ENABLE NETWORKS LIMITED AND ULTRAFAST FIBRE LIMITED

SUBMISSION ON NZCC FIBRE INPUT METHODOLOGIES: DRAFT DECISION – REASONS PAPER AND DRAFT FIBRE INPUT METHODOLOGIES DETERMINATION

28 JANUARY 2020

1. Introduction

1.1 This submission is made by Enable Networks Limited (**Enable**) and Ultrafast Fibre Limited (**Ultrafast Fibre**) (collectively referred to in this submission as **LFC**s) in response to the Commerce Commission's *Fibre input methodologies: draft decision -reasons paper* dated 19 November 2019 (**Draft Decision**) and *Intended implementation approach for [Draft] Fibre Input Methodologies Determination 2020* dated 11 December 2019 (**Draft IM Determination**).

1.2 LFCs are strongly supportive of the overall approach taken by the Commission in relation to input methodologies (**IM**s) for information disclosure regulation (**ID**). We agree with the Commission that in the dynamic environment characterised by developing technology and the likelihood of further competition, a principle-based regime reserving (subject to clear disclosure obligations) flexibility for LFCs to respond appropriately is best suited to accommodate ongoing change in market circumstances.

1.3 However, we remain of the view that the Commission has given insufficient weight to the investment risks faced by LFCs in building the new fibre network, particularly in its draft decisions on asset beta and WACC uplift.

1.4 Part I of this submission responds to issues arising from the Reasons Paper, while Part II addresses specifically the drafting of the various input methodologies in the Draft IM Determination.

PART 1: REASONS PAPER

LEGAL FRAMEWORK

2. **Purpose statements**

UFB Government Policy Statement

2.1 Our submission on the Commission's Emerging Views Paper (**EVP**)[1] was that the Commission had a mandatory obligation under section 19A of the Act to have regard to the 2011 UFB Government Policy Statement (**UFB GPS**), and therefore had to give primacy to the incentives and risks of investing in new telecommunications services that involve significant capital investment.

2.2 On 5 October 2019, the Minister revoked the UFB GPS. This is a very disappointing development. We agreed to invest in the fibre network relying on a commitment from the Government that any future regulation would take into account the start-up risks associated with this investment; we are now faced with regulation that does not take account of those start-up risks because, the UFB GPS having been revoked, the Commission now takes the view that "*the historical requirements of the UFB initiative itself are of limited relevance to the implementation of regulations under Part 6*".[2]

2.3 We do not agree that the revocation of the UFB GPS means that the history of the UFB initiative has limited relevance to decisions under Part 6. The Commission must make decisions that best promote the long-term benefit of end-users. This requires the Commission to give far greater weight to the investment risks faced by LFCs in building the new fibre network (particularly in relation to asset beta and WACC uplift) than it has in the Draft Decision.

2.4 A decision that has the effect of retrospectively reducing the expected return on sunk capital will, as several investors submitted on the EVP, cause the investment community to lose confidence that New Zealand is an environment where they can earn an adequate return on future infrastructure investment. This will deter future investment and will not promote the long-term benefit of end-users.

Section 162

2.5 The s162 purpose statement has four components: to promote outcomes that are consistent with outcomes produced in workably competitive markets, so that regulated entities

(a) have incentives to innovate and invest;

(b) have incentives to improve efficiency and quality;

(c) share efficiency gains with end-users through lower prices; and

(d) are limited in their ability to extract excessive profits.

2.6 LFCs agree with the Commission's view that none of the objectives in s162 are paramount, the objectives are not separate and distinct from each other, and the Commission must balance those

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[1] NZCC *Fibre regulation emerging views: Technical Paper*, 21 May 2019 (**EVP**)

[2] NZCC *Fibre input methodologies: Draft decision - reasons paper*, 19 November 2019 (**Draft Decision**) [2.7]

outcomes to be best promote the long-term benefit of end-users of FFLAS services.[3] This view is consistent with the High Court decision in the Wellington International Airport case.

Section 166(b) (promotion of competition)

2.7 In addition, s166(b) provides that to the extent the Commission considers it relevant, the Commission can consider the promotion of workable competition in telecommunications markets. We agree with the report from the Commission's expert advisory panel for fibre (**Expert Report**)[4] that this is broader than s162, as it covers actual competition in any telecommunication markets, rather than mimicking workable competition in the FFLAS market. However, as "*workably competitive markets can generally be expected to promote economic efficiency*", we agree with the Commission that there are risks in intervening to influence market outcomes by applying the additional "promotion of competition" test, and that such intervention should only be made in those rare cases where "*it is more apparent that market failures exists*"[5], or where the Commission has identified "*distortions in the market that might hinder the emergence of competition*".[6]

2.8 This is particularly the case because, as the expert panel notes "*the existing regulatory framework, which is based on regulated wholesale access to LFC's networks, is by its very existence already promoting service competition in end-user markets*".[7] As a result, according to the Expert Report "*enhancing competition essentially requires innovative acts to find so far undetected or just overlooked possibilities which do not jeopardize the current benefits of the non-competitive but regulated situation*".[8]

