Draft Fibre Input Methodologies Determination

Submission to Commerce Commission

PUBLIC VERSION

28 February 2020

SUMMARY

1. Vocus agrees with the Commission on many elements of the new fibre regulatory regime, and Fibre Input Methodologies (IMs), including the interpretation of its statutory objective, the role of economic principles (with the addition of efficiency incentive and competition principles), adoption of the Part 4[1] WACC IM (with mid-point WACC[2]), Regulated Asset Base (RAB) indexing (following electricity distribution precedent, rather than Transpower precedent) and adoption of an ex ante approval process for base, connection and individual capex (with ex post approval of a variable connection component).

2. Conversely, there are also matters we are uneasy about.

3. Based on our experience with the operation of Part 4 Commerce Act, we consider the Commission has deviated too much from Part 4 IMs precedent on matters that are not industry or legislative specific.

4. While the Commission is erring towards principles-based Fibre IMs, which are much less prescriptive than the Part 4 IMs, we are concerned there are a substantive number of important elements the draft IMs are silent on.

5. For example, we are uncomfortable the Commission has not followed Part 4 precedent and specified Related Party Transactions in relation to the sale of goods and services are capped at a value no greater than if that transaction had the terms of an arm's-length transaction.

6. Similarly, the Fibre Capex IM should provide more direction in terms of the evidence required to justify capex proposals.

7. Even if the Commission considers that it should not prescribe an Investment Test, a principles-based Capex IM would at least require Chorus provide quantified net benefit analysis (including sensitivity analysis etc) to justify its proposals. The Part 4 Capex IM requires this. The draft Fibre Capex IM does not.

8. Vocus considers the Part 4 Capex IM provides sound precedent for consultation obligations. It is not clear why the Part 4 Capex IM requires Transpower to consult, but the Commission is not proposing to require Chorus to consult. We similarly are unclear why the Commission considers its own capex consultation should be limited to base and connection capex, with consultation on individual capex left discretionary. This is not explained and is inconsistent with Part 4 Capex IM precedent.

9. We feel the Commission is taking an unwarranted leap of faith in its statement: *"As Chorus is privately owned and faces some competitive threat from alternative technologies, we expect it to take a disciplined approach to developing its forecasts"*. As

[1] All references to Part 4 are references to Part 4 Commerce Act unless otherwise stated.
[2] We do not consider the statement *"Submissions on our emerging view were split"* to be accurate. No Access Seeker or end-user provided support for WACC above mid-point. Other than Chorus, the only parties that supported above mid-point WACC were ENA (we previously noted ENA's *"comments on WACC percentile should be seen as an attempt to relitigate Part 4 WACC decisions"*) and Austgralian investors (whom we noted *"mis-understand NZ WACC precedent" and all made homogeneous submissions which included "repetition of the same factual errors in each of the submissions"*). Reference: Vocus, Fibre regulation emerging views, Cross-submission to Commerce Commission, 31st July 2019, paragraphs 87 – 90.

Vodafone has noted *"Chorus have a history of over-forecasting whenever they get the opportunity"*.[3]

10. The risk of over-reliance on Chorus to provide information needed to set price and service quality needs to be managed; particularly given the tight time-frame for implementing the new fibre regulatory regime, the planned exclusion of Independent Verification from the first price determination process, and lack of historic Asset Management Plan disclosure. The experience with Chorus' TSO and TSLRIC calculations suggests Chorus will exploit the discretion it is being given, e.g. to select cost allocators/proxies for cost allocation/financial loss determination, to maximise its fibre revenues/profits.

11. We are also concerned the Commission's position on determination of financial losses (adoption of ABAA) and double-recovery from copper and fibre (not addressed) will 'lock-in' excessive profits into Chorus' fibre prices. The Commission should adopt an economic and orthodox approach to loss calculation, consistent with the previous TSO net cost determination requirements, and determine financial losses (if any) on an incremental or avoidable cost basis (effectively a reversal of the ACAM arrangements that were previously in place under Part 4 Commerce Act).

