



**InternetNZ, TUANZ and Consumer submission on
draft UCLL and UBA price review determinations**

20 February 2015

Public version (there is no confidential version)

Table of Contents

InternetNZ, TUANZ and Consumer submission on draft UCLL and UBA price review determinations.....	1
Table of Contents.....	2
Executive Summary.....	3
Introduction	3
Timing of the process.....	3
Backdating.....	3
Timing of the process – the biggest issue.....	5
Self-imposed time pressures are evident from the drafts	7
The considerable impact of the backdating decision - \$130 million	8
The December paper on backdating.....	8
Sufficiency of analysis and evidence.....	9
Impact on approach beyond backdating such as monthly charges	10
A quick overview on the right approach to evidence and analysis	10
Has Commission’s December decision sent the wrong messages to the market?	12
Follow the Part 4 lead?	12

Executive Summary

Introduction

1. Thank you for the opportunity to submit on the draft price review determinations.
2. This submission is lodged alongside the Wigley & Company submission as to backdating and their submission as to other matters. That submission deals not only with legal issues but also economic matters. In this submission, we have focussed on two issues which we see as key, from the perspective of consumers (the end-users of these services):
 - a. The timing of this process; and
 - b. Backdating.
3. As explained in the Wigley submission, we are leaving addressing a number of the modelling and implementation decisions until we have had an opportunity to review the submissions and work of the economists representing other submitters. We already have substantial concerns on those aspects but we propose to submit when better informed, as we think that is more helpful to the Commission.

Timing of the process

4. We consider the speed of this process is having a significant negative effect on outcomes, more so because it amplifies the effects of other facets of the FPP process, including large dollar issues such as choice of the UBA MEA, and ORC v historical cost pricing of re-usable assets.
5. We are the guardians of consumer interests, just as the Commission is also the guardian of consumer interests via the s 18 purpose statement's sole focus on end users.
6. We are continuing to see increasing reasons why time should be taken to get this right.
7. For every dollar that the price goes up or down, the impact of the Commission's decision is around \$140 million. Even movement of just one variable, such as the valuation approach to re-usable assets, could see movement exceeding \$1 billion.
8. All things equal, RSPs will seek to pass on monthly increases (and to compete out monthly reductions). Therefore, in large measure the effect of the Commission's decisions, currently leads to increased payments to Chorus over the IPP given that RSPs will pass through increased prices to consumers. There are overlapping issues as to one off charges (including that high charges reduce churn and competition) and backdating, as below.
9. We cannot understand how it can be suggested that, as matters are developing, the "nice-to-have" objective of speed and earlier certainty can be more important than getting it right when such large numbers are at stake, with large impact on consumers.

Backdating

10. In this submission we have also focussed on backdating. Not only is it a major issue for our stakeholders but it also illustrates our wider concerns around this process, including as to speed.
11. First some context. The effect of the December Commission view on backdating, if implemented, assuming the final FPP is the same as the draft FPP, with a decision in September, will result in a payment from RSPs to Chorus of more than \$130 million.

12. The December discussion paper suggests to us that the Commission is making decisions that impact end users and other stakeholders with significantly less analysis and consideration than would deliver optimal outcomes: the driver for speed has we think gone too far.
13. While the December paper was just a preliminary draft, it was designed to inform the market so that RSPs could decide what to do. The effect has been increased retail prices. We think the outcome could be different if the Commission takes a different approach. We hope that the experience so far will help inform the way forward.

Timing of the process – the biggest issue

14. We raise this first, as this is our biggest concern in this FPP. We think that this has a bigger impact on the pricing than even the largest dollar issues here such as choice of UBA MEA and historical v replacement valuations for trenching etc. This can be seen by us in many of the expediting choices made in the process, such as use of Chorus' data when other data is available, and in not engaging with submissions (such as in relation to the UBA MEA choice, now needing to re-work fully the UBA modelling).
15. As we see it, what is happening demonstrates even more our long standing concerns that this matter is proceeding too quickly and the "streamlined" approach by the Commission produces negative outcomes by a substantial margin:

We have elected to conduct a more streamlined process than advocated for by some parties. Our approach has been driven by the desirability of providing the industry and the market with certainty and stability as soon as possible.¹

