NEW REGULATORY FRAMEWORK FOR FIBRE

Response of Enable Networks, Ultrafast Fibre and Northpower Fibre (LFCs) to Commerce Commission's consultation questions

21 December 2018

Introduction

This response to the Commerce Commission's *New regulatory framework for fibre* discussion paper (**Discussion Document**) is made on behalf of Enable Networks Limited (**Enable**), Northpower Fibre Limited and Northpower LFC2 Limited (**Northpower**), and Ultrafast Fibre Limited (**UFF**).

Enable, Northpower and UFF are the local fibre companies (**LFCs**) responsible for the construction of the Ultrafast Broadband (**UFB**) fibre-to-the-premises network in Christchurch/Rangiora, Whangarei/Kaipara and Tauranga/Hamilton/Tokoroa/New Plymouth/Hawera/Whanganui respectively. Our initial UFB areas accounted for 15.3%, 1.6% and 13.7% respectively of the national UFB network, with Chorus responsible for the remaining 69.4%.

We welcome the opportunity to contribute to the Commission's consultation.

This response is divided into two parts.

Part 1 sets out our general high-level comments on a number of (but given time constraints, not all) the issues raised by the Commission in the Discussion Document.

Part 2 addresses (to the extent relevant) the specific consultation questions listed in Attachment B to the Discussion Document.

The Commission's working assumption is that regulations yet to be made under the Telecommunications Act 2001 (**Act**) will subject LFCs to information disclosure regulation only, and that only Chorus will be subject to price quality regulation.[1] This response is based on those assumptions; for that reason we have not addressed matters relating solely to price-quality regulation at this stage of the consultation process, although we may do so in cross-submission.

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[1] NZCC, New regulatory framework for fibre consultation document, 9 November 2018 at [1.13.1].

Executive Summary

Unlike Part 4 industries, the telecommunications sector is "uniquely competitive"

Part 6 of the Act introduces a form of utility-style regulation that is currently applied to energy networks and airports under Part 4, all of which have been determined to be natural monopolies which face little or no competition. Those competitive environments are far removed from what the Discussion Document describes as "*the unique competitive landscape of telecommunications".*

LFCs face infrastructure-based competition in the broadband access market from fixed wireless (which has already captured more than 10% market share, and which will be upgraded to 5G by 2020), enhanced copper VDSL2 vectored services which Chorus offers only in LFC areas, and in the case of Enable, Vodafone's HFC network. In addition, LFCs face access-based competition from 2020 as a result of their Part 4AA obligation to provide unbundled layer 1 access to their fibre-to-the-premises network on an equivalence basis.

The Commission's starting point should accordingly be that the broadband access market is already workably competitive, and its process should be to determine what parts of the Part 4 framework can relevantly be applied in that context, rather than using previous decisions it has made under Part 4 as its starting point.

The Commission must have regard to the Government's UFB Policy Statement that businesses have incentives to invest in ultra-fast broadband infrastructure

The Commission in making determinations under Part 6 is required to have regard to "*any economic policies of the Government that are transmitted … to the Commission by the Minister*". As a result, the Commission must have regard to the Government Policy Statement that "*the Government's economic policy objective is that businesses have incentives to innovate and invest in new or upgraded ultra-fast broadband infrastructure for the long term benefit of end users.*

This requires that the Commission, in making decisions under Part 6, gives primacy to "*the incentives to innovate that exist for, and the risks faced by, investors in new telecommunications services that involve significant capital investment and that offer capabilities not available to established services*".

Regulation must be proportional

It is a fundamental principle of regulation that the burden of regulatory rules should be proportionate to the expected benefit and potential harm.[2] The Commission must, in making decisions under Part 6, take account of the relatively small size of the three LFCs, and their limited geographic footprint, to ensure that the regulatory burden imposed on them is proportionate.

A set of simplified IMs applying only to ID regulation would ensure a proportionate regulatory framework for LFCs, both in development and implementation.

As LFCs will be subject to ID only, IMs should be principlebased, not prescriptive

The purpose of ID is to ensure that sufficient information is readily available to interested persons to assess whether the s162 purpose is being met. While information disclosure regulation may influence the prices that are ultimately charged for fibre fixed line access services, it does not regulate those prices. LFCs are able to set prices as they see fit.

For reasons of proportionality, IMs for ID should be principle-based. This is also necessary to accommodate potential changes to the scope of regulated services.

To ensure the ID IMs are durable and simple, the Commission should start with core principles, and leverage other well established frameworks (such as GAAP, and tax law). This will reduce regulatory complexity and promote regulatory certainty.

[2] MBIE, Regulating Communications in the Future, September 2015, p24

A more prescriptive ‘rule book’ approach is not appropriate as it would be more likely to introduce regulatory distortions, and would not be sufficiently durable to cope with the pace of change in the telecommunications market. A ‘rule book’ approach is also more costly to establish and maintain, due to the additional detail required.

FFLAS markets are expected to evolve. LFCs will need to be able to innovate, and respond to the changing demands of access seekers and end users. Unnecessary regulatory constraints would limit their ability to meet these needs, which would be inconsistent with the s162 purpose statement.

A regulated supplier must have the opportunity to earn a “normal return’ on its investment

LFCs agree with the Commission that it is imperative that under the regulatory framework “*a regulated supplier has the opportunity to earn profits that compensate for its cost of capital over time (taking into account its exposure to risk) – ie, to earn a ‘normal return’*”. We also agree that “*if suppliers are not compensated for risks that are outside their control, this may have a detrimental impact on investment incentives*”.

