Chorus' price-quality path from 1 January 2022 – Draft decision Reasons paper

Commerce Commission Consultation

2degrees submission, 8 July 2021

Introduction

2degrees welcomes the opportunity to submit in response to the Commerce Commission's Reasons Paper "*Chorus' price-quality path from 1 January 2022 – Draft decision*", 27 May 2021.

The below sets out high-level views given the substantial volume of materials to review, the time and resources available.

The Commission faces challenges and difficulties arising from a truncated timeframe for implementing the new regime

2degrees recognises the Commission has, and continues to face, substantial challenges in establishing the new fibre Part 6 regime, and making the first price-quality path (PQP1) determination for 1 January 2022.

The approach of adopting a transitional Regulatory Asset Base (RAB) value for PQP1 is a pragmatic and prudent way of mitigating some of the challenges and difficulties arising from the truncated implementation period. The RAB value is particularly important given that if the Commission gets it wrong it will lock in excessive returns, to the detriment of end-users, for many years and multiple regulatory periods.

The challenges the Commission is facing have been made more challenging with attempts to effectively relitigate issues such as the WACC Input Methodology (IM) and the exclusion of ACAM and OVABAA cost allocation methodologies. The latter cost allocation issues appear to have permeated Chorus' expenditure proposal (with the Commission and RSP submissions identifying evidence of excess allocation of costs to the FFLAS business) and Chorus' 'ACAM-lite' RAB "submission".[1]

Chorus' expenditure proposal and RAB proposal appear to reflect a realisation of the concerns 2degrees and other RSPs have expressed, throughout the process for developing the new fibre regime, about relying on non-prescriptive, principles-based IMs, and Chorus' history of submitting inflated cost (TSLRIC) and financial loss (TSO) estimates.

One of the problems the Commission faces, unlike with the TSLRIC or TSO determinations, is that it has a hard deadline for the first determination which doesn't afford it the time it had to resolve the issues with Chorus' TSLRIC expenditure and TSO financial loss calculations. These time constraints would be made substantially worse, and prevent the Commission from establishing robust PQP determinations, if Chorus' position on setting the initial RAB value were accepted.[2]

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[1] 2degrees, Commerce Commission Fibre Price-Quality Regulation: Consultation on Chorus' initial price quality RAB proposal, 28 May 2021.
[2] Chorus, Amendments to the Input Methodologies for Fibre August 2021 amendments, 24 June 2021.

Chorus appears to also be engaging in a debate over whether the RAB value(s) it provided to the Commission is a "submission" or a "proposal". Ultimately, whether the regulated supplier proposal model will work successfully, in the way it has under Part 4 of the Commerce Act, depends on whether the supplier engages in good-faith with the process. We have previously commented on the extent to which the Commission has been able to rely on Transpower's IPP proposals, and the CPP proposals of Orion, Powerco and Wellington Electricity, and the extent to which its DPP determination reflects that the Commission has generally been able to rely on regulated supplier opex and capex forecasts.[3]

2degrees supports the staggering of the decisions on cost allocation and the RAB

We support the approach the Commission is adopting of separating out cost allocation and the RAB from other aspects of the draft PQP consultation. There are substantial inter-related issues with Chorus' cost allocation and RAB that the Commission will need to address, including potential substantial over allocation of costs and assets (including shared assets) to the fibre business.

Chorus' RAB submission confirms over-allocation issues

Chorus has been clear – for example in its fibre RAB submission - that it considers allocation on a stand-alone cost basis (i.e. ACAM) is appropriate and somehow considers it to be consistent with the IMs and ABAA. This approach is also evident in its expenditure proposals. The Commission has noted "Chorus has combined its approach to allocating costs for its expenditure proposal with its cost allocation modelling for the fixed loss asset and initial RAB valuations".

Just because the Commission rejected the adoption of ACAM with the FFLAS business treated as the incremental business, for the purpose of calculating the value of the Financial Loss Asset (FLA), it doesn't follow that Chorus can adopt ACAM with the FFLAS business treated as the stand-alone business.