12. We reiterate *"The Commission should be careful to distinguish between the role of a cost allocation exercise for financial separation, and ensuring costs are fully allocated, and the role of determining financial losses (if any) Chorus' has incurred in provision of UFB"*.[4]

13. The Commission should not compensate Chorus for the prospect that development of competition may result in some of its assets being deregulated. In a workably competitive market there is no compensation for the possibility competition may impact recovery of investments. The Commission describes this as compensation for asset stranding risk but this appears to be a misnomer. Just because an asset is deregulated (need for regulation is removed) doesn't mean Chorus won't be able to recover its cost. As the Commission notes: *"Deregulation does not, by itself, strand assets. Competition does not necessarily preclude earning revenue and a normal return"*. Notably, where asssets are genuinely stranded, the Commission does not intend to remove them from the RAB: *"Setting up a system to identify and exclude all 'stranded' assets would be complicated, contentious and suffer from asymmetry of information"*.

[3] Vodafone, New regulatory framework for fibre: Submission on Fibre Regulation Emerging Views dated 16 July 2019, 18 July 2019, page 5.
[4] Vocus, Fibre regulation emerging views, Submission to Commerce Commission, 16th July 2019.

INTRODUCTION

14. Vocus welcomes the opportunity to submit in relation to the Commerce Commission's Draft Fibre Input Methodologies Determination, issued on 11 December 2019, and related material.

15. We preface our comments on the draft IMs with acknowledgement the Commission is having to manage a very restrictive timeframe to develop and implement the new fibre regulatory regime. It appears this is resulting in the Commission having to make less than ideal trade-offs and transition decisions e.g. exclusion of Independent Verification for the first price determination.

16. If you would like any further information about the topics in our submission or have any queries about this submission, please contact:

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PROCESS ISSUES

17. The extent to which we have been able to engage in the draft IMs consultation has been impacted by the Commission's decision to adopt an 'omnibus' consultation approach. The 'omnibus' approach has meant we have had to review a large amount of material within a relatively condensed timeframe. The delay in release of the draft Input Methodologies (IMs) has also impacted the extent to which we have been able to engage in the draft IMs consultation step.

18. We note we did not see value in participating in the Capex IM workshop as the draft IMs were only released the day before the workshop. This did not give us enough time to review the draft Capex IM.

PREPARING FOR THE 2ND REGULATORY PERIOD

19. There are a number of matters the Commission has left for consideration beyond the first regulatory period. Vocus would welcome clarification of the process the Commission intends to undertake for these types of matters.

20. For example, the Commission has commented that *"For the first regulatory period, our draft decision is that there will not be prescriptive cost allocation IM rules for allocating shared costs between different types of regulated FFLAS"*.

21. We are concerned by the comment that *"After the first regulatory period, both the regulated providers and we will have a better understanding of the shared use of assets between different types of regulated FFLAS. We can then consider whether more prescriptive rules should be set for allocating costs between different types of regulated*

FFLAS" [emphasis added]. This implies the matter of cost allocation between different types of regulated FFLAS may not be resolved until the 3rd regulatory period at the earliest. For the avoidance of doubt, we consider this matter should be resolved during the first regulatory period (at the latest) so any changes can take affect from the start of the 2nd regulatory period.

OPENING COMMENTS

22. Vocus recognises the Commission is not in the same situation in developing the Fibre IMs and regulatory regime under Part 6 Telecommunications Act[5] that it was in when it established the Part 4 Commerce Act IMs[6] and regulatory regime. The Commission now has the benefit of experience and hindsight. If the Commission had to do a green-fields development of the Part 4 regime we wouldn't necessarily expect it do things the same way again.

23. We interpret the Commission's approach of taking a more principles-based approach as a mix of pragmatism (given the time available to introduce the regime), learnings from Part 4 Commerce Act and consideration of industry specific circumstances.

24. Our view is that the pendulum has swung too far in favour of a principles-based approach over prescription. We are particularly concerned the approach the Commission has taken to the IMs has resulted in some substantial gaps (silence rather than principles-based regulation). There are elements of the Part 4 IMs which are not industry or legislative specific which we consider should be reflected into the Part 6 Fibre IMs but have not been (even with a principles-based version) e.g. Related Party Transactions in relation to provision of goods and services.

25. We also recognise the 'need to learn to walk, before you can run', and that the Part 6 fibre regulatory regime can and should evolve and develop over-time. We have seen this with incentive mechanisms under Part 4. For example, an Incremental Rolling Incentive Scheme (IRIS) was initially only applied to Transpower, before being applied to electricity distribution. Likewise, the Commission has introduced a tentative price-quality linkage for the most recent two electricity distribution price resets, with a cautious approach to the amount of revenue at risk.