LFCs also agree that “*the allocation of demand risk, and the associated risk of economic stranding is likely to be particularly important in the context of FFLAS. This reflects the greater threat of competition relative to the sectors we regulate under Part 4*”.

LFCs look forward to working with the Commission through the consultation process to identify the most effective way (whether through a margin on the rate of return, reduced asset lives, front-loaded depreciation or other mechanism) to ensure the economic stranding risk is appropriately identified and allowed for.

A sector-specific asset beta is inappropriate

While the Commission may consider a sector-specific approach appropriate under Part 4, it is completely inappropriate for telecommunications where the three LFCs have a significantly greater risk profile than the other regulated supplier Chorus, as a consequence of Chorus’ competing with the LFCs’ fibre network with a VDSL2 vectored service over its copper network.

The risks faced by LFC investors in the UFB Initiative are accordingly substantially greater than those faced by investors in Chorus. A sector-specific asset beta will result in a significant under-estimation of the demand risk and risk of economic stranding facing LFCs, would reduce incentives to invest, be contrary to the Government’s Economic Policy Statement, and would not be in the best interests of end-users of FFLAS (s162) or end-users of telecommunications services generally (s166).

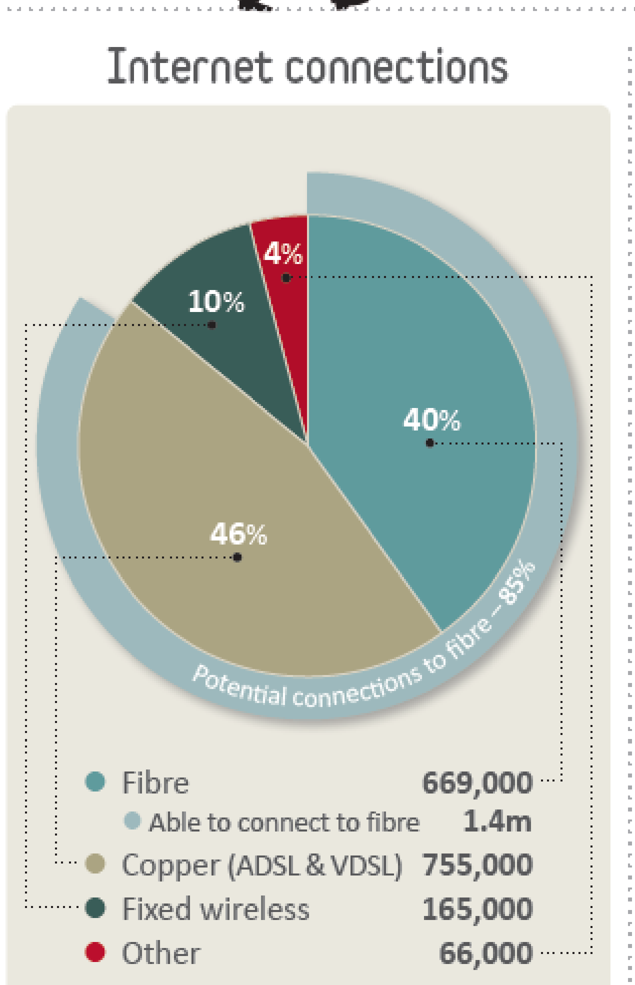
PART 1: GENERAL OBSERVATIONS

Unlike Part 4 industries, the telecommunications sector is uniquely competitive

1. As the Commission notes, Part 6 of the Act introduces a form of utility-style regulation that is currently applied to energy networks and airports under Part 4,[3] all of which have been determined to be natural monopolies which face little or no competition. Those competitive environments are far removed from what the Discussion Document describes as "*the unique competitive landscape of telecommunications*":[4]

> *Wireless services may be a substitute, or may become a closer substitute, for FFLAS in certain market segments eg, for end-users with relatively low bandwidth requirements. Similarly, other access technologies which are substitutes for FFLAS may become available in the future. Even in the existing environment, there is potential for competition between Chorus and the other LFCs where Chorus continues to supply copper-based services, and between Vodafone's HFC network and … Enable's UFB network in Christchurch.*[5]

2. The level of competition in the broadband access market nationally is demonstrated in the internet connection chart in Commission's 2018 Annual Telecommunications Monitoring Report:



[3] Above at [3.12].

[4] Above at [5.24].

[5] Above at [5.33].

3. In addition to competition from alternative technologies, LFCs have existing obligations under Part 4AA of the Act to provide unbundled layer 1 services to wholesale customers at an equivalence standard before the new Part 6 regime comes into effect. This will provide the potential for access-based competition on the fibre network in addition to the infrastructure-based competition referred to above.

4. Parliament has charged the Commission with implementing a utility-style regulatory framework designed for markets where there is little or no competition, in a dynamic broadband access market. This market is characterised by intensive infrastructure competition, emerging 5G technology that will increase the scale and extent of such competition before Part 6 comes into effect, and access-based competition mandated under the existing provisions of the Act.

5. In the Discussion Document the Commission states that it "proposes to use the cost of capital input methodologies determined under Part 4 as the starting point for FFLAS",[6] while having regard, where appropriate, to "the unique competitive landscape of telecommunications".[7] While LFCs understand the Commission's wish not to "reinvent the wheel", in our view this starting point is back-to-front.

