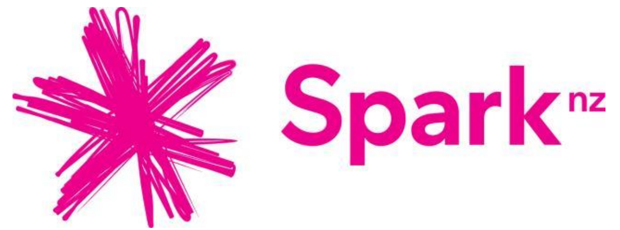

Fibre Input Methodologies: draft determination

Cross submission | Commerce Commission

17 February 2020

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Introduction

1. Thank you for the opportunity to comment on submissions on the Commission's Fibre Input Methodologies Draft Determination (**draft determination**) and Reasons paper (**draft decision**).

2. Submissions address a range of issues relating to the draft IMs and how will apply to price-quality (**PQ**) regulation and information disclosure (**ID**) of Fibre Networks.

3. Given the time available to us, rather than seek to comment on all submissions and all issues raised, we've focused on the matters raised in our earlier submission. In this cross submission, we address:

    a. Proposals to bound the scope of FFLAS services (including ICABs) that provide access to and interconnection with the Fibre Network;

    b. The purpose of cost allocation caps and how these provide incentives to avoid inefficient investment and business models;

    c. Proposals that the Commission limit consideration of potential double recovery or sharing of efficiencies with end users as these considerations relate to the identification of past financial losses;

    d. Proposals to expand the comparator data set used to estimate the asset beta for the WACC; and

    e. Proposals to consider the stranding risk faced by specific assets without fully considering the risk in light of the overall network system.

The draft approach

- Vodafone's concerns highlight that the Commission process, itself, may result in asymmetric outcomes. The Commission should consider how it might bring in expert advice to articulate consumer interests.

- We agree with Chorus that decisions should be evidence based and, while informed by the theory, need to reflect the practical and evidence-based information available to the Commission.

Vodafone's process concerns

4. Vodafone submits that the draft decision appears to be primarily concerned with responding to the LFCs and has given little consideration of views raised by those representing consumer interests. Vodafone notes that the end-result is a Draft Decision that moves the balance heavily in favour of the LFCs[1].

5. Vodafone highlights the importance of maintaining confidence in the framework and implementing a process that demonstrably promotes end user interests and workable competition.

6. We should expect regulated providers able to secure significant financial benefits from incremental change to BBM settings to focus on beneficial elements of the model, using information asymmetries where available. Conversely, individual end users do not have the same incentives and ability to consider the cumulative implications of proposed changes and

[1] Vodafone, 28 January 2019, "Submission, on Fibre Regulation Draft Decision", page 2.

articulate preferred end user outcomes. The Commission addressed the difficulties associated with engaging end users in the process, and importance of representing their interests, in its 2018 funding consultation[2]. We noted in that process that the Commission could look to Australian regulatory approaches and expert advisors (a panel representing end user interests or ask existing advisors to take critical look at proposals) to promote outcomes in end user interests[3].

7. The Commission is tasked with making decisions that give best effect to the s166 end user outcomes and this is ultimately an inquisitorial process. The significant number of expert reports for Chorus that the Commission is obliged to respond to risks taking the focus from areas where consumer interests lie. Accordingly, where the submission-based process risks asymmetric outcomes of the sort that concern Vodafone, the Commission may wish to reconsider options for highlighting end user interests along the lines set out in its earlier consultation.

Reflecting the practical effect and implications of regulatory decisions

8. Chorus' submission proposes that – in relation to competition assessments – the proposals should be specific and evidence based[4].

9. We agree that all decisions should be evidence based and, while informed by the theory, need to reflect the practical and evidence-based information available to it. However, Chorus submits several proposals that ask the Commission to make decisions based on economic theory alone, or to ignore the evidence and context within which a decision is required, and we do not agree with these proposals. For example, Chorus criticises the Commission for, on the face of it, departing from an incentives-based regulatory approach and preference to an approach more consistent with outcome-based regulation[5].