2.9 In addition, a competition assessment of this sort is a major undertaking. We agree with the Expert Report that the process of identifying market failure, or market distortions that hinder the emergence of competition "*requires a large amount of information and analysis*". [9] The Expert Report explains that this involves a sequence of Commission initiatives, starting with a determination of markets and the state and development of competition in those markets, which *"can be a complicated and time-consuming undertaking that should only be done intensely for markets that are deemed strong candidates for policy action*". It requires the Commission to identify the policy action it wishes to take, and then conduct a counter-factual evaluation with and without the proposed policy action.[10]

2.10 Under those circumstances we would expect the situation in which the Commission would consider a competition assessment was relevant in making a recommendation, determination or decision under the Act would be rare. The expert panel agrees, concluding that "*our analysis suggests that a large part of the Commission's role in promoting competition would not require invoking s166(2)(b)*."[11]

2.11 Contrary to the advice of the Expert Report, the Commission proposes to undertake what it calls a "high-level competition screening"[12] for each IM decision by considering if the decision

(a) has the potential to impact competition in any telecommunications market;

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[3] above [2.115]

[4] Ingo Vogelsang and Martin Cave, *Framework for promoting competition*, 19 November 2019 (**Expert Report**)

[5] Draft Decision [2.146]

[6] above [2.144]

[7] Expert Report p7

[8] above p34

[9] above p1

[10] above p4

[11] above p40

[12] Draft Decision [2.254]

(b) has a role in mitigating risks to competition at any market level; or

(c) could be used to promote competition at a given market level.

2.12 While the Commission acknowledges that "*a more in-depth competition assessment might be required for some decision under PQ regulation than for decisions under ID*"[13], the amount of information and analysis of multiple markets required to undertake such a process would seem disproportionate and unduly time consuming. We agree with the Expert Report that the wording of s166(2)(b) "*indicates that the s166(2)(b) objective is meant to be restricted to certain situations to be determined by the Commission or Minister*"[14], and should only be invoked where the Commission is satisfied that there is a risk of limited competition or market failure in the relevant market.

3. Scope of regulated service

3.1 LFCs agree with the Commission that the FFLAS service covers services that enable access to, and interconnection with, the fibre network between the handover point and the user-network interface of an end-user's premises, building, or other access point and that accordingly handover connections, tie-cables, jumper leads, inter CO fibre and ICABS are all regulated FFLAS services.

3.2 The case for including network services (such as network design build and maintenance services) or property development services within the scope of the regulated service is less clear cut. While these services may support the provision of FFLAS[15], it is arguable that they do not "enable" access to and interconnection with the fibre network.

3.3 LFCs do not however object to the services being included, as all LFC services would then fall within the "regulated FFLAS" category under the draft cost allocation IM.

4. End-user of service

4.1 LFCs submitted on the EVP that a wireless broadband customer where the LFC provides fibre to the cell tower should not be considered a FFLAS end-user, because there was no way for the Commission to know whether backhaul was a FFLAS service or not. This is particularly the case in the LFC areas, as Chorus' fibre in another LFC area is specifically excluded from PQ regulation, and in both Enable and UFF's UFB areas Chorus is the predominant provider of fibre to wireless cell sites.

4.2 While LFCs accept the definition includes "*the ultimate recipient of another service whose provision is dependent on FFLAS*", and therefore does extend to wireless customers where FFLAS is an input, the Commission needs to proceed with caution in considering the interests of fixed wireless users under s162,as the Commission accepts that the definition of end user does not include an FWA customer with no FFLAS inputs[16].

5. Quality measures

5.1 As we submitted on the EVP, a quality IM is not needed for ID regulation, because

(a) we are already subject to an extensive quality regime set out in TCF Codes, service level obligations in our wholesale services agreements with service providers, and non-discrimination and equivalence obligations under Part 4AA of the Telecommunications Act; and

[13] above [2.256]

[14] Expert Report p6

[15] Draft Decision [2.63.8]

[16] above [2.136]

(b) we face competition from competing technologies which ensures that we meet end-users quality demands to remain competitive.

5.2 We agree that if quality IM is to apply to ID regulation, mandatory quality performance measures and statistics be limited to “availability” and “performance”.

5.3 We also agree with the Commission’s indication that any other performance measures should be imposed for ID regulation only if there is “evidence that a particular dimension is (or is likely to be) problematic”.[17]

5.4 The Commission suggests it may wish to break down reporting requirements by types of end-users (such as business or residential)[18]. This is problematic in the case of wholesale only providers, because we cannot identify the status of an end-user. A service designed for business use may be taken by a residential user, and many small businesses take services designed for residential use.

5.5 In Part II of this submission we set out more detailed comments on the draft quality IM.

ECONOMIC FRAMEWORK

6. Economic principles

6.1 In our submission on the EVP we supported the proposal to include economic principles consistent with Part 4 regulation. These principles underpin the draft decisions. In particular, we support adoption of the financial capital maintenance (FCM) principle which is consistent with maintaining incentives to invest by allowing for normal returns over the lifetime of an investment, as specified in the s162 purpose statement.

6.2 Consistent with our submission on the EVP, we also support the Commission’s view that there is no requirement for a pricing methodology IM or a competition IM.

7. Cost allocation

7.1 We support a principle-based approach to the allocation of common costs and assets to FFLAS services. This approach best accommodates different business structures between the FFLAS providers. It will also be more durable than a prescriptive ‘rule-book’ type approach to changes in the market for FFLAS and related services over time.