6. The Commission's starting point should be that the broadband access market is already workably competitive, and its process should be to determine what parts of the Part 4 framework can relevantly be applied in that context.

7. LFCs would expect a simpler set of input methodologies and information disclosure requirements under Part 6 than those applying to electricity distribution and transmission, gas pipelines and airports under Part 4.

The Commission must have regard to the Government UFB Policy Statement

8. The Commission in making determinations under Part 6 is required[8] to have regard to "*any economic policies of the Government that are transmitted … to the Commission by the Minister*". As a result, the Commission must have regard to the Government Policy Statement that "*the Government's economic policy objective is that businesses have incentives to innovate and invest in new or upgraded ultra-fast broadband infrastructure for the long term benefit of end users*."[9]

9. This requires that the Commission, in making decisions under Part 6, gives primacy to "*the incentives to innovate that exist for, and the risks faced by, investors in new telecommunications services that involve significant capital investment and that offer capabilities not available to established services*". While this wording is taken from s18(2A) of the Act (which applies only to Part 1 and Schedules 1 to 3 of the Act), these principles apply to Part 6 as a consequence of s21 of the Amendment Act, as the drafting reflects the intent of the Government Policy Statement.

Regulation must be proportional

10. In addition to having regard to the unique competitive landscape of telecommunications, and the Government Policy Statement, the Commission's approach must also take account of the relatively small size of the three LFCs, as disclosed in Table 2.2 of the Discussion Document (set out below), and ensure that the regulatory burden imposed on them is proportionate:

[6] Above at [7.93].

[7] Above at [5.24].

[8] Section 21, Telecommunications (New Regulatory Framework) Amendment Act 2018 (**Amendment Act**).

[9] Statement to the Commerce Commission Concerning Incentives for Businesses to Invest in Ultra-fast Broadband Infrastructure. New Zealand Gazette No 155, 13 October 2011, 4440 (**Government Policy Statement**).

Summary of UFB providers

Fibre service provider	Regions	End-users able to connect (June 2018)	Ownership
Chorus	Auckland, Wellington, Dunedin, Hawkes Bay, Wairarapa, Nelson, Southland and other regions to varying extents	932,000	Publicly listed company
Enable Networks	Christchurch, Rangiora and Rolleston	200,000	Subsidiary of Enable Services Limited, which is owned by Christchurch City Holdings Limited, and which in turn is owned by Christchurch City Council.
Northpower Fibre	Whangarei	25,000	The largest shareholder is Northpower Limited which is an electricity distribution business owned by Northpower Electric Power Trust. Other shares are held by CIP.
Northpower LFC2 (became an LFC in 2017)[26]	Northland		Subsidiary of Northpower Limited.
Ultrafast Fibre	Waikato, Taranaki, Tauranga and Tokoroa	210,000	Owned by Waikato Network Limited which is 85% owned by WEL Networks Limited and 15% by Waipa Networks Limited (both electricity distribution businesses), which in turn are owned by local trusts - the WEL Energy Trust and the Waipa Networks Trust.

11. While it is assumed that the regulatory burden on LFCs will be limited to Information Disclosure (**ID**), and therefore be less intrusive than that imposed on Chorus (which is assumed to also be subject to price quality (**PQ**) regulation), the compliance costs facing the small LFCs under the Commission's proposed three year Input Methodology (**IM**) and ID consultation processes are immense.

12. As the Commission notes, ID is "*underpinned by input methodologies that set out the rules and processes that govern our approach to this regulation*".[10] In addition, the Act does not provide appeal rights in relation to ID Determinations under s170 of the Act because "*there are appeal rights for the input methodologies, which should have a significant bearing on the information disclosure system in practice*".[11] As a consequence, LFCs must be fully engaged throughout the IM consultation.

13. Given the relatively small size of our respective customer bases, the costs we face if the Part 4 processes were to be replicated under Part 6 will be disproportionate, even when we share resources where appropriate.

14. The Commission should therefore develop a set of simplified IMs to apply only to ID regulation, in order to ensure a proportionate regulatory framework for LFCs, both in development and implementation. This will require a clear statement of high-level principles, with discretion for each LFC to apply those principles to its respective businesses in the most cost effective manner, taking into account the size of those businesses, and their existing business information systems and processes.

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[10] Above at [5.50].

[11] Departmental Report to the Economic Development, Science and Innovation Committee on the Telecommunications (New Regulatory Framework) Amendment Bill, 20 April 2018, Appendix 2, item 127.

IMs for Information Disclosure should be simple and principle-based, not prescriptive

15. The LFCs are subject to ID regulation only. The purpose of ID is to ensure that sufficient information is readily available to interested persons to assess whether the s162 purpose is being met. While ID regulation may influence the prices that are ultimately charged for fibre fixed line access services (**FFLAS**), it does not regulate those prices; LFCs are able to set prices as they see fit.

16. This is similar to the regulation of airport services under Part 4 of the Commerce Act, as specified airport services are also only subject to ID regulation, not PQ regulation.

17. Importantly, s191 provides an exemption from applying the cost of capital IM to regulated fibre service providers who are subject only to ID regulation. While LFCs are not bound by the cost of capital IM when setting prices for FFLAS services, the cost of capital IM is used for monitoring and analysing their financial performance.

