

Vodafone Cross-Submission



New regulatory framework for fibre:

Cross-Submission on Commission's proposed approach

1 February 2019



Executive Summary

We appreciate the opportunity to provide a cross-submission at this critical early stage of the process.

Our views remain unchanged after reviewing the submissions from other parties. We continue to believe that the key to making this regime work is to ensure competition thrives wherever possible, and that Chorus and the LFCs are exposed fully to competitive pressures.

We are concerned by submissions that intend to limit competition. For example, Chorus have argued that retail competition must be enhanced above all other markets, a thinly veiled ploy to take attention away from competition over fixed wireless and unbundling. This approach would deny end-users innovative and diverse services to better meet their needs.

There have also been a number of requests from the fibre service providers to be shielded from the few competitive pressures they do face. For example by retaining all stranded assets in their RAB, or providing uplifts to give additional compensation for all competitive risks. Such approaches would diminish the ability for competition to deliver benefits for end-users.

It is also important that end-users have a fair price for fibre services. Submissions from Chorus and the LFCs include a number of windfall gains that, if adopted, would cost end-users for years to come. For example, very favourable treatment of the losses calculation, and a staggering number of uplifts to the cost of capital. This is capped off by an attempt from Chorus to claim that government support would be interpreted by investors as a risk factor.

Finally, we are unconvinced that there is any need to change the Commission's proposed process. Accelerating important decisions like the opening asset base risks creating weak decisions and the uncertainty of legal challenge, as well as potentially creating inconsistencies with the regime going forward.



Contents

The impact of competition on the regime.....	4
Promotion of workable competition.....	4
Stranding risk has been over-played.....	4
Scope of services.....	5
Allocation between different types of fibre services.....	6
Significant risks of unwarranted wealth transfer	8
Over-estimation of WACC due to the leverage anomaly	8
Uplifts to the cost of capital have been requested for everything	9
Inflation of the losses	10
Crown financing didn't impose additional costs	11
Quality.....	13
Process.....	14



The impact of competition on the regime

Promotion of workable competition

1. Chorus has requested a daunting level of micro-management of competition in telecommunications services. They argue that the Commission should prioritise competition in the retail sector at the expense of competition in other related areas. This is likely referring to fixed wireless competition and unbundling.
2. It is completely infeasible for the Commission to have this level of oversight. Furthermore, it would be a serious step away from New Zealand's free and open market economy. Rather, the focus must be on ensuring a level playing field by limiting Chorus' ability to leverage its monopoly assets to manipulate competition to its advantage.
3. It is also important that the Commission doesn't fixate on simple measures of competition such as the number of retail providers. Dynamic factors such as product diversity have a greater positive impact on end-users and are a more important indicator of healthy competition.
4. We agree with Chorus' conclusion that the Commission must equally weigh up the promotion of competition and the section 162 purpose statement.¹ We disagree with their earlier contradictory statements that the purpose statement must be given primacy over the promotion of competition.² This part of their submission appears to have little logical or legal basis.

Stranding risk has been over-played

5. Chorus have shown their true colours by both over-playing the size of stranding risk, and by asking to be compensated for this risk twice. This is an early indication of the approach they intend to take throughout this process, highlighting why the Commission should treat their suggestions with caution.

¹ Chorus, "Submission in response to the Commerce Commission's invitation to comment on its proposed approach to the new regulatory framework for fibre, 9 November 2018, para 95.

² Ibid para 93-94



6. Chorus has requested that they are shielded from the risk of asset stranding by allowing them to retain stranded assets in their RAB.³ They have also asked for a boost to their cost of capital to compensate for stranding risk⁴. This would result in a significant double-counting; they can't have it both ways. In fact, there needs to be significantly more evidence to suggest that any compensation at all is required for the stranding risk.
7. As noted in our submission, the asset stranding conditions are very different for fibre services compared to assets regulated under Part 4 of the Commerce Act. In most cases regulated fibre providers have significantly greater ability to eliminate or at least reduce the size of stranding risk. It is also important that any compensation for stranding does not harm competitive incentives on Chorus or the LFCs.
8. Chorus also argue that competitive assets must be retained in the RAB otherwise the principle of financial capital maintenance is breached.⁵ It is difficult to understand their rationale for this request. Once a service is deemed to be competitive, it must be fully exposed to competitive pressures, just like the rest of us. The principle of financial capital maintenance does not apply to competitive assets which must be removed from the RAB.

Scope of services

9. Regulation should focus on services that have little or no competition. We agree with Chorus' view that it is too broad to define regulated services as anything "that support the operation of a network or its users".
10. At the end-users premise only services at layer 2 or below should be regulated. Any services at or above layer 3 should not be considered, and their associated costs excluded from the price-modelling. Government has long defined this as the boundary between competitive and un-competitive services, and this will continue to be true in 2022 and onwards.