7.2 We support the proposal to largely adopt the Part 4 approach to cost allocation, which has proven to be workable in other regulated sectors, including:

(a) allocating directly attributable costs and assets to regulated FFLAS;

(b) allocating any not directly attributable costs or assets using the accounting-based allocation approach (ABAA);

(c) ABAA is to be applied using causal allocators determined by the regulated provider, or proxy allocators if there are no suitable causal allocators; and

(d) the allocators are to be current and updated every 12-18 months to reflect the dynamic nature of the sector.

7.3 We note that the Draft Decision is for the allocation of common costs to be capped at the level of unavoidable costs if a regulated supplier were to supply no other regulated or non-regulated

[17] above [3.1523.2]

[18] above [3.1529]

services. The discussion in the Reasons Paper[19] is directed at the allocation of common costs between copper and fibre networks. We understand that there is the potential for significant sharing of costs and assets between Chorus' copper and fibre networks, and the focus in the Reasons Paper reflects this.

7.4 We are however concerned that LFCs may be caught up in a complex exercise to establish estimates of 'unavoidable costs' when not directly attributable costs or assets are not expected to be material to LFC FFLAS services.

7.5 As shared costs and assets are to be allocated using ABAA, and these allocations will be transparently disclosed under ID, we submit that a materiality threshold should be applied for ID regulation. We comment further on this point in Part II.

7.6 We support the additional constraint to prevent duplication of the recovery of assets or costs associated with the provision of other regulated services, such as electricity lines services.

Allocation between FFLAS services

7.7 We support the Draft Decision not to prescribe the allocation of costs or assets between different FFLAS services within the first regulatory period.

7.8 The Reasons Paper suggests that regulated providers will instead separately identify directly attributable costs and shared costs between regulated FFLAS families that differ in configuration, but bear essentially the same costs, geographic coverage and functionality[20]. The purpose of this requirement is to help stakeholders, including the Commission, to assess whether prices reflect the efficient costs of supplying different types of regulated FFLAS and to assess potential impacts on competition[21].

7.9 We support a cautious approach to disaggregated cost allocations for this initial period. We note that the Reasons Paper includes a list of potential product families which reflect a long list of services, some of which are not material to us and have very little revenue associated with them[22]. From an efficiency perspective, our preliminary view is that the following four services should be designated as product families: bitstream (PON and P2P), fibre P2P, colocation and interconnect, and backhaul (ICO). This is consistent with a proportionate approach to regulation.

7.10 We expect these requirements will be explored more fully during the ID determination consultation process and look forward to engaging on the product family issue at that time.

Allocations to establish the initial RAB

7.11 The Draft Decision is to prescribe the allocation approach for the financial loss asset, and the initial RAB. While this will be broadly consistent with the principle-based approach to be applied going forward, additional requirements will be applied as follows:

(a) all directly attributable costs and assets associated with the UFB initiative (those that were solely employed for the UFB initiative) will be allocated to the financial loss asset during the financial loss period;

(b) any shared assets or costs associated with the UFB initiative must be allocated by applying ABAA. These allocations are to be reviewed by the Commission, and a suggested non-exhaustive list of allocators is included in the IMs to guide the allocations;

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[19] above [3.409 – 3.418]

[20] above [3.453]

[21] above [3.458]

[22] above [2.63]

(c) allocator metrics must be updated annually for the financial loss period; and

(d) the same allocators used for the financial loss assets will apply to the initial RAB.

7.12 We support the Draft Decision in this respect, subject to the refinements to the drafting of the determination outlined in Part II below.

8. **Asset valuation**

8.1 We support a principle-based approach to the asset valuation IM, and as much alignment with GAAP as possible. This will assist in minimising compliance costs and regulatory complexity. It will also assist stakeholders to understand the valuation metrics to be disclosed under ID regulation.

8.2 In this respect we support the Draft Decision to include commissioned core assets in the regulatory asset base (RAB) at cost (less the value of capital contributions), in the year that the assets are commissioned to provide FFLAS services.

8.3 We note the proposed treatment of capital contributions differs to GAAP. We consider this is appropriate because it is consistent with the financial capital maintenance principle and avoids potential year on year volatility in reported profits which can occur under GAAP due to these contributions.

Initial RAB

8.4 We consider that the proposed derivation of the initial RAB is consistent with the detailed rules set out in s177 of Part 6 of the Act. The UFB assets constructed by LFCs are predominantly new assets built under contract with the Crown. Accounting records exist to support the construction values, and therefore it is possible to establish robust asset registers based on these records for regulatory purposes.

8.5 We agree that there is no justification for the Commission to review the value of these assets or to restate the value of these assets for the purpose of establishing the initial RAB. This would not be consistent with the intent of the Act.

8.6 The IMs are to prescribe the minimum level of specificity for recording assets in the RAB. These are included as Schedule A to the Draft IM Determination. It is proposed that asset information will be maintained for the following dimensions: network layer, asset class, geographic location, shared with other parties, shared with other services, special assets, non-UFB initiative assets[23].

8.7 In practice this is not achievable because the asset registers which will be used to derive the RAB are those that have been established for financial reporting purposes and accordingly reflect information required for GAAP. GAAP is primarily focussed on the value of assets, commissioning date and depreciation class/expected asset life.

8.8 It may be possible to include additional information for assets commissioned after the IMs are implemented, but not before. It would be prohibitively expensive to retrospectively create the information specified in Schedule A, particularly information about the location and purpose or use of the assets.