Regulated suppliers must have the opportunity to earn a normal return

18. We agree with the Commission that it is imperative that under the regulatory framework "*a regulated supplier has the opportunity to earn profits that compensate for its cost of capital over time (taking into account its exposure to risk) – ie, to earn a 'normal return'* ".[12] We also agree that "*if suppliers are not compensated for risks that are outside their control, this may have a detrimental impact on investment incentives*".[13]

19. While the Commission goes on to say that "*price-quality regulation does not guarantee a normal return over the lifetime of the regulated supplier's assets*",[14] the documents footnoted explain that this is because under a PQ regime, prices are set part-way through the lifetime of the assets utilised and information about past performance may not be known,[15] and where average prices are pre-specified, suppliers can potentially earn higher or lower than normal returns, and increase profitability through reducing costs.[16]

20. These conditions do not apply for FFLAS, where the assets are new and costs and past performance are known; as a consequence of the information disclosure regime in Part 4AA of the Act, the Commission holds six years of data which goes back to the launch of UFB in 2011.[17] Consequently, the input methodologies for ID should be accurate enough to ensure a normal rate of return on LFCs' regulated assets over their lifetime.

21. A distinction should be drawn between setting IMs (and PQ regulation) with an expectation of earning normal returns (ex-ante), consistent with workably competitive markets, and acknowledging that ex-post, actual returns may be higher or lower for various reasons. In utility regulatory frameworks, there are opportunities to reset the ex-ante expectations of normal returns from time to time (for example at the beginning of a PQ regulatory period, or during a regulatory review) to ensure that those ex-ante expectations are maintained. This ex-ante expectation therefore must be reflected in the IMs; not to do so would be inconsistent with workably competitive markets.

22. We agree with the Commission that "*the allocation of demand risk, and the associated risk of economic stranding is likely to be particularly important in the context of FFLAS. This reflects the greater threat of competition relative to the sectors we regulate under Part 4*".[18] LFCs look forward to working with the Commission through the consultation process to identify the most effective way (whether through a margin on the rate of return, reduced asset lives, front-loaded

[12] Discussion Document, above n1 at [6.16.1].

[13] Above at [6.28].

[14] Above at [6.16.1].

[15] Input Methodologies Reasons Paper 22 December 2010 at [2.6.28].

[16] NZCC, Setting the customised price-quality path for Orion NZ Ltd, 29 November 2013 at [A.28].

[17] Discussion Document at [2.48].

[18] Above at [6.47].

depreciation or other mechanism) to ensure the economic stranding risk is appropriately identified and allowed for.

23. The Commission must consider this risk in the context of ID regulation where there are fewer regulatory risk allocation tools than under PQ regulation (such as wash ups, revenue vs price caps, expenditure approvals, adequate compensation for investments to meet quality standards etc.). One solution would be a higher ID weighted average cost of capital (**WACC**) range.

24. Under Part 4, accelerated depreciation for stranding risk is allowed only for PQ, but not ID, regulation. The ID WACC IM was set before depreciation change was made, so did not adequately address this stranding risk.

Sector-specific asset beta inappropriate

25. The Commission's proposal to use its Part 4 cost of capital IMs includes the use of a sector-specific asset beta. While the Commission may consider this approach appropriate under Part 4, it is completely inappropriate for telecommunications where the three LFCs have a significantly greater risk profile than the other regulated supplier Chorus, as a consequence of Chorus' competing with the LFCs' fibre network with its copper network. Chorus offers a VDSL vectored UBA service on its copper network in LFC UFB areas (but not in Chorus UFB areas), which improves VDSL downstream speeds by over 40% and upstream speeds by over 30%,[19] for the stated purpose of reducing migration from Chorus' copper network to LFC fibre networks.[20] Chorus has reported that this strategy has been successful in abating the loss of lines to the LFCs. The risks faced by LFC investors in the UFB Initiative are accordingly substantially greater than those faced by Chorus.

26. For that reason the concept of a sector-specific risk beta must be abandoned. It will result in a significant under-estimation of the demand risk and risk of economic stranding facing LFCs, so that LFCs would not have the opportunity to earn a normal return over the life of the regulated assets. Such an outcome would reduce incentives to invest, be contrary to the Government's Economic Policy Statement, and would not be in the best interests of end-users of FFLAS (s162) or end-users of telecommunications services generally (s166).

27. We note that the Commission has, in relation to airports, stated that it is "*open to applying a supplier-specific asset beta that departs from our mid-point WACC estimate. However, it requires an airport to persuade us that there are legitimate reasons why the asset beta should be different to the sector wide asset beta, as determined during the IM Review process*."[21] As ID regulation is designed to monitor performance against the purpose statement rather than set prices, a legitimate approach is to determine an acceptable range, rather than a specific point estimate.

The section 162 and 166 purpose statements

28. Although the Commission has spent more than eight pages of the Discussion Document trying to draw a distinction between "*the long-term benefit of end-users in markets for fixed-line services*" under s162, and the "*long-term benefit of end-users of telecommunications services*" under s166, it remains unclear whether there is any material difference between the two categories.

29. If there is a difference, that difference, and the criteria the Commission would apply to determine whether it was "relevant" to consider s166, needs to be clearly explained. Given the need for predictability in regulatory decision-making, this topic will require careful consideration during the consultation process.

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[19] "Chorus boost broadband bandwidth with VDSL2 vectoring", Computer World, 15 October 2018.

[20] "Chorus reports half year", Reseller News, 26 February 2018.

[21] NZCC, Review of Christchurch International Airport's pricing decisions and expected performance (July 2017 – June 2022): Final report – Summary and analysis under section 53B(2) of the Commerce Act 1986, 1 November 2018, at [A66].

