't apply to Transpower or gas networks.
[9] L1 Capital, Submission to the Commerce Commission (untitled), 28 May 2021.
[10] https://comcom.govt.nz/__data/assets/pdf_file/0022/161914/2-Degrees-Fibre-emerging-views-submission-16-July-2019.pdf

We reiterate we support other RSPs' positions that the Commission should consider development of an additional 'Pricing' IM, and we agree with previous commentary that:[11]

- Axiom Economics: "Chorus will understandably be motivated to engage in strategies to foreclose competition, which suggests it will often be preferable for the IMs to place a reasonably tight rein on its discretion to prevent it from acting on those commercial incentives (e.g., through the way in which it allocates common costs, determines prices for particular services, etc.)"
- Axiom Economics: "if the IMs provide Chorus with flexibility to act in ways that compromises competition in the wireless market (e.g., through the way it allocates common costs, sets prices, etc.), end-users could be deprived of the substantial benefits those services might otherwise deliver."
- Spark: "Given the likelihood of Chorus offering multiple substitutive services, whether layer 2 access products of differing speeds, or layer 1 access products that support competitive layer 2 services, there is a need for more prescription (compared to Part 4) of the pricing methodologies and principles Chorus will be expected to comply with when pricing services that use its RAB."
- Spark: "A more prescriptive pricing principles IM will be important to help guard against the incentive to price in a way that undermines the competitive outcomes the regime strives to emulate."
- Trustpower: "The allocation of shared costs will be a potentially challenging element of establishing the new fibre regulatory regime and we support the Commission in considering this important matter."
- Vocus: "The promotion of competition purpose is directly relevant to the Cost Allocation Input Methodology, as was evident from the statutory review of the Part 4 Input Methodologies. There was substantial debate about the impact Electricity Distribution Business involvement in emerging technology could have on competition, particularly if loose cost allocation rules were exploited to artificially raise the regulated business's costs, and to enable the regulated business to subsidise other activities."
- Vodafone: "... existing competition must be protected and enhanced through robust cost allocation rules."

[11] https://comcom.govt.nz/__data/assets/pdf_file/0013/120424/2degrees-Cross-submission-on-new-regulatory-framework-for-fibre-1-February-2019.PDF