8.9 However, we do not believe that this creates a significant issue for the regulatory regime because:

(a) Asset information is available by network layer, and asset class - where asset class reflects GAAP depreciation categories. Accordingly, we suggest that the asset classes in the IMs are redefined to refer to GAAP reporting categories for each regulated provider. This is sufficient for implementing the RAB roll forward.

[23] Schedule A, Draft IM Determinations

(b) Geographic location of assets by address, building or area is not data that is recorded for financial reporting purposes. Location information is typically held in GIS and asset management systems, which are focussed on the physical asset, not the investment. We anticipate that LFCs will have access to sufficient interfaces between asset systems to be able to assign RAB/GAAP data into geographic areas, but not buildings or addresses. This is sufficient for information disclosure purposes and any potential deregulation adjustments to the RAB.

(c) Assets shared with other parties, other services and not associated with the UFB initiative are not GAAP requirements. They result from the application of the regulatory rules, including the cost allocation IM. They may also be dynamic, as the use of assets changes over time. While each regulated provider will develop its own systems for applying these regulatory methods they may not need to be fully integrated into the RAB asset register for each individual asset.

8.10 We include suggested mark-ups to Schedule A in Part II to reflect this.

Financial loss asset

8.11 In our submission on the EVP we supported a straight forward approach to establishing the financial loss asset, calculated as UFB revenues less UFB costs (net of the benefit of Crown financing). We supported the proposed approach of quantifying UFB costs by retrospectively applying the revenue building blocks consistent with the forward-looking IM methods.

8.12 We support the Draft Decision approach which allows for the full cost of the assets, including a return of and return on the capital invested by the regulated service providers in the UFB cost component. The costs of providing regulated FFLAS services are best reflected by the full cost of the assets, irrespective of funding. The UFB initiative was established on the basis that Crown funding would be repaid, and full ownership of the assets would transfer to the fibre partners.

8.13 A key consideration is quantifying the benefit of Crown financing, and the Draft Decision differs to the emerging view in this respect. The benefit of Crown financing is to be derived as a separate building block and deducted from UFB costs for the purpose of quantifying the financial losses. The specific characteristics of the Crown financing to each UFB partner are to be taken into consideration for this purpose. The cost of debt or cost of equity is to be applied, as appropriate for each UFB partner, for each year of the loss period. This recognises that the nature of the financing differed between the UFB partners, and that it changed over time. We support this revised approach.

8.14 We also note that the Draft Decision has further developed the methodology to derive the historical WACC to be used in the return on capital building block, for the timing factors to be applied in the historical cash flows and for discounting the financial losses to implementation date.

8.15 For the purpose of the financial loss asset, the Commission intends to apply the same asset beta in estimating the WACC for the pre- and post-implementation periods. This is based on the sample of comparator firms formed by CEPA. CEPA notes that its assessment is concerned with estimating an asset beta that will apply from the start of the new regulatory period in 2022, once the UFB roll-out is largely complete.

8.16 CEPA acknowledges that during the fibre roll-out phase, capital expenditure is likely to be especially high for the FFLAS providers. This would indicate a disproportionately high degree of operating leverage and therefore asset beta during this period. However, the Commission has chosen to make no adjustment to the asset beta between the pre- and post-implementation periods. It considers that an adjustment would be arbitrary and difficult to quantify and the basis for an upwards adjustment may be offset by the argument for a lower asset beta due to compensation for losses. We note that there is no guarantee that losses will be fully recovered in the future and therefore investment risk during the pre-implementation period must be taken into account.

8.17 In our view, there is considerable intuitive and theoretical evidence to support a higher asset beta during the pre-implementation period than the post-implementation period. The historical roll-out phase represents a structurally different operating environment with higher operating leverage and systematic risk and this needs to be reflected in the asset beta. It is therefore incorrect to assume the asset beta for the pre-implementation period is the same as the asset beta for post-implementation periods because the post-implementation asset beta will not fully reflect the risks that the regulated service providers faced during the pre-implementation period. It is not appropriate to assume these risks away, simply because they occurred in the past. Therefore, more work needs to be done to determine an appropriate upwards adjustment of the asset beta used to estimate the WACC for accumulated unrecovered returns, relative to the asset beta to be applied in the post-implementation period. For the avoidance of doubt we also consider that the Draft Decision has under estimated the asset beta for the post-implementation period for the reasons set out at paragraph 10 below.

8.18 It is proposed that a WACC will be estimated for each year of the financial loss period based on annual estimates of the risk-free rate with declining terms during the period, and a single debt premium estimate to be applied to all years. For the purposes of estimating the WACC for the financial loss asset, the Commission intends to use the debt risk premium prevailing at the beginning of the year in the financial loss period which the median loss occurred.

8.19 In our view, this approach is inappropriate because it is sensitive to the pattern of relative losses over time for a specific fibre provider as well as changes in the credit spread over time and is inconsistent with the application of the Capital Assets Pricing Model (CAPM). If the Commission persists with its proposal to determine risk free rates that vary each year, then a better approach would be to determine the debt premium separately in each financial loss year because it would be more internally consistent and provide a more accurate measure of credit spread during this period.

8.20 The Draft Decision has also refined the approach to the tax component of the financial loss asset. We comment on this approach in section 11 of this submission.

RAB roll forward

8.21 We support the Draft Decision to roll forward the RAB with annual adjustments for depreciation, capital additions and capital disposals.

