NEW REGULATORY FRAMEWORK FOR FIBRE

Cross-submission of Enable Networks and Ultrafast Fibre (LFCs)

31 January 2019

1. Introduction

1.1 This cross-submission on submissions in response to the Commerce Commission's *New regulatory framework for fibre* discussion paper (**Discussion Document**) is made on behalf of Enable Networks Limited (**Enable**) and Ultrafast Fibre Limited (**UFF**) (collectively referred to as **LFC**s).

1.2 We have focussed our attention on key issues raised in submissions. Silence on other issues raised by submitters does not necessarily signify that we agree with those submissions.

2. Purpose statement

2.1 A number of submitters assert that where there is a conflict between the purpose statement in section 162[1] and s166[2], s166 must prevail. As stated in our submission, LFCs do not agree. We agree with Chorus[3] that in the case of a conflict between s162 and s166, s162 must prevail, as it governs all of Part 6, including s166.

2.2 The reasons given by submitters who assert that s166 must take precedence include that "*promoting competition, where competition is possible, is expected to deliver better benefits to consumers than trying to replicate the outcomes of competition (the second best solution)*"[4], and that "*replicating competitive market outcomes can be expected to be inferior to actual competitive market outcomes*".[5]

2.3 They further argue that s166 "*is relevant to all elements of the Input Methodologies, and other aspects of the new regulatory regime*"[6], "*will likely be key to almost all parameter decisions*",[7] and must be applied "*to a wide range of Commission decisions*"[8]. According to Vodafone "*the promotion of workable competition is relevant in all cases where actual competition exists or there is potential for competition to exist*"[9], while Axiom states that s166 "*is likely to be a highly pertinent consideration a great deal of the time*".[10]

2.4 Spark submits that s166 provides "*a clear legislative direction for the Commission to also consider how its control of the regulated service will impact on competition for the benefit of end users of other (non-FFLS) services*"[11]. This, it argues requires the Commission when making decisions under Part 6 to "*consider whether further steps are required to promote competition in other markets (or prevent distortion of competition)*".[12]

2.5 According to Axiom "*the potential implications of its decisions on the deployment of and competition from 5G technologies may warrant particular careful scrutiny by the Commission*,"[13]

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[1] "To promote the long term benefit of end-users in markets for fibre fixed line access services by promoting outcomes that are consistent with outcomes produced in workably competitive markets".

[2] Decisions made under Part 6 must best give effect to the s162 purpose, and to the extent considered relevant, the promotion of workable competition in telecommunications markets for the long-term benefit of end-users of telecommunications services

[3] Chorus [94]

[4] 2degrees p.9

[5] Vocus [53]

[6] Above [55]

[7] Spark [39].

[8] 2degrees p.9

[9] Vodafone [3]

[10] Axiom p.13

[11] Spark [21a]

[12] Above [21b]

[13] Axiom p.15

while Vodafone submits that s166 requires that the Commission make decisions that "*enable other parties to compete against the fibre providers on a level playing field*".[14]

2.6 Spark submits that the Commission must make decisions which promote or prevent distortion of existing and likely future competition from competing technologies such as fixed wireless, 5G, and services which use FFLAS as inputs;[15] as a consequence it submits that "*limiting prices to recover the efficient costs of providing FLAS may not be sufficient to comply with s166(2)".*[16]

2.7 LFCs do not agree that s166 applies in this way. The purpose tests in s162 and s166 are not alternatives. The Commission is not required to choose between them. Any determination of the Commission that promotes competition in other markets, but does not promote the long-term benefit of end-users in FFLAS markets, would be contrary to the Part 6 purpose statement.

2.8 We agree with Chorus[17] that the Commission must, when it is considering broader competitive effects under s166, take account of the constraints imposed on LFCs by our contracts with the Crown, that restrict our ability to respond to competition from unregulated competing technologies.