10. However, all regulation results in incentives for regulated entities and, in the Part 6 context where several parameters are set by legislation (i.e. washup and accounting based asset valuation), the Commission can only set incentives where these can reasonably have an effect. In which case, we expect the Commission to rely more in our context on mechanisms such as service specification, quality standards and penalties than it might have for Part 4 industries[6].

11. Nonetheless, Chorus' principled recommendation remains and the Commission should be cautious accepting economic proposals when unsupported by practical and evidence-based information available to it, particularly where these imply material transfers from end users to the regulated provider.

Scope of the regulated service

- We don't agree with Chorus that the Commission should limit the availability of FFLAS services such as ICABs that provide access to and interconnection with the Fibre Network.

- We support the Commission's draft approach to setting the scope of services. However, we do agree with Chorus that the Commission may need to provide more guidance on where a service is FFLAS and where it may rely on a FFLAS input.

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[2] Commerce Commission, 30 April 2018, *Implementation of the New Regulatory Framework for Fibre Services Funding*
[3] Spark, 11 May 2018, *IM funding discussion paper submission*, para. 21 – 23.
[4] Chorus, 28 January 2020, *Submission on Fibre Input Methodologies*, para. 81
[5] Chorus, para. 66
[6] Chorus, para. 67

12. Chorus argues that backhaul services - such as ICABs - are not part of the Part 6 regime[7], and that the Commission's proposed approach potentially harms competition in the markets for backhaul services[8].

13. We disagree. The Act provides that Part 6 regulation applies to the regulated service providers Fibre Network, and FFLAS are services service that enable access to, and interconnection with, that network.

14. The Commission further considered Chorus' arguments and other submission on the approach in its specified points of interconnection reasons paper[9]. The Commission noted in the reasons paper that specified points of interconnection are intended to define the upstream boundary of the Fibre Network, and Chorus' proposed approach would likely unintentionally exclude services such as ICABs from the scope of FFLAS. Further, s210 deregulation reviews in the appropriate mechanism for considering competition effects for the Fibre Network.

15. However, Chorus' submission highlights that the Commission will likely need to provide guidance on how FFLAS services will be identified, possibly through the PQ process. For example, Chorus gave several examples in its submission which – depending on the proposed approach - would have implications for Part 6 regulation and access seekers, i.e.:

    a. That where the NBAP or end-user premises is outside the UFB candidate, regulated backhaul services are only available to the nearest point of interconnection[10]. We disagree. The Commission's approach to specified points of interconnection defined the boundaries of the Fibre Network, and interconnection can occur at multiple places within that boundary (and is not limited as Chorus suggests);

    b. That Chorus' Tail Extension Service (**TES**) is not a regulated fibre service as the service provides transport from the specified point of interconnection to an alternative handover location[11]. It is difficult to see a national transport TES service falling within the FFLAS scope. However, TES must relate to the Fibre Network either as a FFLAS where it provides access to the Fibre Network or as a Fibre Network input available to access seekers on a non-discriminatory and EOI basis; and

    c. That network and property development services are not part of the regulatory scope. We support the Commission's proposed approach. While engineering services - in themselves – can be sourced by access seekers from the market, engineering services are also tied to the provision - or form part of - FFLAS services. For example, Chorus requires access seekers to use Chorus provided engineering services for PONFAS and property developer guidelines anticipate Chorus providing design and contracting services[12].

[7] Chorus, para. C35.1
[8] Chorus, para. 43
[9] Commerce Commission *Specified points of interconnection reasons paper* (19 December 2019)
[10] Chorus, para. 45.2
[11] Chorus, para. 46
[12] Chorus *Develop residential or commercial property with Chorus* from website https://www.chorus.co.nz/themes/custom/chorus_consumer/components/assets/docs/property-development/How-to-guide-5-200%2B.pdf

Cost allocation

- Chorus notes that it has incentives to be efficient. However, this efficiency relates to a narrow range of costs and activities. The proposed caps are a means to mitigate incentives to maintain and build unnecessary capability for FFLAS services.