8.22 We note that annual CPI revaluations are also to be included in the RAB roll forward. In our submission on the EVP we suggested that not indexing the RAB was one option for addressing stranding risk. However, the Draft Decision has retained the revaluation approach to the RAB, because this, combined with a nominal WACC, assists to compensate for inflation risk. We have commented on stranding risk under ID regulation below.

8.23 We support the decision to include additions at cost, after applying the cost allocation IM and excluding the value of any capital contributions received. This is consistent with the Part 4 approach.

8.24 The depreciation rules to be applied under ID regulation, for the LFCs who are not subject to PQ regulation, specify that depreciation must be consistent with the time profile of revenue recovery applied at the time of disclosure, and that this may be:

(a) GAAP based depreciation; or

(b) alternative depreciation.

8.25 We support flexibility under ID regulation for alternative depreciation approaches. We agree that GAAP based depreciation is a useful default approach, but there may be circumstances where an alternative approach is required. We note that providing for this flexibility is consistent with competitive market behaviour. We note that these provisions will apply equally to the core assets and the financial loss asset. In respect of the financial loss asset, which has no GAAP equivalent, an appropriate default depreciation approach will be to amortise the asset over the weighted average remaining lives of the core assets, at implementation date.

8.26 We support a principle-based approach to alternative depreciation and agree that if an alternative approach is to be used, aligning it with the expected consumption of assets is reasonable. However, the proposal to match the depreciation to 'the time profile of revenue recovery' creates some challenges for FFLAS services.

8.27 Aligning depreciation and revenue timing was an issue considered for ID regulation for airport services. We agree with the concept but note that revenue recovery profiles are less certain for FFLAS than the airports which are mature businesses. Our revenue recovery profiles may be more dynamic than those of the airports, because of emerging competition, or other factors which may change the profile of demand for our services over time.

8.28 We therefore submit that the depreciation component of the draft IMs includes unnecessary constraints which are not consistent with our evolving businesses. The IM can be improved if this characteristic of FFLAS services is more explicitly incorporated into the methodologies. This is addressed further in Part II of this submission.

9. Stranding risk

9.1 In our submission on the EVP we noted that LFCs are exposed to stranding risk because:

(a) the Crown contracts required LFCs to deploy the fibre network for 100% of each fibre provider's coverage area in a specified timeframe, and there was no flexibility to adjust the network investment according to demand and uptake. The investment is now sunk and irreversible;

(b) in the LFC network areas, the success of fixed wireless access (FWA) and competition from Chorus' upgraded VDSL2 vectored copper service which is not available in Chorus' UFB areas, Chorus fibre in greenfield sites, (and for Enable Vodafone's HFC network) is likely to result in asset stranding, as the invested asset will generate lower revenues than in the initial LFC business case.

9.2 The Draft Decision proposes that some stranding risk is to be allocated to regulated providers as they are best placed to manage it, but the regulatory framework will allow regulated providers to mitigate this risk. This is consistent with providing an ex-ante expectation of earning normal returns, which is embodied in the overarching economic principle of financial capital maintenance (FCM).

9.3 In our submission on the EVP, we noted that ex ante measures were required to address stranding risks. Ex post measures are not feasible because it is not possible to pass on the costs to users after stranding has occurred. Accordingly, our submission supported a WACC uplift to compensate for stranding risk because it is a straight forward means of providing ex ante compensation for this type of risk. We retain this view and submit that a WACC uplift above the 50^{th} percentile is appropriate to address stranding risk for LFCs on an ex-ante basis.

9.4 In the Draft Decision it is proposed that ex-ante mechanisms for mitigating stranding risk will include the ability to modify cost recovery profiles. We agree that providing ex ante allowances are necessary to mitigate potential price shocks for users in the future.

9.5 The options to be reflected in the IMs include alternative depreciation paths or shorter asset lives, partial recovery of stranded assets (but not deregulated assets) and a small allowance from end users. We note that this latter option does not form part of the IMs which apply to ID regulation, and therefore is not included as a mitigant for LFCs. Accordingly, the WACC uplift option is valid for LFCs subject only to ID regulation.

9.6 The Draft Decision suggests that there is no need for a specific stranding allowance for LFCs subject to ID regulation, even though they may be subject to standing risks. Instead it is proposed that LFCs will have more freedom in how stranding risk is mitigated and will be required to disclose information about how this risk is being managed in their annual disclosures. [24]

9.7 We support the proposal for flexibility for LFCs subject to ID regulation to manage stranding risk. We acknowledge that the proposed asset valuation IM for ID regulation includes mechanisms, such as alternative depreciation, which support this approach.

10. Cost of capital

10.1 In our submission on the EVP we provided over-arching support for the general approach to the cost of capital IM, consistent with Part 4 regulation. We supported updating the tax adjusted market risk premium for this purpose.

10.2 We raised three key concerns with the proposed approach to determining the regulatory WACC for LFCs subject to ID regulation:

(a) For the purpose of estimating the asset beta, the comparator firms identified by CEPA as having similar systematic risk to FFLAS providers included firms which were not suitable for this purpose, such as tower and satellite companies. In addition, the equal weighting of the sample of wholesale and integrated service providers was flawed[25].

(b) Systematic risks are higher for LFCs than Chorus, because of the competition LFCs face from Chorus. Rather than adopting a service wide approach to the WACC, the Commission should determine higher asset betas for the LFCs relative to Chorus, resulting in different ID WACC benchmarks to those to be applied to Chorus for the purpose of PQ regulation[26].