PART 2: LFCs' RESPONSE TO CONSULTATION QUESTIONS

Q1 What changes to our process (if any) would you suggest to enhance the opportunity for you, and other stakeholders, to provide input and views to us as we develop the fibre input methodologies?

The LFCs have requested that the date for cross-submissions on this consultation document be extended.

The Commission should consider staggering its IM draft decision and determination consultations. The IM consultation under Part 4 of the Commerce Act involved substantial volumes of material for interested parties to consider and respond to. This process was made manageable by the submission deadlines being staggered across the key consultation periods.

The Commission has set itself a target for draft IM determinations by the end of 2019, two years prior to the implementation date. While we understand the amount of work to be done, we encourage the Commission to take sufficient time to fully consider how the FFLAS market differs to the markets regulated under Part 4 of the Commerce Act, to ensure that the Part 4 precedents are only applied where they are fit for purpose for the competitive environment in which the new regulatory framework for fibre is to be applied. This is particularly important for the cost of capital, asset valuation and cost allocation IMs.

Q2 What input methodologies (if any) could be progressed to draft or final decisions earlier to provide more certainty to stakeholders on the new fibre regulatory regime?

The Cost of Capital and Asset Valuation IMs should be given priority, as they are the two most important building blocks. In addition, there will need to be a transitional period after the IMs have been determined, to allow the Asset Valuation IM to be implemented. Regulatory Asset Base values need to be determined before the new ID regime can come into effect.

Q3 What are your views on our proposed interpretation of 'end-users of telecommunications services' in s 162 and s 166(2)(b)?

We do not agree, as the Commission suggests at 5.28, that customers taking a fixed wireless access (**FWA**) service should be included in the s162 definition of "*end-users in markets for fibre fixed line access services*", simply because FWA providers are using fibre backhaul provided by a regulated fibre access provider. The term "*end-users in markets for fibre fixed line access services*" should be limited to end-users of fibre services, not end-users of other telecommunications services whose service provider uses fibre somewhere in its network.

The addition of FWA end-users whose service provider is obtaining fibre backhaul from a regulated FFLAS provider rather than an unregulated competitive supplier of backhaul services is also impractical, as the Commission has no easy way of distinguishing the first category of end-user from the second.

There is no policy reason to include FWA end-users as FFLAS end-users. Section 166 provides the mechanism for the Commission to consider the benefits flowing to that group of end-users if it considers it relevant to do so.

Q4 What are your views on our preliminary views on how s 162 and s 166(2)(b) interact?

As noted in our General Observations, it is not clear to us from the Discussion Document how the Commission sees s162 and s166(2)(b) interacting.

We think greater clarity is required in relation to the circumstances under which the Commission (or the Minister) is likely to consider it "relevant" to consider competition in telecommunications markets other than for fixed line access services. If the application of s162 alone leads to one outcome, but s166(2)(b) leads to a different outcome, which is to prevail (both being mandatory considerations)?

Q5 What are your views on our preliminary view on how s 173 applies when we set the input methodologies?

We agree with the Commission's views on s173, which reflects the guidance given by the Court of Appeal on this point.

Q6 What are your views on our preliminary view that a BBM approach similar to that adopted under Part 4 would best give or be likely to best give effect to the objectives in s 166?

We support the BBM approach, but with significant changes to the implementation of the BBM model under Part 4, as outlined in our General Observations, and in our answers below.

Q7 How relevant to the fibre input methodologies are the three key economic principles used under Part 4?

We agree that the principles of real financial capital maintenance (**FCM**), allocation of risk and asymmetric consequences of over and under-investment as described in 6.16 are applicable to Part 6.

As we discuss in our General Observations, we agree with the Commission that the allocation of demand risk, and the associated risk of economic stranding is likely to be particularly important in the context of FFLAS in relation to incentives for further investment, and this issue should be the focus of the Commission's analysis.

The Discussion Document recognises that UFB network is essential infrastructure. The asymmetric consequences of under-investment must therefore be taken into account, because the harm to end-users is greater if investment is insufficient to meet their needs, than it is if investment is more than required to meet their needs.

The principle of FCM is particularly important as this is the principle which ensures that service providers are incentivised over time, and compensated for meeting the needs of their end-users. Service providers must be compensated for their fair costs and the risks they incur, in providing FFLAS services. End-users benefit from FCM because the required level of investment is made to provide the services demanded, at fair cost.

Q8 How does the prospect of infrastructure-based and access-based competition affect the application of the three economic principles in the fibre input methodologies?

The three economic principles are already at work in the broadband access market, as a consequence of infrastructure-based competition from fixed wireless (which has already captured more than 10% national market share[22], and which will be upgraded to 5G by 2020), enhanced copper VDSL2 vectored services which Chorus offers only in LFC areas, and in the case of Enable, Vodafone's HFC network, coupled with the obligation to provide unbundled layer 1 access to the LFCs' fibre-to-the-premises network on an equivalence basis.

Q9 What other economic principles should we have regard to when developing the fibre input methodologies? For example, should we include pricing efficiency as an economic principle for fibre?

The introduction of pricing principles into a market which already has significant competitive constraints on pricing, and which is subject to rapid change, has the potential to cause unnecessary disruption and distortion.