26. The limited timeframe for introduction of the Part 6 fibre regime, and the short, 3-year, period for the first price determination helps support taking an initial approach which focuses ensuring price is set at an appropriate level (limiting excessive profits) with 'bells and whistles' such as incentive mechanisms considered as part of future price determinations.

[5] All references to Part 6 are references to Part 6 Telecommunications Act unless otherwise stated.
[6] All references to Part 4 are references to Part 4 Commerce Act unless otherwise stated.

MATTERS VOCUS IS UNEASY ABOUT

27. There are a number of material elements with the approach the Commission is taking to the development of the IMs and overall fibre regulatory regime we are uncomfortable with. We have some reservations whether the purpose to promote competition and the long-term interests (benefit) of end-users will be meet as well as they could:

(i) **Based on our experience with the operation of Part 4 Commerce Act, we feel the Commission has deviated too much from Part 4 IMs precedent on some matters which are not industry or legislative specific.** We detail below the example of Related Party Transactions in relation to the sale of goods and services which under Part 4 is required to be capped at a value no greater than if that transaction had the terms of an arm's-length transaction. We see no equivalent safeguards in the proposed Fibre IMs.

(ii) **The Fibre Capex IM should provide more direction in terms of the type of evidence required to be provided to justify Capex IM proposals:** We acknowledge the Commission is reluctant to follow the Part 4 Capex IM precedent and prescribe an Investment Test methodology in the Fibre Capex IM. However, the approach the Commission has taken in the fibre Capex IM has gone much further than simply adopting a principles-based approach rather than a precriptive IM. As it stands, Vocus considers that Chorus will be provided too much discretion over the evidence to justify any particular capex proposal.

A principles-based Capex IM would still reasonably be expected to specify Chorus is required to undertake Cost Benefit Analysis, including quantification of the net expected benefits from its capex proposals.[7] We would also expect a principles-based approach to require sensitivity analysis and evidence of consideration and evaluation of alternative options.

Our general view is that the minimum information requirements for capex proposals should direct Chorus to provide more information than is currently proposed. For example, while we acknowledge some of the Commission's *"Assessment factors"* would be more or less important depending on the nature of any specific capex proposal, we consider they should all be included as part of the minimum information requirements. Where Chorus considers a particular assessment factor has limited or no relevance it should be required to detail why it considers this to be the case.

(iii) **The Part 4 Capex IM provides sound precedent for consultation obligations:** It is not clear why the Part 4 Capex IM requires Transpower to consult, but the Commission is not proposing to impose any similar requirements on Chorus.

We are also unclear why the Commission considers its own consultation should be limited to base and connection capex, with consultation on individual capex left discretionary. This is not explained and is inconsistent with Part 4 Capex IM

[7] E.g. as required by clause 3.2.1, subpart 2, part 3 of the Transpower Capital Expenditure Input Methodology Determination 2012 (Principal Determination).

precedent which has the same consultation requirements for all capex types (base and major capex).

(iv) **The risk of over-reliance on Chorus needs to be managed**; particularly given the tight time-frame for implementing the new fibre regulatory regime, the planned exclusion of Independent Verification from the first price determination process, and lack of historic Asset Management Plan disclosure. A challenge for the Commission will be to ensure it is not overly reliant on Chorus for information on costs etc required for the price-quality path determination.

(v) **Chorus' incentives will be to select cost allocators/proxies which will help maximise its fibre service revenues/profits:** Vocus remains concerned elements of the proposals could result in restrictions on excessive profits being weaker than they should.

As an example, the discretion Chorus is being afforded to determine allocators/proxy allocators in relation to cost allocation for financial separation and financial loss determination purposes will naturally lead Chorus to select allocators which will maximise its profits (raise the amount of costs allocated to the fibre business). Where there is a shared cost between the copper business (with locked in Final Pricing Principle prices) and fibre (where prices depend on cost allocation) Chorus' incentives will be to select allocators which result in a higher allocation to the fibre business.