³ Chorus, "Submission in response to the Commerce Commission's invitation to comment on its proposed approach to the new regulatory framework for fibre, 9 November 2018, paras 115 – 116

⁴ Ibid para 114

⁵ Ibid para 116



11. At the other end of the network, all fibre services before the designated UFB hand-over points should be included in the regulatory regime. We strongly disagree with Chorus' suggestion that the Intra Candidate Area Backhaul Service (ICABS) should not be regulated. This service is a crucial input into mobile backhaul, equal in importance to the Direct Fibre Access Service (DFAS). In many cases there are no competitors to the ICABS service, allowing Chorus to manipulate mobile prices to suit their own needs.
12. It is clear from MBIE's departmental report on the draft Bill that this is what was intended by Government. In that document MBIE note that "DFAS and ICABS are both Fibre Fixed Line Access Services (FFLAS) and will be subject to regulatory oversight under the new Part 6."⁶
13. Excluding ICABS would also be challenging from a practical perspective. All current UFB residential services, including the proposed 100/20Mbps anchor service, run from aggregated 'regional exchanges' to the premise. To achieve this, these products use ICABS to connect together with smaller exchanges. What Chorus is proposing would mean ICABS remains in the regime for the anchor products, but is excluded for everything else.
14. For the regime to effectively mitigate the risks associated with ICABS, the prices must also be fixed at their current levels using regulations under section 228. We will elaborate on this proposal in more detail in the upcoming consultation on the regulations being run by MBIE.

Allocation between different types of fibre services

15. Chorus raise a number of practical concerns with developing too much granular information on costs for different types of fibre services. We agree that doing so for every product is not practical.
16. However, for certain products such as layer 1 GPON unbundling, the cost allocation exercise is both more achievable, and critically important. Table 1 below sets out the specific services that must have their costs allocated separately.

⁶ Ministry of Business Innovation and Employment, "Telecommunications (New Regulatory Framework) Amendment Bill: Departmental Report to the Economic Development, Science and Innovation Committee", 20 April 2018, Para 93.



Table 1: Fibre services which must have a separately identifiable cost base

Service	Why it must be allocated separately	Why it is practically achievable to allocate separately
Layer 1 GPON (unbundling)	Allows assessment of Chorus compliance with the Fibre Deeds. Also provides the basis for a cost-based price in the future.	A margin squeeze test can be applied, which will clearly identify which costs are layer 2, and what the remaining costs are.
DFAS and ICABS	Allows assessment of any market manipulation by Chorus on mobile services. Also provides the basis for a cost-based price in the future	Limited amount of shared infrastructure with these services as they use a dedicated fibre. Will be a similar cost allocation exercise for ducts and poles as will be required for allocating between copper and fibre.
Anchor services	Allows assessment of whether these prices are appropriate in the current market. Also provides the basis for a cost based price in the future	Will be challenging, requiring agreed upon proxies.