LFCs have neither the incentive nor ability to charge supra-competitive prices for their services because of infrastructure-based competition and regulatory equivalence of inputs (**EOI**) obligations in the case of fibre unbundling. This is evidenced by the fact that all LFCs have wholesale prices for the 1Gbps/500Mbps service that are substantially below the price-book price in the CIP Deed, and substantially less than the Chorus wholesale price in its UFB areas.

[22] NZCC, 2018 Annual Telecommunications Monitoring Report, p7

For this reason there is no need to adjust for price shocks, as LFCs will be managing the relationship with their wholesale customers, and will be subject to market forces which constrain pricing discretion.

Q10 What are your views on our approach to determining the activities and/or services that fall within the scope of FFLAS (including the treatment of copper-based services, POIs and services provided above layer 2)?

We disagree with the Commission's statement at 7.17 that all services that support users of telecommunications services fall within the ambit of regulated services.

"*Fibre fixed line access service*" in s5 of the Act is defined as a telecommunications service "*that enables access to, and interconnection with, a regulated fibre service provider's fibre network*". Accordingly, the only services that fall within the scope of FFLAS are services delivered over the fibre network, or are necessary to build and/or maintain the fibre network.

By way of example, providing advice to an end-user on in-house wiring is a telecommunications service, but (because it is beyond the ONT) it is not a service that enables access to, and interconnection with, the fibre network, and accordingly is not a regulated service.

Copper-based services

We agree that services using the copper network as outlined in paragraphs 7.18 - 7.20 of the Discussion Document do not fall with the scope of FFLAS.

Points of interconnection

We agree that the first notice the Commission must issue prescribing points of interconnection must prescribe the points that apply under our UFB contracts at 31 December 2019. There are no grounds to specify additional points of interconnection under section 231(5)(b).

Services above layer 2

Services above layer 2 will be regulated services only if they are delivered over the fibre network, or are necessary to maintain the fibre network. Services such as home routers or content management systems would not be regulated services, as they are not dependent upon the underlying fibre network.

Q11 Are there any further key implications of the scope of regulated services for the setting of input methodologies for price-quality or information disclosure regulation?

Extending the regulatory framework beyond access/interconnection will not promote competition for the long term benefit of end-users. To the contrary, it will stifle competition in markets that are currently competitive, because it will impose restrictions on some market participants but not others.

It would also be inconsistent with the fundamental principle set out in the Explanatory Note to the Telecommunications (New Regulatory Framework) Amendment Bill that "*regulation is only applied to the extent necessary to address a lack of competition*".[23]

As noted in the Discussion Document, the IMs will need to be sufficiently flexible to accommodate any changes to the regulated service definition which may be made over time, including removing specified services from within the scope of regulated FFLAS. This flexibility will need to be considered for all IMs to provide the necessary durability, while balancing the s173 purpose of input methodologies "*to promote certainty…*"

This supports a principle-based approach to IMs for ID, not just for cost allocation and asset valuation as noted in the Discussion Document, but also for the treatment of tax, quality dimension and cost of capital IMs.

[23] Explanatory Note to the Telecommunications (New Regulatory Framework) Amendment Bill at p2.

Q12 Do you agree with our application of s 166(2)(b) in practice as illustrated in the example? Where else may s 166(2)(b) be relevant in setting input methodologies?

It is unclear from the example how s166(2)(b) is being applied. Is the Commission saying that if it was applying s162 alone it would not allow the additional expenditure because the improved service quality would not benefit users of fibre services?

As noted in our General Observations, we cannot envisage any situation where s166(2) will be relevant, and look forward to further engagement with the Commission on this issue.

Q13 What are your views on our proposal to determine only those input methodologies listed in s 175(1) by the implementation date? What additional matters should be determined as input methodologies by the implementation date?

The Discussion Document includes very little information about the different roles that IMs play for ID regulation compared to PQ regulation. As LFCs are subject to ID regulation only, the IMs which apply to us will be used to assess our performance against the s162 purpose statement.

In our view, this means:

(a) the valuation of assets IM will contribute to providing a baseline against which the profitability of the regulated service will be assessed;

(b) the treatment of taxation IM will apply to the way in which regulatory profit is reported;

(c) the cost allocation IM will determine the boundary between regulated and unregulated services, and will be applied to shared costs and assets. This will also flow through into profitability assessments;

(d) the cost of capital IM will not apply to LFC pricing of FFLAS, but will be used to monitor the profitability of each LFC;

(e) the quality dimension IM will specify measures but not standards. LFCs will report on these measures for the purpose of assessing performance against the s162 purpose; and

(f) competition in the FFLAS market needs to be considered individually for each IM, as well as across the whole framework.

The IMs for regulatory processes and rules and capital expenditure projects apply only in relation to PQ regulation, and are not relevant for ID regulation. Section 175(1)(d) indicates that the capex IM relates to approvals for PQ regulation, similar to those undertaken for Transpower (for their IPP) and gas and electricity suppliers (for their CPPs).

The s185 purpose of ID regulation is '*to ensure sufficient information is readily available to interested persons to assess whether the purpose of this Part is met'*. This does not require the processes for capex approvals described in s175(1)(d).

LFCs request that the Commission confirms as soon as practicable that the process and rules and capex IM will apply only to PQ regulation; as the Commission will be aware, there is no process and rules or capex IM for ID regulation under Part 4.

No additional input methodologies need to be determined by the implementation date.

Q14 Which of the fibre input methodologies (if any) do you consider most appropriate for us to consider the use of a more 'principle-based' specification?