16. Chorus' submits that the Commission does not benchmark cost allocators[13] and that the proposed caps are unnecessary as it has incentives under a revenue cap to avoid inefficient costs[14].

17. We disagree. We support the draft approach whereby the Commission will determine cost allocators and will determine allocators that best achieve the s166 outcomes. In some cases, the Commission will need to reject accounting-based allocators where these fail to best achieve the s166 outcomes. The proposed benchmarking will provide information and transparency for determining which allocators will be permitted.

18. Further, as set out in our earlier submission, we support the unavoided cost and proposed standalone cost caps to mitigate concerns with the accounting based allocation of shared costs. These reflect that Chorus has only limited incentives to be efficient over a narrow range of decisions relating to some input costs. For example, Chorus has incentives to maximise the allocation of costs into the Fibre Network and to build or maintain unnecessary capability for the relatively simple wholesale fibre services.

19. We agree with Chorus that the Commission should aim to provide efficient incentives[15]. Properly constructed unavoided and standalone cost caps should provide these incentives as Chorus will make decisions in the knowledge that only appropriate costs will be built in to the BBM.

Past financial losses

- Identifying past financial losses requires detailed consideration of cost recovery in prior regulatory periods and across Chorus' business. Past financial losses increase end user and other firms' input prices with significant inter-sector implications.

- The Analysis Mason report highlights TERA's advice that the use of different cost models is the source of potential double recovery. However, as it assumes that the Commission should consider UFB fibre deployment as a standalone project, it does not help resolve core issues relating to the existence of - and means of controlling for - double recovery and sharing of efficiencies with end users.

- The TERA approach remains a viable and reasonable means of controlling for the misstatement of costs across regulatory periods and provider's business.

20. The identification of losses incurred by providers in providing fibre services under the UFB agreements, if any, requires detailed consideration as:

    a. The Commission is inevitably making the assessment part way through the life of an asset; and

    b. The UFB networks were deployed in the context of existing businesses – in the case of Chorus a copper network that was transitioning to fibre in any case - and policy

[13] Chorus, para. 177
[14] Chorus, para. 187
[15] Chorus, para. 187

framework which was expected to leave Chorus fully funded over the prior regulatory period.

21. This means that the assessment must look to how the costs of assets are recovered across the providers business and regulatory periods (where the Commission is looking back into a prior regulatory period). Experts agree that differences in the regulatory models in the prior period can result in a misstatement of costs.

22. There should be a strong, specific and evidence-based case made before the Commission awards past financial losses. Past financial losses could have significant implications:

    a. For end users. Vodafone noted earlier that some analysts predict past losses could total as much as $2b for Chorus alone[16]. However, over the same period as losses are claimed to have occurred, Chorus has achieved significant average returns on equity of over 24%[17]; and

    b. For firms that rely on Fibre Network inputs. The inter-sector and economic implications of over-stating past losses are likely to be significant. The ITU estimates that a 1 per cent increase in the digitisation of an economy (of which connectivity is a contributor to this outcome) will increase GDP by 0.13 percent[18].

<u>Submissions</u>

23. All parties agree that double recovery of costs is not permitted by the Act. However, there are different views on whether the Commission is permitted to consider double recovery of costs, and how far the Commission should go to ensure that Part 6 implementation avoids double recovery.

24. While the Analysys Mason (**AM**) report prepared for Chorus illustrates the differing views, it does little to resolve concerns relating to the overlapping application of different cost models and potential double recovery.

25. AM reaches a similar conclusion to TERA that the application of different cost standards to the same business risks a misstatement of costs[19]. As TERA note, double recovery is inherent to using two different modelling approaches with different principles[20].