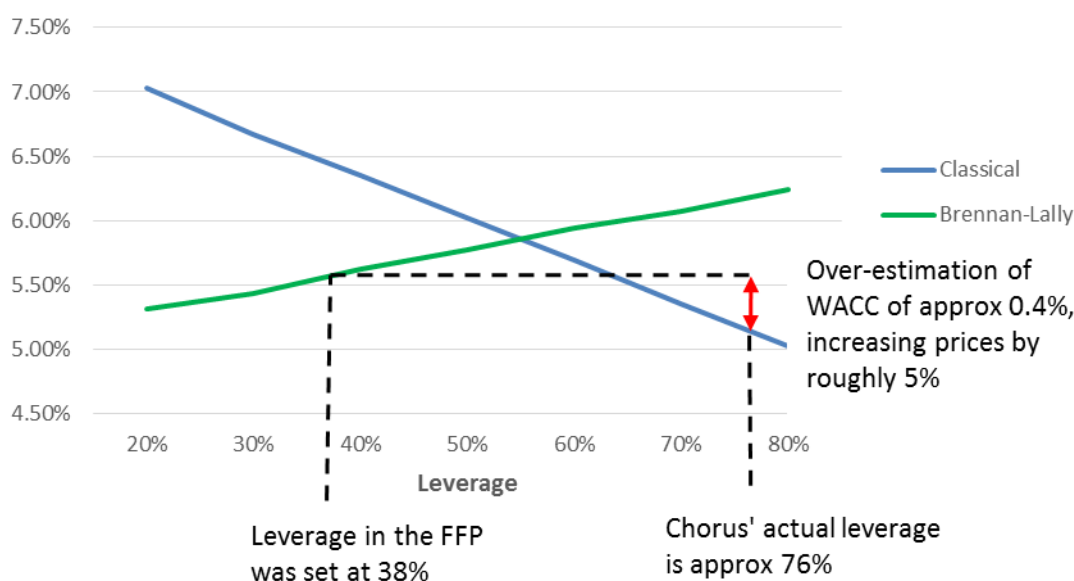


Significant risks of unwarranted wealth transfer

Over-estimation of WACC due to the leverage anomaly

17. In our submission we suggested that Chorus' actual leverage should be applied to its cost of capital, especially for the losses period. However, we were unaware of the leverage anomaly highlighted in Pat Duignan's submission. Having considered this problem, and reviewed the debate in Part 4, we now consider that a nominal leverage based on comparator firms is a reasonable compromise solution.
18. However, given Chorus' extremely high leverage, picking a nominal leverage is likely to result in an over-estimation of the WACC. Figure 1 below demonstrates that the likely magnitude of this over-estimation is around 0.4 percentage points, which on our current estimations may rise prices by around 5%, making this a highly material error.

Figure 1: Likely magnitude of the over-estimation of Chorus' WACC due to the leverage anomaly





19. Figure 1 uses the WACC inputs from the 2015 final FPP decision and shows the various WACC rates at given amounts of leverage for both the simplified Brennan-Lally CAPM, and a classical CAPM.⁷ The 0.4 percentage point over-estimation is derived from comparing a nominal leverage of 38% in the Brennan-Lally model to Chorus' actual leverage of 76% under a classical CAPM.
20. We support the continued use of the simplified Brennan-Lally model given its superior treatment of New Zealand conditions. However, the material uplift that is created by the leverage anomaly must be taken into consideration by the Commission when balancing other features of the regime.
21. For example, when making judgements about any uplifts to the cost of capital, the Commission must satisfy itself that the over-estimation due to the leverage anomaly is not already sufficient to mitigate any additional risks. A significant amount of evidence would be required to show that a 0.4 percentage point uplift is not sufficient to cover the risks raised by Chorus and the LFCs (discussed further below).

Uplifts to the Cost of Capital have been requested for everything

22. Chorus and the LFCs have requested a staggering number of uplifts to the WACC. Table 2 below lists these out with our responses.

Table 2: Uplifts requested by Chorus and the LFCs and Vodafone's response

Uplifts requested	Vodafone response
Stranding risk	As above, this risk is being severely over-played.
Systematic risks associated with greenfields investments	The risk of poor uptake of UFB has largely subsided
Exposure to regulation	The regulation faced by Chorus is no more onerous or risky than that faced by other regulated monopolies
Competition	Chorus and the LFCs have significant ability to minimise risks associated with competition
Innovation	An uplift to the WACC is a poor way to incentivise innovation. The uplift applies to all sunk costs, and the incremental incentive component is typically considered too small to have any effect. Other more

⁷ We applied the same methodology to these calculations as applied by the Commission in its 2010 paper "Effects of Leverage on WACC under two different CAPMs".



	effective innovation incentives like exposure to competition must be prioritised.
Risk of under-investment	As per our submission the risk of under-investment is significantly smaller for fibre providers than it is for many other types of businesses
Size	The LFCs have argued that their size means they face more risk. If these businesses are truly sub-scale, regulations should not dis-incentivise any mergers or acquisitions that would deliver a better outcome for end-users.

23. Fundamentally the challenge for Chorus and the LFCs is to demonstrate that these risks are not accounted for in the standard debt premium and asset beta's used by the Commission. The information in submissions does not provide enough evidence to demonstrate that this is true, especially when the leverage anomaly over-estimation is taken into account.

Inflation of the losses

24. Nothing in submissions alters our view that it is unlikely any losses actually occurred since fibre was first deployed. We agree with Chorus' assertion that in aggregate, the initial UFB prices and terms were "competitively tendered and heavily negotiated, and as a result reflects competitive market outcomes".⁸ A competitive market outcome is sufficient for Chorus and the LFCs to recover their costs, anything less would have been financially irresponsible given the uncertainty about the future regulatory regime.
25. However, despite this, Chorus in particular have seized on the opportunity to extract a wealth transfer from end-users by asking for very favourable treatment of the losses calculation.
26. Chorus have requested that the losses be calculated as a single 10 year period – a regulatory period of any length is only appropriate where the regulator wants to create some form of incentive. Incentives are not effective when applied to past behaviour. As per our submission, the losses must be calculated on a year by year basis.

⁸ Chorus, "Submission in response to the Commerce Commission's invitation to comment on its proposed approach to the new regulatory framework for fibre, 9 November 2018, para 20.