(c) Difficulty in quantifying a WACC uplift for LFCs for the purpose of ID regulation is not reason for not doing so. In addition, under ID regulation the length of the regulatory period is less relevant when establishing WACC parameters, as is a single point WACC estimate because it is applied in an ex-post context. Accordingly, we submitted that a longer term should be assumed for deriving the ID WACC estimates, and that these should be expressed within a range[27].

Asset beta

10.3 In updating its advice for the Draft Decision, CEPA has revised its asset beta estimate, and the comparator sample used to support its estimate. However, despite these revisions, the comparator set used by CEPA continues to under-estimate the risk faced by fibre only service providers. It places significant reliance on comparators who are wholesale and integrated companies, including mobile tower companies and satellite operators who face lower risks than pure play fibre providers.

10.4 In our view, betas for tower and satellite companies are entirely irrelevant to establishing the asset beta for fibre services provided by either Chorus or LFCs. The factors that drive the systematic risk of tower and satellite companies are very different from those that drive the systematic risk of fibre service providers. For example, CEPA argues that the long-term value of tower companies is driven by end-user demand for data and high-bandwidth applications. However, as detailed above, ownership and management of real estate assets forms a key part of tower companies' businesses. Real estate is widely considered as a unique asset class with returns that respond

[24] Above [3.1301 – 3.1303]

[25] See section 6 of our submission on the EVP

[26] See section 4 of our submission on the EVP

[27] See section 7 of our submission on the EVP

differently to macroeconomic cycles relative to other asset classes. In addition, tower companies are not exposed to the same level of competition as FFLAS service providers as they typically service all retail service providers (RSPs) and are therefore exposed to very little competitive risk.

10.5 CEPA accepts that there are differences between companies included in its wholesale sample (in particular, tower companies and satellite operators) and FFLAS providers. However, it argues that these companies should be still included as comparators so as not to disregard relevant evidence completely.

10.6 In our view it is not appropriate to include comparators and assign them equal weighting if the degree of comparability with the target is low. Doing so risks biasing the estimated asset beta. More focus should be placed on ensuring that the systematic risk of the sample is as close to that of the target as possible.

10.7 The Commission's intended approach to establishing the asset beta differs from CEPA's recommended approach of giving equal weight to the beta estimates derived from the wholesale and integrated service provider subsamples. The Commission intends to weight each company in the sample equally to obtain an average asset beta. It argues that FFLAS companies more closely reflect vertically integrated companies and since there are more of these companies in the sample, this method assigns more weight to them.

10.8 While we agree that this approach provides a more relevant and accurate estimate than CEPA's approach, assigning less weight to companies considered to differ materially from the target based on relative sample size is arbitrary. Companies that are not appropriate comparators should not be included in the sample.

10.9 We therefore submit that the resulting asset beta continues to be too low, because it is based on comparator data which does not adequately reflect the risks faced by fibre providers.

10.10 This is clearly evidenced by comparing the Commission's draft asset beta of 0.49 for Chorus with the asset beta of 0.55 applied by Ofcom for BT's network business Openreach in its 2019 Broadband Connectivity Market Review[28], and the asset beta of 0.57 it has adopted in its 2020 Wholesale Fixed Telecoms Market Review consultation.[29]

10.11 In addition, in its 2020 consultation Ofcom proposes to apply a price premium of £1.10 for the 40/10 fibre to the premises services to reflect the higher broadband speeds and additional benefits consumers receive from a fully fibre service relative to fibre to the curb services (which utilise the copper connection from the curb to the premises).[30] This is equivalent to a WACC premium for fibre services recommended in the Brattle Report[31], discussed at 6.9 – 6.11 of our 16 July 2019 EVP submission.

10.12 The Commission must therefore revisit its draft asset beta decision for FFLAS, including updating its WACC estimate cross-check at paragraphs 3.1247 and following, and the data in Figures 3.7 and 3.8 of the Draft Decision. It is inconceivable that the risks faced by fibre-only wholesale providers in New Zealand could be so much lower than in the United Kingdom.

[28] Ofcom, *Promoting competition and investment in fibre networks: review of the physical infrastructure and business connectivity markets*, 28 June 2019

[29] Ofcom, *Promoting competition and investment in fibre networks: Wholesale Fixed Telecoms Market Review 2021 -26*, 8 January 2020

[30] above Appendix 22, Estimating the 40/10 fibre premium, p232

[31] The Brattle Group, *Review of approaches to estimate a reasonable rate of return for investments in telecoms networks in regulatory proceedings and options for EU harmonisation*, 2016

ID WACC estimate for LFCs

10.13 The Draft Decision is for the mid-point WACC to be published annually for ID regulation for the purpose of monitoring regulatory profit disclosures on an ex-post basis. This will be specified on the same basis as the WACC to be used for PQ regulation, by adopting similar terms and input parameters. It will be published within one month of the start of the disclosure year.

10.14 In addition, a WACC range will be determined by estimating and combining plausible ranges for individual parameters in order to derive an estimate of the standard error. The standard error can be used to derive a WACC estimate at a specified percentile, however unlike Part 4 regulation the Commission will only publish a mid-point WACC.