16. We also remain of the view that taking longer on some steps, and getting the right information, will in fact end up with an earlier not later final decision. For example, the idea that the Commission would depart from long standing practice by having a conference before the draft determination (and not having one to address connection charges and, perhaps, backdating) seems to us to be leading to additional problems and delays later, when it would ultimately be quicker to have the conference at the normal time. We do, however, support having a conference prior to the post draft determination conference as well. This appears to be a symptom of juggling timetables away from what is best practice, as applied by the Commission for many years, for the sake of trying to expedite matters.
17. Our three organisations – Consumer, TUANZ and InternetNZ - are the guardians of consumers. As the Act is **solely** focussed via s 18 on the interests of consumers, the Commission is also the guardian of the consumers.
18. As guardians of consumers, we remain firmly opposed to the Commission's choice to prioritise speed (and earlier certainty although we doubt that would happen) ahead of getting-it-right. We do not see that as in consumers' interests. Furthermore, the lack of justification or analysis for this despite repeated requests from end-user representatives remains a concern.
19. This can be illustrated by the financial impact of the Commission's decisions as to monthly charges on consumers. It is readily apparent that the monthly charges can move up or down across a wide range of dollars. That Analysys Mason can produce a model with nearly twice the draft FPP prices demonstrates that, but this can readily be seen anyway by the multiple options and choices available which cumulatively add up to a large range of outcomes.
20. For every dollar that the monthly price goes up or down in the final FPP prices, the impact is around \$140 million, given a 5 year regulatory period. (Say, 1M broadband customers, 1.8M UCLFS lines at \$1 over 5 years). Even just one variable, such as the valuation of trenching etc, could move the total price over 5 years by over \$1 billion.
21. We cannot understand how it can be suggested that the "nice-to-have" objective of speed and earlier certainty can be more important than getting it right when such large numbers are at stake, in what is the largest issue for telecommunications before the Commission for many years.
22. Importantly, the parties most affected by this are consumers and Chorus. At this point, the desire for speed appears to be benefiting only Chorus. Any UBA, UCLL and UCLFS price increases

¹ Commerce Commission, Draft pricing review determination for Chorus' UCLL service, 2 December 2014, paragraph 6.

paid to Chorus are more likely to be ultimately passed through to consumers by RSPs, although that depends on market conditions, etc. If those prices drop the reverse is likely – the savings will not be passed back to consumers for some time. Ultimately the impact of the Commission's decisions will be on New Zealand consumers.

23. Similarly as to one off charges, which are emerging as a major issue, and of course are important to consumers as high connection charges reduce churn and that is bad for competition.
24. There is also the issue of backdating, worth \$130 million as we will outline further.
25. A particular facet of the current approach, and the speed, is the absence of key evidence and adequate analysis of the evidence. For example, we cannot understand how higher payments to Chorus are justified by the Commission on the basis of investment incentives as to UFB, on quite briefly stated high level grounds, when clearly Chorus has no need for such incentives. It was contractually committed years ago to deliver UFB. We cannot understand why there is no reference to such essential facts in the analysis. If somehow the UFB (or any other project) justified higher payment, it must be on some ground other than providing incentives to invest and predictability, the decision to invest (and in large part the investment) having been made years ago. Likewise as to the s 18(2A) variant of promotion of competition for the LTBEU, as to incentives and risks faced by investors in new telecommunications services.
26. That is even more concerning when the Commission's own expert, Professor Vogelsang, can say "the TSLRIC method currently proposed by the NZCC is likely to be substantially more than needed by Chorus for covering the cost of its copper access network. Thus, the copper access network is likely to remain highly profitable."² And he can say "even if the Commission were to reverse its stand on the re-use of civil works would Chorus be [sic] able to generate substantial profits from its UCLL and UBA offerings".³
27. It is clear from Professor Vogelsang's comments that both the IPP and FPP prices are more than sufficient to ensure Chorus recovers a normal rate of return, but that he believes it will actually recover excessive returns.
28. We also cannot understand why the Commission has not engaged in writing with submissions, made by us and on our behalf many times, that this level of analysis by the Commission is not sufficient (not sufficient legally but in any event not sufficient in terms of getting best outcomes from a consumer perspective). Related, we cannot understand why the Commission has not taken the approach signalled by guidance to the Commission such as in the IM judgment. The absence of sufficiently evidence based and empirical analysis contrasts with past practice in telecommunications regulation beyond IPPs.
29. The current approach would have very large sums being paid by consumers to Chorus (via RSP pass through) for unjustified and incorrect reasons, namely high level reference only to investment incentives and dynamic efficiencies (which is an approach unequivocally dismissed by the judge and the two experienced economists who decided the IM appeals).
30. This is compounded by the Commission's emerging view that it should backdate the FPP determinations to 2 December 2014. This creates a number of adverse impacts for consumers, such as: (i) increases in retail prices before the FPP decision has been made; (ii) risk that RSPs will attempt to increase prices more than the drafts would suggest necessary to mitigate the risk