Chorus claims a stand-alone cost RAB best meets the requirements of the Telecommunications Act and the IMs; notwithstanding that ACAM is specifically excluded under the IMs and the IMs require an ABAA method to be adopted. This is reflected in their view 100% of various shared assets should be allocated to the fibre business, which conflicts with ABAA. It is a concern that Chorus views this as "permitted by the IMs".

We do not agree that the UFB initiative "required" Chorus to establish itself as a standalone fibre business – there are clearly other services within the Chorus business (e.g. copper), and this confuses the separation of wholesale versus retail, rather than separation of fibre. It is reasonable to expect that Chorus' view on

[3] 2degrees, Cross-submission on Commerce Commission Fibre Regulation Emerging Views Paper, 31 July 2019.

standalone cost is reflected in Chorus' PQP proposal, which is consistent with the concerns raised by the Commission and RSPs such as Spark in their submissions on Chorus' PQP proposal.

A significant amount of work will be required to disentangle Chorus' proposals and information it has provided to ensure the Commission does not adopt an inflated RAB and expenditure allowance.

We reiterate, "The Commission will need to be careful to ensure Chorus' fibre RAB/costs are not inflated (and its profits are not masked), by:

- Allocating copper assets and costs, including stranded copper assets, which have limited value to fibre, to the fibre business; and/or
- Allocating assets and costs from competitive market services to the fibre business (which would raise s 166(2)(b) issues)."[4]

Spark and others have similarly warned the Commission will need to be careful to ensure Chorus' fibre RAB/costs are not inflated: "The High Court observed that there is little or no impact to beneficial consumer outcomes from increasing the value of the initial RAB, but "what initial RAB values do have a direct impact on is the extent to which suppliers are limited in their ability to extract excessive profits." Accordingly, "an initial RAB value would, in our view therefore, be fundamentally flawed if it generated prices that were inconsistent with the achievement of the s 52A(1) purpose and outcomes, in particular if it failed to limit suppliers' ability to extract excessive profits over time.""

Chorus' expenditure proposal lacks transparency afforded under Part 4 of the Commerce Act

As a rule of thumb, material Transpower and other regulated suppliers operating under Part 4 of the Commerce Act provide, or are required to disclose, and information Chorus and other LFCs will be required to disclose under Part 6 Information Disclosure, should not be treated as confidential in the draft PQP1 determination.

The amount of information that has been treated confidential in the draft PQP extends well beyond Part 4 precedent and limits the extent to which stakeholders can engage with the consultation, or comment on the reasonableness of forecast demand and expenditure.

While we recognise the industry is going through a transition to the new Part 6 regime, one of the aspects we are concerned about is the treatment of key elements

[4] 2degrees, Submission in response to the Commerce Commission's proposed approach on the new regulatory framework for fibre, 18 December 2018.

(particularly cost allocation) of the expenditure proposal and draft decision as confidential.

We appreciate the reversals to some of the redactions in the 16 June update of the consultation paper. For example, the following was clearly not confidential and should never have been treated as such:[5]

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4.169 Chorus reversed the stretch efficiency reduction in the expenditure proposal and added it back into the expenditure forecast as a 5-year plan variance, while not accounting for any of the over forecasting in its proposal. These amounts total to at least 5% of the proposed capex. We consider that the reductions in the five-year plan are appropriate for PQP1. Our decision has been supported by an assessment for Chorus' track-record between historical forecasts and actual capex.

4.170 Therefore, we have proposed to make an overall adjustment to the base capex allowance of 5%[180] or $28.2m[181] of the proposed expenditure to reflect over-forecasts in Chorus' proposal.

We have previously raised concern “There is significant and material risk that Chorus will over-forecast its opex and capex requirements”[6] but confidentiality restrictions mean stakeholders cannot properly test the extent to which these are concerns are reflected in Chorus’ proposal and the draft decision.