At the very least, Chorus should be required to disclose details of the financial impact of different allocator options so the Commission (and stakeholders) can scrutinise whether Chorus' proposed choices are appropriate and should be adopted in the Commission's determinations.[8]

(vi) **Determination of financial losses on an ABAA basis would result in over-allocation of common costs and windfall gains for Chorus:** The Commission has not provided any sound basis for rejecting calculation of financial losses on an incremental or avoidable cost basis. The draft Reasons Paper provides limited engagement with the previous submissions on this matter.

We reiterate *"Any common or shared costs included in the financial loss calculation would result in overstatement of financial losses and excessive profits. The excessive profits would be a pure windfall gain for Chorus and NOT a reward for innovation or efficiency gains. It would be a straight wealth transfer from consumers to Chorus with no compensating benefit to consumers"*.[9]

(vii) **The Commission has not provided new or sound basis for applying ABAA for determination of financial losses:** The Commission seems to assume the

[8] We note Axiom has suggested Chorus be required to produce a "Cost Allocation Statement" which would be reviewed and approved by the Commission. This is an option that could be worth considering; particularly if the disclosure requirements included details of the impact of different allocator/proxy options.
[9] Vocus, Fibre regulation emerging views, Cross-submission to Commerce Commission, 31st July 2019.

reasons for applying ABAA for financial separation purposes can also be applied to use of ABAA for financial loss purposes. We respectfully disagree.

By way of simple illustration, one of the reasons the High Court identified for preferring use of ABAA over ACAM for financial separation purposes is that use of ACAM results in over-allocation of common costs to the regulated business. This argument is only relevant if the regulated business is being treated as the 'stand-alone business' and not the incremental or avoidable business.

In the case of determining any financial losses the fibre or UFB business may have incurred, the objections the High Court raised would apply to ABAA not ACAM i.e. ABAA would result in over-allocation of common costs to the regulated business to the detriment of end-users.

(viii) **Double-recovery of costs between copper and fibre services:** Vocus remains of the view that the Commission should address double-recovery between copper and fibre and failure to do so would result in Chorus obtaining (unquantified) excessive profits. We note, in particular, Chorus' admission that *"The sharing of assets is substantial"*.[10]

Vocus and Spark provided some suggested guidance in relation to ensuring double-recovery is avoided or minimised. The Commission has not engaged in response to these submissions.

(ix) **Proposed lack of Independent Verification for the first price determination creates risk:** We are uncertain about the Commission's view that Independent Verification isn't feasible for the first price determination. Chorus suggested *"tailored"* verification could be undertaken for *"a material subset and range of our capex programmes"*.[11]

If there isn't time for Independent Verification it is unclear Chorus' proposals will be properly scrutinised for the first regulatory period. While the Commerce Commission has provided for the possibility of seeking its own advice on the matter this would also take time and the Commission has not committed to the step. At best, the Commission considers that seeking its *"own external expert opinion of Chorus' base capex proposal for the first regulatory period … may help address concerns about not having an independent verification report for the first regulatory period"* [emphasis added].[12]

(x) The Commission's asset stranding proposals would provide uplift to Chorus, while allowing Chorus to retain stranded assets in the Regulated Asset Base (RAB). The Commission should not compensate Chorus for the prospect that development of competition may result in some of its assets being deregulated. In a workably

[10] Chorus, Submission in response to the Commerce Commission's fibre regulation emerging views dated 21 May 2019, 16 July 2019, paragraph 117.1.
[11] Chorus, Submission in response to the Commerce Commission's fibre regulation emerging views dated 21 May 2019, 16 July 2019, paragraph 119.
[12] https://comcom.govt.nz/__data/assets/pdf_file/0034/197692/Chorus-Capex-IM-workshop-Clarification-questions-regarding-our-draft-decisions-and-our-responses-12-December-2019.pdf

competitive market there is no compensation for the possibility competition may impact on recovery of investments. The Commission describes this as compensation for asset stranding risk but this appears to be a misnomer. Just because an asset is deregulated (need for regulation is removed) doesn't mean Chorus won't be able to recover its cost. As the Commission notes: *"Deregulation does not, by itself, strand assets. Competition does not necessarily preclude earning revenue and a normal return"*. Notably, where assets are genuinely stranded, the Commission does not intend to remove them from the RAB: *"Setting up a system to identify and exclude all 'stranded' assets would be complicated, contentious and suffer from asymmetry of information"*.