² Ingo Vogelsang, Current academic thinking about how best to implement TSLRIC in pricing telecommunications network services and the implications for pricing UCLL in New Zealand, 25 November 2014, paragraph 24.

³ Ingo Vogelsang, Current academic thinking about how best to implement TSLRIC in pricing telecommunications network services and the implications for pricing UCLL in New Zealand, 25 November 2014, paragraph 118.

that the FPP final determination prices could be higher than the draft decisions; and (iii) paying too much for backdating if the FPP final prices are less than the draft or less than the IPP prices.

Self-imposed time pressures are evident from the drafts

31. We acknowledge a substantial amount of work has been put into the UCLL and UBA FPP draft decisions, by the Commission, its staff and consultants TERA.
32. The amount of work required to pull together even incomplete drafts (that didn't include transaction charges and backdating) highlight that December was an ambitious target for the draft, let alone the previous target of August 2014.
33. It is apparent from review of the draft decisions, and modelling, even without undertaking a full review of the modelling, that they reflect the time pressure of the December deadline e.g.:
 - Various submissions have previously documented the short-cuts in the Commission's process to reach the draft decisions;
 - Not including draft decisions on transaction charges and backdating which are required to meet the Telecommunications Act's requirements for a draft determination;
 - Considerable reliance on Chorus' data even where information is available from other New Zealand operators. This is evident, for example, by the Commission making data requests to Chorus that it did not make to other service providers that would also have relevant information e.g. requesting data on asset lives from Chorus but not from other operators that use the same or similar assets;
 - Various inconsistencies between what the draft decisions say and the modelling approach TERA actually adopted e.g the draft UBA decision states "EPMU involves allocating each service a share of non-network common costs in proportion to that service's share of total attributable costs"⁴, consistent with the TERA Model Reference Paper,⁵ but the TERA Model Documentation states that common costs are allocated on the basis of total opex rather than total attributable costs. Says TERA, contrary to the draft UBA Decision "Once the amount related to non-network costs for UCLL and UBA services is calculated, it is allocated between the two services with an EPMU approach based on the total OPEX of each service".⁶ This is just an example.
 - Poor TERA documentation which makes it extremely difficult to follow their model e.g. there is no detail that we could find on how the model optimises line length and the source of all data is not fully documented;
 - A lack of audit or validation of data used as inputs into the TERA model; and
 - A lack of peer review and audit of the TERA model to confirm that it does what it is supposed to in the way that it is supposed to.

⁴ Commerce Commission, Draft pricing review determination for Chorus' unbundled bitstream access service, 2 December 2014, paragraph 702.

⁵ TERA, Unbundled Copper Local Loop and Unbundled Bitstream Access services - Model Reference Paper" November 2014, section 4.1.2.

⁶ TERA, TSLRIC price review determination for the Unbundled Copper Local Loop and Unbundled Bitstream Access services Model documentation, November 2014, page 46.