26. However, while common ground that there is the potential for the misstatement of costs, AM submits that TERA's proposals are misconceived because the regulatory framework and Act do not permit the Commission to consider costs across the copper and fibre network[21]. AM's approach highlights the differing views of submitters relating to controlling for double recovery. The AM approach assumes, in effect, that the UFB network is a standalone project (set apart from Chorus' existing business except for causal cost allocation of shared costs). However, the AM proposed approach sits uncomfortably with:

    a. Section 177 which leaves discretion with the Commission relating to how it identifies past financial losses, subject only to best taking the approach that best supports s166 outcomes;

    b. UFB network deployment in practice which was made in the context of wider business concerns.

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[16] Vodafone *Submission on Commission's proposed approach* (21 December 2018), para. 80
[17] Vodafone, 21 December 2018, para. 83
[18] ITU, 2018, *The economic contribution of broadband, digitization and ICT regulation*, page 22
[19] Analysys Mason, 24 January 2020, *Report for Chorus Response to TERA paper on "over-recovery"*, para. 1.2.1
[20] TERA report, page 21
[21] Analysys Mason, para. 1.2.2

The scheme booklet highlights that UFB participation was based on overall Chorus value with and without participation – i.e. avoiding overbuild of the Chorus network by a Government sponsored operator, and the benefits of aligning with Government policy – rather than the narrow technical approach AM propose. Chorus also operates the copper network which is expected to transition to fibre; and

c. The existing regulatory framework which was expected to leave Chorus fully funded. The regulatory framework was expected to fund the provision of services, and anticipated performance improvement as Chorus migrated to the fibre network.

27. The Commission is not limited from looking across Chorus' business to remove double recovery, and there is consensus that the existence of two regulatory models will inevitably result in a misstatement of costs.

28. TERA advised that double recovery is not consistent with cost-oriented regulation – which is consistent with submitters understanding of the Act – and that controls should be applied with an appropriate consistency check[22]. As the TSLRIC model is in place, these controls and consistency check need to be applied with the BBM model. We believe that TERA provides a practical means of controlling for the double recovery of cost, proportionate for the significant implications of overstating past losses.

29. As AM takes a project view of the fibre network, it provides no insight in to how best to control for double recovery and provide for the sharing of efficiencies with end users as required by the Act. The TERA approach remains the best means to ensure these outcomes.

Proposed further adjustments

30. Chorus further proposes that:

a. The Commission set out how it will apply the cost allocation rules[23]. The Commission should agree to apply the same general causal cost rules that Chorus would apply, assure Chorus that the cost allocation data has been applied correctly and implement a Chorus led process (the Commission role being limited to subsequent review); and

b. Additional default cost allocators be added to the list.

31. We don't support Chorus' proposed changes to the process that will likely result in allocations inconsistent with those required by the Act, for example:

a. The process should anticipate Chorus acting on incentives it has to select the most favourable accounting-based allocator for any circumstance rather than an allocator that best supports the s166 outcomes, i.e. minimises double recovery or sharing of efficiencies with end users.

Provider discretion is a further concern where proposed allocation options increase the range of allocation outcomes and risk, i.e. *used length of linear assets* will significantly increase the allocation of costs to the Fibre Network over unit-based allocations such as per connected customer (see below); and

b. There are no efficiency gains or end user benefits from a backward-looking application of the cost causality rules, i.e. the selection has no purpose beyond

[22] TERA report, page 21
[23] Chorus, para 162.2 and 162.3

setting the allocation of shared costs. Therefore, there is no wider benefit or efficiency for which Chorus is better placed to select the allocator.

32. In effect, Chorus' proposed methodology would leave it with a significant influence over the costs attributed to the Fibre Network when its incentives are to make decisions that are not consistent with s 166. Therefore, we support an approach whereby the Commission:

    a. Determines the allocation of costs to the fibre network (as proposed); and

    b. Selects allocators that best support the purposes of the Act – i.e. avoiding double recovery, sharing efficiencies with end users and promoting workable competition – and apply the cross check suggested by TERA and a top down adjustment where the check highlights a material disconnect.