3. Unbundling

3.1 Vodafone devotes a number of pages of its submission to unbundling of the fibre network. It submits "*the Commission must do all in its power to help make unbundling a commercial reality*",[18] "*an unbundling input methodology is essential*",[19] and that the unbundling IM must include "*how equivalence of inputs obligations apply to price*".[20]

3.2 According to Vodafone "*in the absence of any guidance from the Commission, it is unclear how the fibre providers must interpret the EOI requirement*"[21]. It attaches advice from James Every-Palmer that concludes that the EOI obligation "*requires the UFB provider to price the layer 1 service at a level which would allow the layer 2 services and prices to be replicated by an equally efficient rival*".[22] Vodafone describe this approach in its submission as an economic replicability test.[23]

3.3 The Vodafone unbundling submission is without merit because:

(a) The Part 6 unbundling obligations will not come into effect until 2025 at the earliest, so any unbundling IM would have no application for many years; and

(b) The IM would not apply to the unbundling obligations that come into effect on 1 January 2020 under Part 4AA of the Act. The Part 4AA regime does not include an IM regime. An unbundling IM made under Part 6 would apply only to services regulated under Part 6.

3.4 Furthermore, there is no lack of clarity about the equivalence obligations that apply to price under Part 4AA. Section 156AB is clear that the price charged by the service provider must be the same as the price charged to the service provider's own business operations.

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[14] Vodafone [4.1]

[15] Above

[16] Above

[17] Chorus [120]

[18] Vodafone [20]

[19] Above [27 - 30]

[20] Above [30]

[21] Above [31]

[22] James Every-Palmer, letter to Vodafone, 2 September 2018, [5a]

[23] Vodafone [32]

3.5 It follows that, of the three pricing models described by Vodafone, only one ("*cost based - where the bottom-up costs of Layer 1 are calculated*")[24] applies to Part 4AA. The "economic replicability test" discussed by James Every-Palmer is not a feature of the Part 4AA regime.

4. RAB

4.1 2degrees is critical[25] that losses suffered under the UFB contracts are to be included in the RAB, on the basis that "*Chorus and the LFCs bid for, and won, provision of UFB at a price that they considered was appropriate at the time. It is not the role of access seekers or end-users to compensate parties of commercially - agreed arrangements*"… "*The effect of these requirements is to transfer risk from Chorus to RSPs and end-users*".

4.2 The 2 degrees analysis omits the important fact that the counter-party to the Chorus and LFC contracts was the Crown, and that the contracts with the Crown dictated the design of the FTTP network. LFC's design and build obligations, timetable and operational conditions, and the requirement that no charge be made for connections to premises, were non-negotiable.

4.3 The arrangements with the Crown included that a new regulatory regime (the 2018 Amendment Act) would replace those contracts in 2020[26]. Contrary to 2degrees' and Spark's submissions[27], the legislation clearly contemplates that the actual costs incurred by LFCs in providing the UFB services under their respective contracts with the Crown be included in the RAB.

4.4 In relation to financial losses, we agree with Chorus[28] that the legislation points to a retrospective building blocks approach, including the actual financing costs incurred by each fibre supplier. This concept is usefully explored in some detail by Pat Duignan[29].

5. WACC

5.1 Vocus[30] and 2 degrees[31] both submit that the fibre WACC IM "*should be straightforward*" on the basis that the WACC adopted in the UCLL/UBA FPP process with a 50% percentile should simply be transferred to the fibre WACC IM.

5.2 LFCs have in their submission explained why the adoption of the FFP WACC is inappropriate for FFLAS, and agree with the submission by Pat Duignan which highlights the greater risks faced by investors in the UFB Initiative.

5.3 LFCs expect the Commission to determine a WACC (or WACC range as appropriate) consistent with the risks that fibre service providers face in the FFLAS market. This is consistent with the Purpose Statement and the FCM principle. As noted by Chorus[32] these risks will include, to the extent relevant, the risks of competitive substitution, such as demand and asset stranding risk associated with the greater competition in the telecommunications sector compared with industries regulated under Part 4.

5.4 Moreover, as Chorus[33] suggests, if there are residual risks that are not able to be adequately reflected in the WACC parameter estimates, then a percentile above the midpoint may be required. This may also be appropriate if there is significant uncertainty in estimating the appropriate cost of capital.

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[24] Above [32.2]

[25] 2degrees p.12

[26] Section 157AA, Telecommunications Act 2001

[27] Spark [88]

[28] Chorus [30 - 31]

[29] Pat Duignan, The determination of financial losses incurred in providing FFLAS under the UFB initiative.

[30] Vocus [40]

[31] 2degrees p.2

[32] Chorus [23]

[33] Above [32.2]

5.5 Some submitters have suggested that, unlike for electricity and gas distributors under Part 4 price-quality regulation, there should be no percentile on the WACC under Part 6[34]. This is because while electricity is an essential service, and the cost of outages for users is therefore significant, there are substitutes for fibre (such as mobile and fixed wireless services) and therefore reliability of supply is less important to users.