Any UCLL or UBA price increases should not be backdated

The considerable impact of the backdating decision - \$130 million

34. In addition to focussing on the timing of the process, we have also focussed on backdating as it illustrates our wider issues as to what is happening on this FPP process, the steps the Commission might take to get better outcomes, and how we might help the Commission in achieving that.
35. If the Commission backdates as it indicates it may in its December paper, from September 2015 to December 2014, and the final FPP is the same as the draft FPP, the dollar impact exceeds \$130 million on UCLL, UBA and UCLFS backdating.⁷
36. That shows backdating is a very large issue irrespective of whether the final FPP price goes up or down relative to the draft FPP.
37. The December discussion paper suggests to us that the Commission is making decisions that impact end users and other stakeholders with significantly less analysis and consideration than would deliver optimal outcomes: the driver for speed has we think gone too far.
38. As representatives of consumer interests, who are the sole focus of s18 and of the Act, this remains a key concern for us.
39. We were one of the parties advocating for a more fulsome approach ahead of speed. Our concerns, representing consumer interests, remain, if not increase, in light of the December draft decision as to backdating.
40. In particular, we see real value in terms of the right outcomes for all stakeholders if the Commission deals with the evidence thoroughly, undertakes sufficiently quantitative and detailed analysis, and engages with submissions in writing.
41. There are, additionally, issues around what the law requires as to evidence, analysis and handling of submissions which we think are better resolved during this process rather than by way of judicial review or appeal by one or other of the parties.

The December paper on backdating

42. While we appreciate that the December paper sets out just a preliminary view, and we particularly value the Commission developing its thinking via such iterative approaches, there are firm indications that the Commission is preparing to make final decisions on backdating based on less than optimal evidence and analysis based on that evidence, as we see it. That is in addition to the legal points in the Wigley & Company submission, on which we rely.
43. Whether or not to backdate is dominated by s 18 considerations. Section 18, including s 18(2A) is solely focussed on promotion of competition in the long term interests of end users of

⁷ There are approximately \$1M lines, mostly UBA (uplift \$3.95 per month for UBA, relative to IPP, and \$4.70 for UCLL), and \$1.8M UCLFS lines (uplift \$4.70). Relevant period is from the start of December 2014 to the end of September 2015. Total backdating for 10 months exceeds \$130M.

telecommunications services (LTBEU), which includes the stakeholders that we represent. Any assessment as to whether to backdate must be carefully assessed **solely** on what provides **all** of:

- a. Promotion of competition in telecommunications markets;
- b. In the long term interest of end users;
- c. Of telecommunications services.

44. We note in particular that even s 18(2A) must be addressed **solely** through that lens of the end user. Incentive and risks as to new telecommunications services are solely relevant to the extent they relate to promotion of competition for the LTBEU. S 18(2A) states (highlighting added):

(2A) To avoid doubt, **in determining whether or not, or the extent to which, competition in telecommunications markets for the long-term benefit of end-users of telecommunications services within New Zealand is promoted**, consideration must be given to the incentives to innovate that exist for, and the risks faced by, investors in new telecommunications services that involve significant capital investment and that offer capabilities not available from established services.

Sufficiency of analysis and evidence

45. Nowhere yet is it apparent in the Commission's documents why competition in telecommunications markets for the long term benefit of end users is promoted by backdating, beyond relatively broad brush statements. We suggest it is not enough to say, for example, that dynamic efficiencies are sufficient to justify backdating, which the Commission largely only does. We think that the decision should be made, based on the evidence and upon quantitative analysis.

46. The High Court on the IM appeal has directly rejected such generic and high level approaches by the Commission and we think their comments are helpful for the Commission in deciding the way forward here. For example, the Judge and the two economists on the court said:

"No supporting analysis was provided by the Commission. Indeed, the propositions advanced for choosing a point higher than the mid-point seemed to be considered almost axiomatic. This extended to a strongly expressed, but unsupported, view of the benefits of dynamic efficiencies deriving from investment, without apparent regard to the nature of the investment."⁸

"Where a proposition is simply asserted by economic experts, we give it little or no weight."⁹

47. Essentially the High Court is saying to give little or no weight to mere assertions, including as to simple unsupported reliance on the benefits of dynamic efficiencies.

48. It is hard to think of a clearer judicial observation on what the Commission is doing here. Reframing in its language, "Where [as here] a proposition is simply asserted by economic experts [the Commission] we give it little or no weight."

49. On these issues, including as to having quantitative analysis based on evidence, and dealing with submissions of the parties, we have already made firm submissions, not yet responded to by the

⁸ Wellington International Airport Ltd & Ors v Commerce Commission [2013] NZHC 3289 [11 December 2013], paragraph [1462].

⁹ Wellington International Airport Ltd & Ors v Commerce Commission [2013] NZHC 3289 [11 December 2013], paragraph [1745].

Commission (including in the December 2014 draft UBA and UCLL determinations). Even the Commission's long standing telecommunications practice of doing quantitative cost benefit analyses for matters beyond IPPs does not appear to be being applied and we do not understand why the Commission has departed from its long standing practice.