33. Chorus has proposed several additional allocators[24]. It's unclear whether any change is necessary as – on the face of it - the draft decision permits other allocators and we expect these could be adopted if they better support s166. Therefore, Chorus' additional options could already be considered within the proposed process.

34. In any case, Chorus' recommendations highlight the significant difference the allocator will make to cost allocation. For example, allocating duct and trenching costs based on length of linear assets would result in significantly more costs allocated to fibre when demand is low than if a per connection allocator were used.

35. The Commission should further be cautious applying EPMU which is a function of other selected allocators, and therefore risks simply compounding poor allocator choices. Nonetheless, we agree the Commission should be open to considering additional allocators to those based solely on asset utilisation. For example, the allocation of shared costs on the basis of a service's contribution after direct costs is a viable allocation methodology for past losses.

Cost of capital

- Submitters agree that the Commission should consider the nature of Fibre Network risk further. We also raised several questions relating to impact of UFB arrangements and regulatory framework on Chorus risk.

- Sapere, in a report for Chorus, recommend that the Commission adopt a wider comparator set for estimating the asset beta. However, this dataset is less comparable to that used in the draft and has no obvious additional informative value. The Commission has considered the nature of a firm's risk with specific institutional arrangements – i.e. most recently in the Fonterra consideration - and has an accepted methodology for adjusting for these differences (through comparator selection).

- Past Commission expert reports highlight that a zero beta is a viable option for past losses, and that the draft comparator set is skewed to firms with higher risk than the Fibre Network.

36. Submitters agree that the Commission should consider the nature of Fibre Network risk further:

    a. Chorus and its advisors recommend that the Commission make several adjustments to WACC parameters that imply the Fibre Network faces higher risk tha identified by the Commission in the draft;

    b. Vodafone identifies several WACC parameter choices that it believes, overall, moves the regulatory balance heavily in favour of the LFCs; and

[24] Chorus, para. 167

c. We submitted that the Commission should consider the implications of UFB arrangements and regulatory framework on residual risk faced by the Fibre Network in practice.

37. Policy makers should also want the proposed approach considered further as it implies a PPP with the Crown inevitably has greater risk than commercial agreements in a competitive infrastructure market.

38. We note that submissions also highlight differing views over the treatment of Crown funding. While the Commission proposes to treat Crown equity funding as debt, NERA refers to the S&P Global ratings report that concludes the opposite, i.e. that these instruments should be treated as equity[25]

> *About half of the UFB build cost is funded by payments from Crown Infrastructure Partners (CIP, a New Zealand government-owned entity), through its CIP securities issued to Chorus in the form of debt and equity-like securities. We treat the equity securities as 100% equity in our financial ratio calculations, and the net present value of the debt securities as 100% debt.*

Asset beta

39. We have already questioned whether the proposed Asset Beta reflects the actual Fibre Network risk.

40. The Sapere report prepared for Chorus concludes that the significant differences between the proposed comparator sample and a pure play FFLAS provider mean other evidence should be considered[26]. Sapere recommends the Commission adopt a larger dataset of companies that are broadly related to the entity and not check for comparability.

41. It's unclear why the Sapere proposed approach would provide further insight on the risk faced by Fibre Network, although we appreciate that the approach will bring in more firms operating in competitive markets and increase the asset beta estimate. The Sapere approach results in a comparator set that is less representative of a regulated wholesale fibre provider. As Professors Partington and Satchell note in their 2019 report to the Commission[27]

> *Using comparator sets to estimate beta suffers from the problem that there are frequently very few suitable candidates to put into the set. Adding a large number of unsuitable companies to increase sample size does not improve matters, but actually makes them much worse, […].*

42. Rather, the Commission should look to the comparator set to inform its assessment of risk. The Commission has significant expertise estimating asset betas for entities with specific commercial arrangements, access to overseas expertise, and an accepted methodology for building a comparator set that has informative value, i.e.