5.6 We do not agree, and note Chorus' submission[35] that users are demonstrating increasing reliance on fibre network services.

5.7 In addition, while the asymmetric impact on consumers of non-supply of electricity and gas was one of the reasons supporting the WACC percentile uplift under Part 4, it was not the only one. Other factors taken into consideration included the risk of under investment in other areas. For example:

> *'Erring on the high side is likely to be in consumers interests. Doing so reflects otherwise unquantified (or unquantifiable) factors that are likely to result in greater benefits to consumers in the long term, in terms of efficient investment and innovation that meets current and future consumers' demand at the quality they want'*[36].

5.1 Further, it is necessary to consider the wider regulatory incentives for suppliers to meet consumer demands for services. In its most recent assessments of the WACC percentile for Part 4 regulation, the Commission considered the role of quality regulation to incentivise suppliers to invest to meet consumer needs.

5.2 The Commission acknowledged that practice quality standards may not provide sufficient protection for consumers against under-investment, particularly as quality regulation is still developing and it may be expected that incentives improve over time. For example:

> '*Developing quality standards, to limit the opportunities to run down investment is difficult. As quality becomes better understood, for example through further information disclosure and summary and analysis, the incentives and controls on quality are likely to improve.*[37]

5.3 This is a relevant consideration for FFLAS services, where the quality regime is not yet established.

5.4 Uncertainty in estimating the true cost of capital is also a factor for consideration. For example Oxera, for the Commission, highlighted other factors not explicitly reflected in the WACC, such as the risk of model error, or incremental risks within regulatory periods around parameters such as the risk free rate.[38]

5.5 Spark[39] has also submitted that the information disclosure requirements for airports do not specify a WACC percentile uplift, and therefore none is required under Part 6. However, one of the key reasons for the airports decision is the dual till approach to regulation, which recognises that airports earn significant amounts of revenue from unregulated but complimentary activities.[40] These circumstances are not present for FFLAS services.

5.6 In addition, the WACC percentile decision is only one component of the regulatory framework, and cannot be assessed in isolation. As the Commission has previously stated:

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[34] Spark [121], Vodafone [78]

[35] Chorus [125.2]

[36] NZCC, Amendment to the WACC percentile for price-quality regulation for electricity lines services and gas pipeline services, Reasons Paper, 30 October 2014 [2.39]

[37] Above [3.25]

[38] Above [6.9.5]

[39] Spark [121 a.]

[40] NZCC, IM Review, Professor Yarrow report and emerging views on the airport WACC percentile, [16.2]

(a) *there are potentially complex interactions between investment, capital expenditure incentives, quality incentives, innovation and the uplift on WACC*[41]*;* and

(b) *the percentile was, and continues to be, the last decision made regarding the WACC (after reaching a view on all other parameters)*[42]*.*

5.7 It is therefore important that the Commission take into account all relevant considerations when determining the WACC parameters and percentiles for price-quality and information disclosure regulation.

6. Pricing principles IM

6.1 Spark[43] supported by Axiom[44] submit that a pricing principles IM should be determined, and that it should be prescriptive.

6.2 We note that unlike Part 4, s176 does not include pricing methodologies as matters to be covered by input methodologies. However, consistent with Part 4, they are listed in s187(2) as matters that may be required for information disclosure regulation.

6.3 In addition, Part 6 does not contemplate regulating the prices of those suppliers of FFLAS subject only to information disclosure regulation. This suggests that Parliament considered disclosure of pricing methodologies sufficient for Part 6 regulation. A pricing methodology IM is accordingly not consistent with the legislative intent for the Part 6 information disclosure regulation that will apply to LFCs.

6.4 For price-quality regulation, s194 specifies that the form of control in the initial price-quality determination for Chorus must be a revenue path and provides for maximum prices for specified services (eg: anchor services, direct fibre access services and unbundled fibre services) and other pricing constraints such as geographically consistent pricing. Price-quality regulation will provide significant regulatory oversight of these aspects of Chorus' pricing, and a pricing methodology IM is therefore not required.