27. They have also argued that the costs of Crown financing imposed additional costs on their business. We discuss this issue in the following section.
28. These requests make it abundantly clear that Chorus and the LFCs are singularly focussed on inflating the costs of the initial losses. It is, therefore, not appropriate for Chorus to be granted the right to propose an initial value of the losses. This would likely slow down the process as the Commission and the rest of the industry would have to slowly pick through the proposal to find all the generousities that Chorus had granted itself.

Crown financing didn't impose additional costs

29. Chorus claim that the concessional interest free funding received from the Crown imposed costs on their business, which must be compensated for in an inflated cost of capital. We fail to see how this could be the case. Fundamentally investors must have viewed the Crown funding as a huge show of support from Government significantly reducing the risks of investing in Chorus.
30. The costs of Crown funding that Chorus claim can broadly be broken down into three categories, none of which require any uplift:
 - 30.1. Direct transactional costs, such as legal fees in setting up the funding instruments. These should be measurable costs as part of the initial RAB. This has no impact on the cost of capital going forward.
 - 30.2. Costs (or lost revenues) associated with roll-out conditions, such as Government imposed phasing. As Chorus itself notes if these costs exist they will be naturally compensated for in the losses calculation through lower revenues than would have otherwise been possible.
 - 30.3. Changes to Chorus' risk profile which increase the cost of capital for the privately funded part of the UFB build. Figure 2 below compares key risks with and without the Crown funding and concludes that the Crown funding likely reduced rather than increased privately funded capital costs.



Figure 2: assessment of the impact of Crown financing on the cost of capital

	With Crown financing	Without Crown financing	Impact on cost of capital of Crown financing
Risk of mismanagement	Government has the right to step-in and correct course, reducing the risk of management failure.	No safety net to poor management.	 Reduction in risk and the costs of capital.
Risk of low uptake	Strong incentives to meet Government uptake targets, balanced against the risk of penalties if targets not reached.	Reduced incentive to meet uptake targets, but no penalties.	? More analysis needed to determine any effect on the cost of capital.
Default risk	Near zero. Government backing indicates a strong commitment. Unlikely Government would let the largest provider fail	Risk of default rests squarely on investors.	 Reduction in risk and the cost of capital.

On balance the Crown financing has reduced risk for Chorus and the LFCs, resulting in a lower cost of capital.

31. Chorus also claims that some of the restrictions in the agreements signed with the Crown reduced revenue in other parts of their business. For example, the Network Infrastructure Partner Agreement (NIPA) prohibits Chorus from offering financial incentives for end-users to remain on copper.⁹

⁹ Schedule 2, clause 4H.



32. This concern is outside of the scope of Part 6. Section 177(5) clarifies that the initial value of a fibre asset only relates to costs incurred for UFB connections. Any costs imposed on other parts of Chorus' network (which we doubt are of any scale) are not within the scope of this calculation.

Quality

33. Chorus has asked that, in the first regulatory periods, there should be no consequences for them failing to meet any quality standards. They equate this to the treatment of Transpower's first regulatory period from 2011.
34. This is completely inappropriate for Chorus in 2022. There is a substantial commitment to improving the installation process and telecommunications services generally. Letting Chorus off the hook during this critical period puts the efforts of the rest of the industry at risk.
35. The Commission's decision in 2010 to not have any revenue impact from the quality measures for Transpower also appears to have been influenced by their lack of experience in setting and administering such targets. In the following years, the Commission has now done this many times, and can draw on this expertise.
36. Chorus have also asked that industry input into developing quality measures should only come from Chorus itself. The quality standards imposed on Chorus have a significant impact on how we conduct our business. Chorus does not have end-users, so is unlikely to correctly assess and design those aspects of that are important and valued by end-users. Shutting out RSPs and other interested parties would be a mistake and likely result in further problems. For example the implications of any quality measures placed on RSPs through consumer quality codes must be well aligned with the quality measures placed on Chorus.



Process

37. We continue to support the process proposed by the Commission.
38. Chorus have asked for certain key decisions such as the initial asset base to be brought forward. This would come with considerable risk for two key reasons:
 - 38.1. This is a very important decision that will have long lasting effects, it is better to take the time now to get it right than rush a decision. Rushing a decision may also lead to greater uncertainty by opening up the decision to legal challenge.
 - 38.2. Certain decisions such as the initial asset base are intertwined with other parts of the input methodologies. For example it is critical that the losses calculation is consistent with other methodologies, such as cost allocation, and only diverges where necessary.
39. Other submitters have also asked for decisions to be staggered, effectively to reduce their workload. We are concerned that this might result in the process dragging out further, ultimately resulting in a larger workload.