Impact on approach beyond backdating such as monthly charges

50. This is not just an issue for backdating. \$130 million is a big number but it is small relative to impacts on monthly charges etc. The same concerns arise as to monthly and other charges where the analysis is largely high level too.
51. The differences between the IPPs, the draft FPPs and the Analysys Mason prices shows there is room to move quite a few dollars up or down on the final FPP prices.
52. Leaving aside the legal requirements, we have some difficulty in understanding why, when so much is at stake, there is so much a preference for speed. This preference for speed was not evident during the IPP determination processes where straightforward benchmarking took two years. Nor was it evident at the start of the FPP process where little progress in the first year after applications were made.

A quick overview on the right approach to evidence and analysis

53. We think that nothing replaces fulsome evidence, analysis, and engaging with submissions, but the following highlights some concerns.
54. A very large consideration is that Chorus is already contractually committed to deliver UFB. Chorus getting more money through this process makes no difference to their position in this regard as they are already contractually bound to deliver. (If there was something, that would need to be demonstrated empirically.) Generic reference to dynamic efficiencies and similar high level concepts would miss such issues.
55. At first sight this seems to be a very big consideration. It appears that, if Chorus gets more funds due to backdating, then, to the extent that is ultimately funded by consumers via higher retail prices, they get nothing back for it, such as improved services. If that is so, clearly s 18 would not permit backdating. The same point applies if backdating payments to Chorus end up being funded by RSPs.
56. If there is "pure" pass through of any backdating from the RSP to the end user, the end user pays for the backdating, and the benefit goes directly to Chorus. The RSP would just be the middleman. In that scenario, the end user is obviously paying more. That detriment to end users is only justified under s18, including s 18(2A), if the end user is better off in some other way such as innovative services being made available, etc. That must be clearly demonstrated.
57. We suggest it will not be enough for Chorus simply to say the payments by the end users are transferred to Chorus and they use that to build UFB and the like (even if this is true), to end users' benefit in terms of new services and so on. Likewise it will not do simply to talk to dynamic efficiencies and incentives to invest generally.
58. There is every reason to think that all the backdating will do is to transfer funds from RSPs and consumers to the Chorus by way of increased profits.

59. We suggest that the Commission cannot know, on its current high level approach, cast in a generic approach, whether that is happening.
60. That is one of the reasons why the legal requirement to do detailed analysis based on evidence is appropriate.
61. For example, the Commission's analysis thus far is far removed from the way the court dealt with issues in the IM High Court judgment. For example:

"... Future investment choices by suppliers must rationally be influenced by expected earnings on those future investments, not by earnings on past investments ...

The idea that greater revenues produced by higher allowed earnings on past investments (ie on the initial RAB) provide the wherewithal for more future investment is contrary to rational investment choice. Those existing higher earnings, once earned, are a given. The source of funds for future investments does not influence the riskiness of future investments; nor, therefore, does it influence their attractiveness. If anything, an abundance of capital is likely to lead to wasteful investment."¹⁰

62. The IM judgment adds (in observations applicable just as much to this FPP process):

"... the Commission did remarkably little ... to justify its assertions about the relative costs of over and underestimating the cost of capital ..."¹¹

"... we have some sympathy with MEUG's submission that the Commission's approach to the asymmetric costs of over and underestimating the WACC lacks a solid basis."¹²

63. It is not clear, at this point prior to analysis by the Commission of wealth transfers between parties, etc, whether any backdating, or lack of backdating, will pass through to end users. That is, we suggest, a further key issue to address, quantitatively, before deciding whether or not to backdate, have regard to the primary test as to promotion of competition for the LTBEU.
64. We are told that RSPs' recent price increases are insufficient to recoup fully the backdating assuming the final FPP is the same as the draft FPP. Full backdating means that the RSPs fall short and they may seek to recoup the deficit from future retail price increases, if the market allows them to do that.
65. The only sort of quantitative analysis the Commission has said it will do is to check on the impacts on RSPs. That is useful as a start. Generally, it is not in the interests of end users for otherwise viable RSPs to go out of business due to backdating.
66. In this regard we come back to s 18. S 18(2A) must be applied solely to ensure "competition in telecommunications markets for the long-term benefit of end-users of telecommunications services within New Zealand is promoted". That is the only option and promotion of competition is a required component. Questions such as how does more money going to Chorus promote competition in the LTBEU? That takes into account that Chorus is an upstream provider and therefore there are particular needs around showing that "competition" is promoted. Does that money going to RSPs better promote competition in the LTBEU? Are consumers better served by no backdating? We think the Commission should engage with and answer those questions,

¹⁰ Wellington International Airport and others v Commerce Commission [2013] NZHC 3289, paragraph [1479] ad [1480].