The proposals provide an allowance for asset stranding risk, but omit any mechanism for removing stranded assets from Chorus' RAB. This would result in Chorus being both compensated for asset stranding risk and also insulated from asset stranding risk as stranded assets would remain in its RAB and be able to be recovered from non-stranded assets.

The Commission has noted that *"When we have applied judgement to estimating the asset stranding risk, we have exercised caution and consider that the onus should be on regulated providers to demonstrate why the compensation should be higher. To date we have received little pertinent evidence"*. We do not consider the Commission has gone far enough. The onus shouldn't just be on Chorus to provide evidence *"the compensation should be higher"*. The onus should be on Chorus to provide evidence compensation is needed at all.

RELEVANCE AND APPLICATION OF PART 4

28. Vocus agrees with the Commission's observations that: *"Parliament made a deliberate decision to base the regulatory model in Part 6 on the existing model in Part 4. Some of the key provisions in Part 6, including the purpose statement in s 162, are based on corresponding provisions in Part 4"* and *"We must always consider the specific characteristics of the telecommunications market and respect the particular structure and language of Part 6. Nevertheless, to develop and implement the new regulatory regime for Part 6, in addition to our experience of telecommunications regulation, we are able to draw on our experience of regulation under Part 4"*.

29. With respect though, we are not persuaded the Commission has drawn on the Part 4 IMs precedent to the extent to which it should or that it would be in end-users interests to do so. While we have previously indicated the Commission has done a reasonably good job at being transparent about the consistency/deviations from Part 4 precedent which we appreciate, we do not feel this is the case in relation to the differences between the Part 4 IMs and the draft Fibre IMs.

30. The time available between release of the draft Fibre IMs and the submission due date has meant we have only been able to do a cursory comparison of the Part 4 IMs with the

draft Fibre IMs. Based on this comparison, it isn't clear why the Commission hasn't drawn on the Part 4 IMs precedent more heavily.

31. One example we found is in relation to related parties. While the Fibre IMs requires *"arm's-length transactions"* where Chorus acquires a core fibre asset through a Related Party Transaction, and the provisions mirror Part 4 equivalent precedent, the draft Fibre IMs are entirely silent in relation to related party provision of goods or services. We can see no apparent reason why the following provisions from the electricity distribution IMs[13] should not be applied to the Fibre IMs.[14]

D12 Related parties

(1) Identify and describe all **related parties** in respect of whom costs are disclosed for the last **disclosure year** of the **current period**, and relationships with those **related parties**.

(2) Describe, at an aggregate level, the-

(a) nature of the **services** undertaken by all **related parties** in the last year of the **current period**; and

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(b) processes for procuring **services** undertaken by **related parties**, or by anticipated **related parties**, during the last year of the **current period** and the **assessment period**.

(3) For **services** identified in subclause (2), describe-

(a) whether similar **services** are expected to be provided by **related parties**, or by anticipated **related parties**, during the **next period**;

(b) whether any additional **services** are expected to be provided by **related parties**, or by anticipated **related parties**, during the **CPP regulatory period**; and

(c) the basis for establishing the **related party** transaction values for the purpose of the **capex forecast** and the **opex forecast**.

(4) Describe the nature of the contract for any periodic **services**, including the duration of any such contract.

(5) For each **service** identified in accordance with subclause (2), provide an example of-

(a) any tendering process used to procure the **service**;

(b) relevant documents used to tender for the provision of the **service**, including, but not limited to, requests for tender, and tender submissions;

(c) explain-

(i) whether the **service** procured are provided under a discrete contract or provided as part of a broader operational contract (or similar); and

(ii) whether the **service** was procured on a genuinely competitive basis and if not, why not; and

(d) methodologies, consultants' reports, or **key assumptions** used to determine components of the costs included in the contract price.

32. This omission seems somewhat surprising given the attention the matter of Related Party Transactions received in the statutory review of the Part 4 IMs and electricity retailer concerns that the existing Related Party Transaction provisions were too loose and could

[13] Commerce Commission, Electricity Distribution Services Input Methodologies Determination 2012, 31 January 2019.
[14] The following section provides additional examples from the Transpower Capex IM.

provide regulated suppliers with opportunities to inflate their regulated network costs, and to adversely impact on potential competition. The issues that were raised by electricity retailers would seem equally applicable to Chorus and the fibre regulatory regime.