10.15 The Draft Decision acknowledges that there may be valid reasons for LFCs to choose to set target revenues or report annual return measures which differ to the mid-point WACC estimate. We agree with this view for the reasons included in our submission on the EVP, including those reasons set out in the above bullet points.

10.16 Accordingly, we submit that the information disclosure WACC should be specified within a reasonable range as it is for information disclosure regulation for those electricity distributors which are not subject to price-quality regulation. The 25th to 75th percentile boundaries are appropriate for monitoring purposes and can be derived from the WACC and standard error components specified in the Draft IM Determination.

10.17 The Draft Decision acknowledges that the risks and therefore the appropriate target WACC range may differ for LFCs relative to Chorus, and that there is flexibility in the information disclosure regulatory regime for in this respect, because:

(a) LFCs will be able to publish whatever WACC is considered appropriate alongside their disclosures.[32]

(b) The Commission will publish the midpoint and a standard error and require regulated providers to disclose which WACC they use and explain any differences as part of ID requirements.[33]

(c) If LFCs consider a different risk-free rate or term is appropriate they can publish their view of the appropriate risk-free rate, any impact on the WACC and provide justification for this in their disclosures. The Commission will take that justification into account when assessing providers' performance.[34]

(d) The Commission is open to further evidence of systematic risks that differ across regulated providers, for adjusting asset betas.[35]

(e) Ex post profitability analysis under ID can take account of stranding risk, when comparing actual returns to cost of capital benchmarks. [36]

(f) LFCs could publish estimates of non-systematic stranding risks and any contingencies provided for in cash flows to account for this. This could include evidence to support additional LFC stranding risk.[37]

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[32] Draft Decision [3.709]

[33] above [3.1227 and 3.1231]

[34] above [3.711]

[35] above [3.934]

[36] above [3.1406]

[37] above [3.1407]

10.18 We appreciate the additional guidance provided in the Draft Decision in this respect and will take this into consideration in assessing our future business plans and pricing approaches.

11. Taxation

11.1 We support the Draft Decision to adopt a tax payable approach for the ID IMs. We agree that this provides a relatively simple approach to estimating the tax obligations of the regulated entity, and that maintaining consistency with the tax rules as far as practicable will assist regulated providers to comply with the information disclosure IMs in a cost-effective way.

11.2 This approach includes estimating notional interest consistent with the cost of capital IM and ignoring the tax position of the wider corporate entities which provide the regulated services. Accordingly, any tax losses generated by the regulated service are rolled forward and assumed to be utilised by the regulated service in future years. This is consistent with the overarching approach to the tax building block which is to estimate the notional tax obligations of the regulated service – noting that the regulated service provider is not necessarily of itself a tax paying entity.

11.3 We also support establishing the initial regulatory tax value based on a roll forward of the tax value of the assets constructed from the beginning of the UFB initiative, after applying the same allocation ratios as applied to the UFB asset values. This value will remain unchanged if the assets are acquired from another regulated service provider.

11.4 The Draft Decision proposes that returns under ID regulation will be disclosed using measures which are comparable to a post-tax WACC and a vanilla WACC. For LFCs the post-tax WACC measure is most suitable because it is a common measure of returns. It is therefore more readily understood by stakeholders including FFLAS users and management, directors and shareholders of FFLAS businesses.

Tax treatment for the financial loss asset

11.5 We support applying the same regulatory tax methodology to the financial loss asset as that to be used on a forward-looking basis. This is consistent with the overarching approach to establishing the value of the financial loss asset, which is to retrospectively apply the regulatory building blocks across this period and compare actual UFB revenue with UFB costs derived using regulatory building blocks. Any tax losses associated with the provision of the regulated service are to be offset against this tax building block. In addition, the notional interest is to be calculated consistent with the Crown financing costs, where the financing was debt.

11.6 We note that the notional deductible interest component of the tax allowance in the accompanying model[38] references the UFB asset base value and the unrecovered return on investment asset base value in each year of the pre-implementation period. These values are combined to derive the notional value of debt, after applying the notional leverage estimate (from the WACC). The cost of debt (from the WACC) is applied to the notional debt to derive notional deductible interest.

11.7 We submit that the unrecovered return asset should not be included for this purpose during the pre-implementation period because at that time the asset did not exist, and it could not have been included in the gearing calculation. The logic in the Draft Decision is circular and inconsistent with the underlying principle for the tax IM of deriving a tax allowance for the regulated entity consistent with the tax rules. We note that s177(2) of the Act indicates that the financial loss asset is only established at implementation date.

11.8 Accordingly, for the purpose of the notional deductible interest calculation, in the tax component of the UFB costs the “Adjusted UFB initial asset values” should be set equal to the “opening UFB asset base value” and ignore the “opening balance of unrecovered returns”.

11.9 We comment on this further in Part II.

[38] NZCC, *Financial-loss-asset-Draft-determination-illustration-workbook*-17-December-2019.xlsx

PART II: DRAFT FIBRE INPUT METHODOLOGIES DETERMINATION 2020

12. **Cost allocation – Part 2, Subpart 1**

12.1 Clause 2.1.3 Allocation constraints for ABAA: Consistent with our discussion above, the allocation constraint in subclause (4) should only apply where directly attributable costs or assets comprise less than 95% of the allocated RAB or allocated opex for the disclosure year.