    a. The Commission considered the nature of regulation and commercial arrangements, and the impact this had on setting risk. For example, in the 2019 Fonterra determination, the Commission responded to expert reports that considered in detail similar concepts relating to defining the asset beta in the regulatory and commercial

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[25] S&P Global Ratings, *Chorus*, 19 November 2019, p. 11

[26] Sapere, para. 120 and 121

[27] Graham Partington and Stephen Satchell, 14 March 2019, *Report to Fonterra: Discussion of the Asset Beta for use in Milk Pricing,* page 11

context[28]. Professors Partington and Satchell (**P&S**) considered Fonterra's asset beta in light of the main drivers of a firm's asset - i.e. the firm's revenue beta scaled up by operating leverage – and concluded that these parameters are likely low. CEPA reviewed P&Ss report for the Commission[29].

The Commission could apply a similar assessment to the Fibre Network, i.e. consider the unique Part 6 and UFB arrangements in light of their impact on revenue beta and operating leverage (likely low as framework minimises revenue variations.

b. The Australian Energy Regulator considers the nature of regulatory frameworks when setting the equity beta[30]

Our view is that regulation reduces the equity beta estimate of a firm which suggests placing relatively more weight on firms that are (majority) regulated (under our framework) such as Spark and AusNet. This is because they would better match an efficient firm in the supply of Australian regulated energy network services (see section7.4).

c. As noted in our earlier submission, Dr Lally advises that changes in risk due to the implementation of different regulatory models can be addressed through careful selection of comparators[31]; and

d. The Commission considered the nature of risks faced in considering changes to the form of regulatory control (from a price cap to a revenue cap). CEPA advised how the form of regulatory control influences risk faced by the regulated provider. CEPA further advised that[32]

There is a spectrum that can be derived for the riskiness for companies of being regulated in different forms. The below table illustrates the type of regulation and the riskiness of elements within the regulatory setting.

The spectrum goes from cost of service regulation (or rate of return regulation) to a revenue cap to a price cap, each time increasing the elements which are not regulated.

[28] Graham Partington and Stephen Satchell, 14 March 2019, *Report to Fonterra: Discussion of the Asset Beta for use in Milk Pricing*
[29] CEPA letter to the Commission, 11 July 2019, *RE: Notional Processor asset beta*
[30] Australian Energy Regulator *Rate of return instrument Explanatory Statement* (December2018) para. 7.10.1. https://www.aer.gov.au/system/files/Rate%20of%20Return%20Instrument%20-%20Explanatory%20Statement.pdf
[31] Dr Martin Lally report to Commerce Commission *Review of further WACC submissions* (23 November 2016)
[32] CEPA 2015, section 2.3.1

Table 2.1: Profit elements controlled by the form of regulation

Regulation type	*Regulated elements*	*Unregulated elements*
Cost of service	*P, Q, C, U*	
Revenue cap	*P, Q*	*C, U*
Price cap w/ cost pass through	*P, U*	*Q, C*
Price cap	*P*	*Q, C, U*

Source: Alexander, Mayer and Weeds (1996)
Note: P is the regulated price, Q is the regulated quantity, C is controllable cost and U are uncontrollable costs.

With a hypothetical cost of service regulation form where the regulated price instantaneously adjusts to equalise allowable revenues and realised costs, the regulated firm would arguably bear no diversifiable or non-diversifiable risk, and thus if they bore no risk, a zero asset beta may be assumed. In practice, we are unaware of any regulatory package where the firm does not bear some risk, as this would not contain strong incentive properties. At the other end of the spectrum in the table i.e. price cap regulation, the range of returns will depend on the extent to which the price cap bites. If this ceiling is significantly above the price a firm would wish to charge, there would be little difference between the firm being regulated and not-regulated, purely based on the form of regulation.

Where systematic risk has been transferred from the regulated company to consumers, this should be reflected in the use of a lower asset beta, and subsequently lower charges paid for by those same consumers. […]

43. The Commission has the capability to consider the nature of risk and the asset beta, and the Sapere approach fails to ensure that informative data is considered.