33. We also consider that elements of the Part 4 Information Disclosure regime in respect of Related Party Transactions would better sit in the IMs, both in relation to the Part 4 Commerce Act IMs and the Part 6 Telecommunications Act IMs. This would be consistent with our view that *"As a general principle, regulatory processes and rules should be prescribed in the IM unless it would be desirable for the Commission to have flexibility to enable different approaches to be taken at each reset"*.[15]

34. For example, the following rules requiring the value of goods and services acquired in a Related Party Transaction be set as if the transaction had occurred on an arm's-length basis is a rule that should be enduring and should be included in the IMs:

Related party transactions

2.3.6 For the purpose of clause 2.3.1, the value of a good or service acquired in a **related party transaction**, or the amount received for the sale or supply of assets or goods or services in a **related party transaction**, must be set on the basis that-

(1) the value of a good or service acquired in the **related party transaction** must be given a value not greater than if that transaction had the terms of an **arm's-length transaction**;

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Electricity Distribution Information Disclosure Determination 2012 (consolidated April 2018)

(2) the value of an asset or good or service sold or supplied in the **related party transaction** must be given a value not less than if that transaction had the terms of an **arm's-length transaction**;

(3) an objective and independent measure must be used in determining the terms of an **arm's-length transaction** for the purpose of subclauses (1) and (2); and

(4) for the purpose of subclause (1), where a good or service is acquired in the **related party transaction**, the value of the good or service must not exceed the actual amount charged to the **EDB** by the **related party**.

SETTING SERVICE QUALITY TARGETS WILL BE AN IMPORTANT ELEMENT OF THE PRICE DETERMINATION

35. Service-quality setting is an essential part of any price control regime.

[15] Vocus, Fibre Input Methodologies – Regulatory processes and rules, Submission to Commerce Commission, 9th September 2019.

36. We agree with the Commission's comments, in relation to Part 4 price determinations, that: *"… quality standards … are a crucial part of promoting the purpose of Part 4 of the Act. Most directly, they are important for ensuring distributors have incentives to provide services at a quality that reflects consumer demands. However (given distributors' revenues are constrained by the price path), quality standards are also important for ensuring distributors have incentives to invest, and are constrained in their ability to earn excessive profits".*[16] These comments are equally valid in relation to telecommunications and fibre regulation under Part 6 Telecommunications Act.

37. The appropriate service quality requirements, both in terms of the types of measures and targets that may be set, is something which will change and develop over-time, in line with changing end-user preferences etc. There isn't the same scope to 'lock-in' service quality into the Quality Dimensions IM as there is for WACC in the WACC IM (where the main moving part is the risk-free rate).

38. We consider the main focus of the Quality Dimensions IM should be to help ensure a broad range of service quality dimensions can be captured in both the service quality measures used for Information Disclosure and targets for the price determination. The Quality Dimensions IM should also align with the principles that there should be no degradation of service quality, and supply of fibre fixed line access services should be of a quality that reflects end-user demands (consistent with section 162(c) of the Telecommunications Act).

39. The Commission should aim capture service quality measures and targets for each of the seven elements reflected in the draft Quality Dimensions IM. We anticipate the Commission will face similar challenges to those it encountered when it attempted to broaden the range of service quality measures and targets applied to electricity distribution under the 2020 Default Price-Quality Path reset.

40. Where the Commission has problems determining appropriate targets, based on lack of current and historic data on service quality, we recommend the Commission: (i) adopt a 'non-degradation' service requirement, and require that Chorus discloses evidence on the extent to which it has meet this requirement (or under/over-achieved); and (ii) require disclosure of performance against the service quality measures to help inform the setting of service quality targets for future price determinations.

41. We also consider that the Commission should apply a general disclosure requirement on Chorus to provide evidence of what it has done to determine the service levels for fibre fixed line access services which would reflect end-user demands (consistent with section 162(c) of the Telecommunications Act), as well as details of Chorus' findings in terms of the service quality that would reflect end-users demands.

[16] Commerce Commission, Reasons Paper, Default price-quality paths for electricity distribution businesses from 1 April 2020 – Draft decision, 29 May 2019, paragraph 7.14.