6.5 A principle-based approach to pricing methodology disclosure, similar to Part 4, is appropriate and consistent with the legislative intent. Axiom[45] has questioned the effectiveness of principle-based pricing under Part 4, referring to reviews of transmission and distribution pricing undertaken by the Electricity Authority. However, the Electricity Authority's current review of the 2010 electricity distribution pricing principles and disclosure requirements does not contemplate moving away from principle-based regulation;[46] the review has in fact endorsed the principle-based approach. We note that it is appropriate to review regulatory settings from time to time, as the Electricity Authority is doing, to ensure they remain fit for purpose.

6.6 This principle-based approach has served the energy sector well, as pricing approaches have been able to adapt to changes in the market, including consumer needs, while retaining consistency with underlying principles that promote economic efficiency in pricing. A more prescriptive approach has the potential to restrict pricing responsiveness, which is inconsistent with competitive market outcomes.

6.7 Trustpower[47] submit that the IMs should include processes for amending price structures '*in response to changes in relevant markets and technologies'*. Consistent with the paragraphs above, LFCs consider pricing methodology disclosures, and standard contractual negotiations between fibre suppliers and their customers will adequately address this issue.

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[41] Above n.36 [3.28]

[42] Above [X23]

[43] Spark [74, 75]

[44] Axiom [3.2, 3.3, 4.3]

[45] Axiom [2.4]

[46] Electricity Authority, More efficient distribution prices, Consultation Paper, 11 December 2018

[47] Trustpower [2.1.5]

7. Cost allocation IM

7.1 Spark and Vodafone[48] submit that the cost allocation IM should be prescriptive. These submissions fail to recognise that the LFCs and Chorus have different operating models, business structures and asset bases. Only a principle-based allocation approach is able to determine effectively the boundaries between costs for FFLAS services and other services for multiple entities.

7.2 In addition, a principle-based approach is necessary to ensure that the cost allocation IM is able to endure for up to seven years (as envisaged by s181), in a market which is still developing. An overly prescriptive approach creates a high risk of unintended consequences and sub-optimal outcomes.

7.3 The principle-based approach has worked well under Part 4. The Commission endorsed this approach in its most recent review, despite considerable challenge from some parties. While the Commission refined the principles, and strengthened the transparency of the allocations made through information disclosure regulation, it retained the underlying principles.

7.4 In relation to the financial loss component of the RAB, Vodafone[49] has submitted that historical allocations of common costs should be minimal for an emerging business. We submit that LFCs should have the opportunity to recover common costs not recovered through other services during this period.

7.5 Further, the investment in common assets will be influenced by the range of services (including UFB) provided by a supplier. It is not appropriate to conclude that because assets provide UFB and other services, no part of their cost should be allocated to UFB.

7.6 Axiom[50] for Spark, and Frontier[51] for Vodafone, submit that the cost allocation IM should apply at the service level, including between layer 1 and layer 2. As LFCs are subject to information disclosure regulation only, and are not subject to service specific price regulation, this proposal is without merit.

7.7 It is important to draw a distinction between cost allocation and pricing methodologies. The disclosure of pricing methodologies will provide transparency as to how suppliers have determined their prices for different services, and the costs they are seeking to recover. This is currently a requirement of the pricing methodology disclosures under Part 4[52], and is consistent with the s185 purpose of information disclosure regulation.

7.8 Accordingly, the focus of the cost allocation IM should be on determining the boundary between regulated (FFLAS) and unregulated/other regulated services.

8. Timing

8.1 LFCs agree with Chorus[53] that there is merit in bringing forward the development of the ID regime between the draft and final stages of the IM development. This would allow sufficient time for LFCs to develop systems to comply with their ID requirements before the regime comes into effect.

8.2 The Commission should endeavour to carry over into the Part 6 IMs for ID and its s170 ID determinations for LFCs as much as possible of the information disclosure and annual reporting requirements, methodologies and reporting templates set out in the LFC Information Disclosure

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[48] Spark [109], Vodafone [48]

[49] Vodafone [53, 93]

[50] Axiom [p. 26]

[51] Frontier [5.1.2]

[52] Electricity Distribution Services Information Disclosure Determination, 2012 [2.4.3(4)]

[53] Chorus [76]

Determination 2012[54]. This will minimise the amount of work and cost required of LFCs to develop new systems to meet new disclosure requirements.

8.3 Based on more than 6 years' experience of the Part 4AA ID regime, LFCs consider that the existing requirements would require only minor modification to comply with s188. Most of the information required under Part 6 (listed in s188(2)) is included in reports that are already provided under the Part 4AA regime.

END

[54] NZCC 15, 28 June 2012