<u>A cross check on the results of the comparator set</u>

44. Vodafone further questions proposals to adopt an asset beta greater than zero[33].

45. The earlier CEPA report[34] is consistent with this approach in recommending that a zero-asset beta may be appropriate for past financial losses on the basis that (past) allowed revenues will exactly equal to realised costs.

    With a hypothetical cost of service regulation form where the regulated price instantaneously adjusts to equalise allowable revenues and realised costs, the regulated firm would arguably bear no diversifiable or non-diversifiable risk, and thus if they bore no risk, a zero asset beta may be assumed.

46. Dr Lally advised that a zero beta is a viable option for determining past financial losses. In this case, the Commission's proposed past financial losses approach ensures that allowable revenues exactly equal costs, and Chorus is left with no risk for which an asset beta greater than zero is necessary. Dr Lally's zero beta option would not be inconsistent with the earlier CEPA report.

47. Further, the CEPA hierarchy of risk from cost of service through to price cap regulation highlights that the draft comparator set, without specific consideration of the framework, likely

[33] Vodafone, page 12
[34] CEPA 2015, section 2.3.1

skews results to a higher asset beta. Sapere's proposed approach results in a further skewing of the comparator data set.

48. The table below illustrates that the draft benchmark data appears to be weighted towards higher risk regulatory frameworks, with the Sapere proposals increasing the relative weighting to higher risk firms. The Fibre Network framework likely has less risk than a conventional revenue cap as Part 6 implementation – i.e. asset valuation at acquisition cost and past financial loses - shifts key cost related risks on to end users.

49. In our submission we questioned whether the draft reflected the benefits of the UFB arrangements and regulatory framework and recommended that the Commission consider how these beneficial arrangements might be reflected in the asset beta.

Regulation type	Regulated elements	Unregulated elements	Commission Draft comparators	Sapere proposed comparators
Cost of service	P, Q, C, U		-	-
Fibre Network				
Revenue cap	P, Q	C, U	-	-
Price cap w/ cost pass through	P, U	Q, C	-	-
Price cap	P	Q, C, U	Med weighting	Low weighting
Unregulated		P, Q, C, U	High weighting	Higher weighting

Fibre network stranding risk

- We're not convinced that NERA's proposed approach for Chorus reflects the relationship between network components and how costs are recovered in practice. The approach more or less estimates risk at the network component level in isolation. However, the components and recovery of costs within the network system are related.

- Nonetheless, the NERA report highlights that many key parameters for a reasonable assessment of the risk have yet to be determined, i.e. the application of causal cost allocation rules, unavoided cost cap, pricing principles and implied end user prices. Therefore, with this complexity and lack of information, we recommend the Commission defer any decision until after the first regulatory period.

<u>NERA considers categories of costs that are related in practice</u>

50. NERA notes in a report prepared for Chorus that it is important to consider the categories of assets within the RAB that might be stranded, and that the stranding risk associated with these assets should be considered separately[35].

[35] NERA, 22 January 2020, *Assessment of Type II asymmetric risk for Chorus' fibre network*, para.8

51. We're not convinced that the NERA approach reflects the nature of networks and how stranding might occur in practice. NERA's segmented approach doesn't reflect the relationship between components of a network system and how costs are recovered through pricing.

52. The core network and lead-ins support several regulated and non-regulated services, and while the utilisation of some elements may increase or decrease, the overall value of the network is maintained, and overall costs recovered. For example, a reduction in the value of lead-ins due to wireless competition would correspond with an increase in value of the core network which underpins the technologies that replace lead-ins. Lead-ins at the premises level are unlikely to be stranded - because they are retained for the next customer (utilisation of the asset may fall). Further, Chorus' allocation of costs and pricing principles leaves significant discretion to recover costs across multiple services and platforms.

53. Further, as Vodafone notes in its submission[36], the Commission is considering stranding risk in very specific circumstances, i.e. where certain assets become deregulated and then some of those assets face competition that means their economic value is reduced below the residual recovered from the regulatory model.