For reasons of proportionality, as outlined in our General Observations, IMs for ID should be principle-based. This is also necessary to accommodate potential changes to the scope of regulated services, as noted in response to Q11 above.

While some IMs will have more elements than others, the IMs will be durable and simple if the Commission starts with core principles, and leverages other well established frameworks (such as GAAP, and tax law). This will reduce regulatory complexity and promote regulatory certainty.

A more prescriptive 'rule book' approach is not appropriate as it would be more likely to introduce regulatory distortions, and would not be sufficiently durable to cope with the pace of change in the telecommunications market. A 'rule book' approach is also more costly to establish and maintain, due to the additional detail required.

As noted in the Discussion Document, FFLAS markets are expected to evolve. Regulated fibre service providers will need to be able to innovate, and respond to the changing demands of access seekers and end users. Unnecessary regulatory constraints would limit the ability of service providers to meet these needs, which would be inconsistent with the s162 purpose statement.

Q15 What are your views on our proposal to use a high-level approach consistent with Part 4 for the asset valuation IM? Please note that we have not yet set out our views on the treatment of depreciation or asset revaluations.

LFCs support a high-level approach to determining the assets to be included in the regulatory asset base (**RAB**), rather than exhaustive or prescriptive lists of assets. This is consistent with principle based/proportionate regulation, as discussed in response to Q11 and Q14 above.

A starting point for asset definition should be the current information disclosure requirements. This will provide a straightforward and cost-appropriate approach to defining the RAB assets.

Q16 What are your views on our proposed approach to adopt cost as the measure of asset value for assets constructed or acquired after implementation date?

We support a cost approach to valuing assets post implementation date, with as much alignment with GAAP as possible. Setting depreciation, asset commissioning and disposal rules with reference to GAAP is consistent with a principle-based approach to the asset valuation IM, and will minimise regulatory cost and complexity.

Q17 What specific rules or approaches (if any) are needed for the treatment of particular types of assets, or to deal with practical aspects of asset valuation?

The LFCs' preference is to avoid specific rules wherever practical, and rely on GAAP for the reasons outlined above. However we agree that some consideration will need to be given to the treatment of the financial loss asset after implementation date.

Other considerations include the depreciation profile over time, consistency with the FCM principle, and whether cost recovery smoothing (for example via annual revaluations) should be included.

The interplay with the cost allocation IM, where assets are shared with non FFLAS services, will also need to be considered.

Q18 What are your views on our interpretation and proposed application of ss 176(2) and (2AA) for the calculation of financial losses?

As the Discussion Document recognises, LFC UFB providers have incurred financial losses since 2011 due to the UFB contract terms, and the progressive uptake of UFB services. We agree that 'accumulated unrecovered returns' on investment should be calculated by retrospectively applying a building blocks approach, using methods broadly consistent with those to be applied after implementation date.

In particular:

Q18a What is your view on any simplifying assumptions for the allocation of common capital and operating expenditure costs that should be applied?

We agree that the application of a principle-based approach to the retrospective application of the building blocks is reasonable, including in the allocation of opex and capex between regulated and unregulated services. The LFCs note that the cost sharing issue is not expected to be material as we do not own or operate copper networks.

Q18b What are your views on how the rate of return on investment and discount rate for the loss period should be calculated?

A retrospective building block approach to derive the financial loss component of the initial RAB involves calculating a return on investment building block. This will require cost of capital estimates which should be derived consistent with the cost of capital IM.

We agree that the financial losses should be aggregated to the implementation date with a time value of money adjustment, to derive a present value of the losses.

We provide further comment on the cost of capital IM in response to Q23 and Q24.

Q19 What preference do you have regarding the two methods outlined above for reflecting the actual costs of Crown financing, and why? What other methods could be used?

It is not possible at this stage to comment on a preferred approach to the financial loss estimation method, or how the Crown financing arrangements should be reflected. There is insufficient information available on the potential methods to be used to derive the building blocks, including tax treatment, the different funding arrangements of the fibre suppliers and the various elements of the cost of capital.

We are attracted to a simple method for the recognition of Crown financing arrangements, but only on the condition that this derives an accurate financial loss estimate consistent with the requirements of s176, by appropriately recognising all '*accumulated unrecovered returns on investment'* and the '*actual financing costs incurred by the provider'.*

The LFCs look forward to engaging with the Commission on this topic further as the IM consultation process progresses.

Q20 How should we consider the involvement of related parties to the funding arrangements (eg, LFC parent companies)?

Consistent with the legislation, the actual financing costs of the UFB provider should be reflected in the financial losses estimate, including the cost of any funding provided by related parties and any financing transaction costs.

Q21 Are there other approaches to allocating costs between regulated FFLAS services and other services that could be used? Are there features of suppliers or services that require particular consideration (eg, business structure, presence of other forms of economic regulation, accounting systems etc)?

For information disclosure purposes, each LFC should have flexibility to apply its own approach for allocating costs between regulated and unregulated services, and be required to disclose that approach under its ID obligations. This is consistent with a principle-based approach to the cost allocation IM. The approach has worked well for regulated energy suppliers under Part 4, as it accommodates different business structures and changes in the scope of regulated and unregulated services over time. Disclosures provide the necessary transparency of the allocations made, and the rationale for them, consistent with the principles set out in the IM.

As under Part 4, when determining the cost allocation IM, it is necessary to consider any consequential impacts on other markets in which fibre service providers participate.