¹¹ Wellington International Airport Ltd & Ors v Commerce Commission [2013] NZHC 3289 [11 December 2013], paragraph [1440].

¹² Wellington International Airport Ltd & Ors v Commerce Commission [2013] NZHC 3289 [11 December 2013], paragraph [1470].

analytically and empirically, based on evidence, including as to engaging with submissions. Our legal advice is that the Commission must do so.

Has Commission's December decision sent the wrong messages to the market?

67. It is not until the forthcoming draft determinations that the Commission is clearly legally required to articulate adequately its reasons.¹³ Iterative views can short cut the analysis and the reasons but so far as possible they should be consistent with what ultimately is required. However, we question if the Commission has gone down the right path, without adequate reference to facts and analysis, and that has sent the wrong messages to the market.

68. The Commission appreciated that its iterative draft would have market impacts, whatever the formal status. It said so. It said in its December 2014 draft (we have added bold):¹⁴

“..we recognise that it is difficult for retail service providers to set retail prices when their input prices are subject to backdated changes and that the backdating of changes that have not been anticipated by the market may simply result in a wealth transfer. **These problems may, however, be lessened where a draft determination has been published.**”

69. It seems that the Commission is choosing to influence the prices that consumers pay during this uncertain phase up to the final FPP. However it is not doing so based on the sort of evidential and analytical approach outlined above. For example, it is relying on high level conclusions around efficiencies to draw draft conclusions, instead of completing the analysis first, based on detailed evidence, or outlining the work yet to be done to decide the position based on detailed efficiency analysis of the evidence.

70. Iterative views and consultation on those views are very valuable, as the Commission's work over the years has shown. But we question if the approach in the December paper works, as it seems so different from what is ultimately required and appropriate.

71. It seems to us that the Commission is therefore sending unjustified signals to the market. That has meant consumers have faced retail price increases based on a preliminary signalling from the Commission which does not appear to adopt the sort of analysis and evidence ultimately required. The changed approach may lead to substantial change.

72. In all this we are largely repeating what we have submitted before, although the Commission has not engaged with those submissions. We think engaging with them will be valuable for stakeholders

73. As we see it, the Commission should now undertake the full and correct analysis based on the evidence including engaging with submissions. It is a little difficult to put the December draft indication on backdating back in the bottle, but what happened as a consequence becomes part of the evidence to be analysed and decided on by the Commission.

Follow the Part 4 lead?

¹³ Wigleys note that some duties as to reasons and engaging with submissions arise before then.

¹⁴ At [17]

74. The Commission in its Part 4 work has fixed the problems identified in the IM judgment,¹⁵ but it appears to us that this may not be happening in telecommunications yet. For Part 4, the Commission accepted the High Court's criticism and acknowledged "the 2010 decision on the WACC percentile was not well supported by analytical and empirical evidence..."¹⁶ and "Our previous decision to use the 75th percentile for price-quality regulation was a matter of judgement. At the time of our original decision we had limited empirical or analytical information to assist us in determining the specific WACC percentile, including on the likely response of regulated businesses (in terms of their investment behaviour) to the WACC estimates that would result from applying the cost of capital IMs".¹⁷
75. It is not apparent to us why the Commission in its telecommunications role is not taking the same approach of remedying the position to have fulsome analytical and empirical evidence. We think it is important for the Commission to do so.

¹⁵ Although arguably it did not go far enough in terms of analysis and evidence

¹⁶ Commerce Commission, Amendment to the WACC percentile for price-quality regulation for electricity lines services and gas pipeline services, Reasons paper, 30 October 2014, page 7.

¹⁷ Commerce Commission, Amendment to the WACC percentile for price-quality regulation for electricity lines services and gas pipeline services, Reasons paper, 30 October 2014, paragraph X5.