54. Accordingly, any component level assessment of stranding risk approach that fails to fully reflect these relationships and specific circumstances within which the adjustment can apply, will inevitably overstate the risk.

<u>The Commission should defer further consideration until after first regulatory period</u>

55. We agree with Vodafone that the likelihood of deregulation and stranding of assets is likely very low. It's further difficult to imagine, in the regulatory context within which we operate, that there could be a material stranding of assets. The High Court observed in Wellington Airports that the risk of stranding is obviated by the regulatory regime[37]:

> *[1739] More broadly, the basic point is that regulated suppliers do not face the same risks as firms in workably competitive markets. They are protected to a high degree from the vagaries of demand and the pressures of competition. Their risk of not receiving a return on assets that get stranded is obviated by the regulatory regime. They can be compensated after the event for catastrophic events. There is no likelihood that they would be allowed to fold and cease providing services.*

56. Nonetheless, the NERA report highlights the significant difficulty associated with deriving a sensible estimate of stranding risk, and that many of the decisions that would support quantification of the risk have yet to be made, for example

    a. The MAR and implied medium-term end user prices are not yet known. A low end-user price would imply the risk of stranding is lower than if implied prices were high;

    b. Cost allocation and unavoided cost cap rules have yet to be determined and, therefore, the expected impact reallocated costs with changes in demand is unknown;

    c. Pricing principles will be considered in subsequent regulatory periods. These are key to understanding how costs are allocated to FFLAS services and expected impact from a change in demand of deregulation of a specific FFLAS; and

[36] Vodafone, page 6

[37] Wellington Airports at [1739]

d. The allocated asset values for the RAB are not yet known. While NERA has adopted Chorus reported fibre capex for its worked example, this does not reflect a causal cost allocation between regulated and unregulated services. In other words, while categorised as fibre capex for Chorus reporting purposes, this is not the Part 6 allocation we expect to see in practice.

57. Therefore, given the complexity and lack of key information necessary to sensibly quantify the risk, we recommend that the Commission defer any decision to quantify the stranding risk until after RP1. It may also be the case that, based on this information, a different approach might be taken to mitigating the stranding risk. For example, the Commission already has multiple mechanisms in play to address stranding risk and it may be that an alternative option is preferred, i.e. if there is significant MAR headroom at current prices (which is likely based on low interest rates and benchmark prices), then accelerated depreciation may be preferred.

<u>Transitional measures to provide an incentive to offer efficient pricing and performance</u>

58. At this stage, the Commission should simply clarify an intent that the effect of actual asset stranding will be assumed by Chorus. Chorus is best placed to manage the stranding risk as it will determine pricing to a significant extent and drive the pace of innovation. It is important to provide Chorus efficient incentives as the likelihood that assets are overbuilt in practice will materially depend on Chorus decisions.

59. The NERA report illustrates the impact of Chorus decisions. NERA note that unbundling may result in ONTs being stranded as they are not useful and the cost to re-deploy is too high[38]. However, Chorus rejected access seekers requests to rent or buy Chorus ONTs when the premises has been unbundled. Accordingly, the possibility that the ONT is stranded with unbundling is solely due to Chorus' commercial choices. We have concerns with the Chorus approach and have asked the Commission to consider the approach and other non-price discriminatory practices in the Commission's *Consultation on draft guidelines on the equivalence and non-discrimination provisions in Telecommunications Regulation*[39].

60. At this stage, the Commission IM approach should recognise that Chorus decisions will determine to a material extent the possibility of stranding and should look to create incentives for Chorus to act efficiently. The Commission clarifying an intent that Chorus will not see any compensation or RAB transfers for stranding of specific assets will provide an incentive for efficient decision making.

[End]

[38] NERA para. 88

[39] Commission consultation https://comcom.govt.nz/regulated-industries/telecommunications/projects/unbundled-layer-1-fibre-service