Q22 What views do you have on whether an input methodology for allocating costs between different FFLAS services should be set for information disclosure and/or price-quality regulation?

There is no justification for extending the ID cost allocation IM to different types of FFLAS. Each LFC should have flexibility to apply its own approach for allocating costs across FFLAS services, and be required to disclose that approach under its ID obligations.

This is consistent with the Part 4 approach to regulation and the s187 information ID for FFLAS.

The obligation on the Commission to set maximum prices for certain services under PQ regulation does not extend to LFCs, as we will be subject to ID regulation only. Accordingly, the cost allocation IM does not need to extend to the service level for ID purposes.

The imposing of cost allocation rules at the service level under ID would have the effect of specifying the level of costs able to be recovered through prices for different FFLAS services under PQ regulation. This would be inconsistent with the policy intent, which is to not impose price limits on FFLAS supplied by the LFCs after implementation date.

Q23 What is your view on our proposal to use the Part 4 and UCLL/UBA FPP approach as the starting point when determining the cost of capital input methodologies for FFLAS?

We support using a weighted average cost of capital method to derive the cost of capital IM, and acknowledge that the simplified Brennan-Lally CAPM has features which reflect the New Zealand market, and therefore has widespread support in New Zealand.

However, there is significant work required to derive estimates of each of the parameters which are inputs to the CAPM. It is not acceptable for the Commission to simply rely on previous work in this respect (under Part 4 or the UCLL and UBA FFP determinations) as suggested in the Discussion Document.

The cost of capital estimate must reflect the characteristics of the FFLAS market. Because the risks faced by LFCs are greater than those faced by Chorus (as discussed in our General Observations), the traditional Part 4 approach of adopting a sector-specific asset beta is inappropriate. We therefore disagree with the Commission's suggested approach at 7.9 which would reduce incentives to invest, be contrary to the Government's Economic Policy Statement, and would not be in the best interests of end-users of FFLAS (s162) or end-users of telecommunications services generally (s166).

The cost of capital IM for ID is to be used to assess profitability. It can be expected that year on year profitability will vary, and therefore profitability performance will need to be viewed over time. A cost of capital range, similar to the Part 4 cost of capital IM for ID purposes, will be appropriate for this purpose.

Q24 What matters do you think will differ from the Part 4 approach, are novel for the regulated fibre sector, or will require re-estimation/a different approach? Should we re-estimate parameters that apply across sectors, such as the TAMRP?

As set out in our General Observations, the differences include:

(a) the competitive nature of the broadband access market compared with Part 4 markets which have little or no competition;

(b) the differing risk profiles of the FFLAS regulated entities, with one (Chorus) engaged in infrastructure-based competition with the others; and

(c) the Government Policy Statement which requires a focus on the risks faced by UFB investors.

Q25 What are your views on CEPA's advice on the approach to setting the quality dimensions input methodology?

Quality standards are relevant to PQ regulation only. Quality measures are relevant to ID regulation, and should be the focus of the quality IM for ID purposes.

It is important that quality measures are restricted to those over which fibre suppliers have control.

While we acknowledge the research completed by CEPA on international regulation on quality of wholesale fibre services, the regulatory frameworks in the countries which were surveyed have important differences to New Zealand. The practical application of the quality regulation appears to largely be via contract terms or agreed quality standards, neither of which is relevant to ID IMs.

The Commission states that it is considering a general 'customer service' dimension for quality regulation. Section 162(b) refers specifically to quality that reflects end-user demands. This suggests that quality dimensions should focus on those things that matter most to end-users, such as customer satisfaction, call centre performance, complaints handling etc.

LFCs currently disclose service and production performance using measures (including in relation to provisioning, availability, etc.) set out in Schedule 7 of the Commission's Information Disclosure Determination dated 28 June 2012[24] (**IDD**) made under s156AU of the Act. Additional information about network capacity and utilisation is disclosed under Schedule 8 of the IDD.

These measures should be used as a starting point for the ID IM.

Q26 What specific factors of the telecommunications environment do you think are relevant to setting input methodologies for quality dimensions?

The imposition of quality measures should involve a cost/benefit trade-off – i.e. what can be measured, in a cost effective way, which leverages existing systems and processes, and which is of value to end-users.

Quality measures should not impose costs on fibre providers for which end-users are not prepared to pay. They should be durable, as it is expected the standards will change over time as the market evolves.

Q27 What views do you have on the approach or processes that should be adopted for setting price-quality paths? For example:

N/A

Q27a Should a supplier be required to present a price-quality path proposal? What role would the Commission have in evaluating the proposal?

N/A

Q27b What historical or forecast information should be required and where should this information be sourced from? Should the information be subject to customer consultation and/or independent scrutiny or other verification?

N/A

Q27c Is there a role for a forecast total expenditure (totex) approach instead of requiring building blocks to be set with reference to capital and operating expenditure?

N/A

Q28 Do you have any views on additional incentive mechanisms (such as IRIS) that would be beneficial to consider including? (Note that the scope to include any additional mechanisms may be limited, given the time constraints we are under.)

N/A

Q29 For any additional input methodology-related issues you wish to raise, please explain:

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Q29a the nature of the issue;

Q29b the likely significance of the issue, when it will be likely to arise in practice, and whom would it affect;

Q29c what further information or analysis would be required to understand the issue; and

Q29d what potential solutions can be identified to resolve the issue?

LFCs do not wish to raise any additional issues at this early stage of the consultation process.

END