13. **Asset valuation – Part 2, Subpart 2**

13.1 In clause 2.2.3 Initial RAB value of financial loss asset, there is an error in the formula in subclauses (14) - (23) in the calculation of the compounding factors. The term '1+' is missing from the WACC component, ie: (1+30 June 2012 WACC), etc.

13.2 In clause 2.2.6 Depreciation for regulated providers subject only to information disclosure:

(a) references to the **time profile of revenue recovery** should be changed to the **expected** time profile of revenue recovery. This term needs to be more dynamic than currently drafted, as due to future demand uncertainty, the time profile may change over-time;

(b) references to **at the time of disclosure** should be changed to **for the disclosure period** to allow for the expected revenue recovery concept to be reflected in annual disclosures, which are measured on an ex-post basis. As the time of disclosure occurs after the disclosure period, this could potentially result in a mis match between revenue and depreciation; and

(c) a depreciation method for the **initial financial loss asset** should be inserted, with reference to clause 2.2.9 (see below).

13.3 In clause 2.2.9 Asset life:

(a) insert a definition of asset life for the **financial loss asset**, with reference to the weighted average remaining life of the initial core fibre asset base.

(b) insert an option for an **alternative asset life** to be applied where alternative depreciation is used. Otherwise any alternative depreciation will always be tied to GAAP asset lives. We submit this is an unnecessary constraint, and not consistent with the Draft Decision.

13.4 In Schedule A, Table A:1: Minimum levels of specificity to describe assets in the RAB:

(a) Modify the description of asset class to GAAP asset classes. In this respect we note:

(i) A cabinet is one type of distribution point, is currently not recorded for ID purposes, and is not a meaningful category on its own. It is included as part of distribution, with fibre located inside a cabinet included as the feeder fibre

(ii) Distribution fibre extends to the customer premises, and therefore customer premises and equipment are part of distribution fibre for each of layer 1 and layer 2 networks

(b) Modify the description of geographic location to 'area as recorded in the regulated provider's asset management systems' and remove reference to address and building

(c) Remove references to sharing with entity # and shared with power lines, copper telco cables/assets which is a non-exhaustive list and is not required in the RAB register.

14. **Taxation – Part 2, Subpart 3**

14.1 Consistent with our discussion at 11.7 above, the notional deductible interest should be based only on the UFB asset, and not the financial loss asset. Accordingly, Clause 2.3.1. Regulatory tax allowance, (7) Notional deductible interest needs to be changed as follows*:*

(a) Replace reference to '**adjusted UFB asset initial values**' with '**opening UFB asset base value**'

14.2 Clause 2.3.4 Tax costs for determining the unrecovered returns on investment:

(a) Sub-clause (3) Remove reference to the '**opening balance of unrecovered returns on investment for notional deductible interest**';

(b) Remove clauses 2.3.4(4) and (5) relating to the **unrecovered returns on investment for notional deductible interest**.

15. **Cost of capital – Part 2, Subpart 4**

15.1 Clause 2.4.5 Methodology for estimating the 50th percentile WACC:

(a) While the draft determination includes the estimate of the standard error of the mid-point WACC, it does not specify how this estimate is to be applied to estimate a WACC range. The determination could be improved by providing this additional material, by way of example. We suggest using the same form of equation as included in the Part 2, Subpart 4 IMs for electricity distribution businesses, issued under Part 4 of the Commerce Act.

15.2 Insert new Clause after 2.4.5 Methodology for estimating the WACC range, similar to clause 2.4.5 of the Part 4 IMs applying the electricity distributors.

16. **Quality – Part 2, Subpart 5**

16.1 Clause 2.5.1 (1) (a) (availability):

(a) "maximum downtime" is not an appropriate measure, as there will always be circumstances where a particular outage may take longer to fix and having to identify the longest downtime instance in a reporting period and explain the reasons for it may be burdensome to the LFC. The requirement to report average downtime will ensure that downtime on a fault by fault basis is as low as possible;

(b) "notification to access seekers of outages" should only be included as a regulated quality measure if there is an obligation on access seekers to notify their customers.

16.2 Clause 2.5.1 (b) (performance) suggests reporting on frame delay, loss, and delay variation. In the almost 10 years of the UFB rollout, no consistent approach to capture performance of these metrics has been agreed, and there is no way to measure these factors that is not traffic intrusive and/or disproportionately expensive. As port utilisation is the input measure which determines these factors, reporting on port utilisation and customer usage should be sufficient.

16.3 Clause 2.5.2 (optional quality dimensions)

(a) An ordering dimension (2.2.2(1)(a)) is too low a level; relevant information can be captured under "provisioning" (2.5.2 (1)(b)) if the time period commences from when the request is sent;

(b) an optional "faults" dimension (2.5.2(1)(d)) is unnecessary, as the relevant information can be captured in the mandatory "average downtime" quality dimension;

(c) an "end user connection satisfaction" dimension (2.5.2(1)(e)(i)) is unnecessary, given the mandatory availability and performance dimensions;

(d) a "time to establish an access seeker" dimension (2.5.2(1)(e)(iii)) is unnecessary as it only happens once a year.

16.4 Clause 2.5.3 (quality reporting requirements)

(a) as service provision should be network agnostic it is not clear why a fibre network architecture requirement (2.5.3(2)(b)) should be contemplated; and

(b) it is inappropriate to impose an "end users" requirement (2.5.3(2)(d)) on structurally separated wholesale only networks who have no end user relationship.