At the workshop on Chorus’ expenditure proposals 2degrees noted concerns about the extent to which Chorus was relying on claims about confidentiality of expenditure related information. These concerns have been realised in the draft PQP decision, for example, exclusion of information on forecast capex for 2025, forecasts of opex for 2020 to 2026, forecasts of demand/connects during the regulatory period and asset maturity.

We note while Chorus’ expenditure forecasts beyond PQP1 have been treated as confidential, this is out of step with Transpower IPP engagement, and Part 4 Asset Management Plan disclosure.[7] By way of illustration, Transpower’s expenditure proposals (and consultation) included the following:

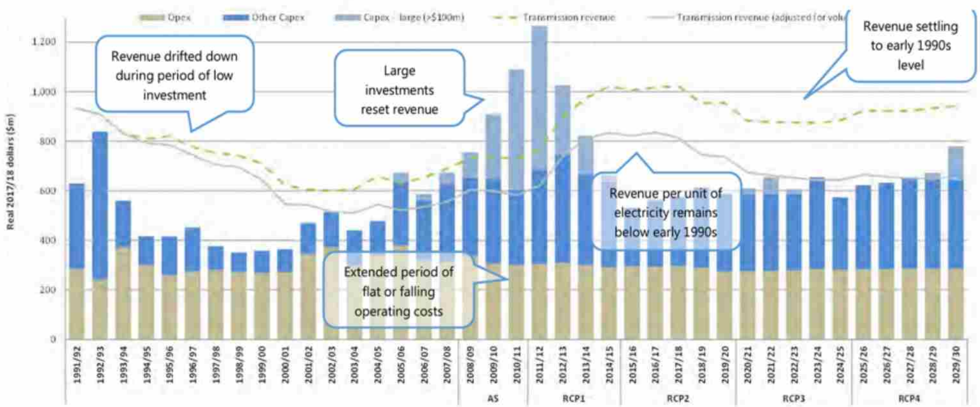
[5] The Commission also acknowledged that “The more recent December 2020 MBIE forecasts expect a reduction of [ ] from the 2019 forecasts” should not be treated as confidential in its technical workshop, but we are concerned it is symptomatic of undue conservatism about what is and is not confidential .

[6] E.g. 2degrees, Commerce Commission Fibre Input Methodologies, Cross-submission, 17 February 2020.

[7] The Chorus’ Asset Management Policy is of limited use and needs to be a companion to a full asset management plan e.g. from Transpower’s most recent RCP3 proposal: https://www.transpower.co.nz/sites/default/files/uncontrolled_docs/Asset%20Management%20Plan%202018%20-%20FINAL.pdf

Appendix 3 – Long-term trends

Given the long lives of transmission assets, it is useful to put the coming decade into perspective by looking at the longer-term transmission revenue path. Given the long timeframe, the following chart uses real prices (i.e. adjusts figures to remove inflation).



Assumptions

Demand growth (1.9% in 18/19 and then averages 1.1% in RCP3 & RCP4).

CPI (1.8% 18/19, 1.9% 19/20 at 2.0% to the end of RCP4) – this is used to discount to real $.

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Transpower has also been clear that its view of the future has implications for how its plans for and maintains the National Grid (including in the immediate PQP).

While Chorus has responded that it was uneasy about the quality of the forecasts, we see this as more of a reason to include qualifications with the forecasts rather than to withhold the forecasts altogether. It also highlights the importance of testing the forecasts in years 1, 2 and 3 of PQP1.

We also note information relating to asset management planning and maturity is required to be released under Part 4 Commerce Act Information Disclosure. This contrasts with the approach taken under Part 6 of the Telecommunications Act, where the same information has been withheld. It is clear scrutiny is important, with the Commission commenting: “Based on our own analysis alongside the observations from the AMCL report, we consider it is unlikely that the proposed expenditure is forecast at an efficient level. Therefore, we consider there is potential to further reduce the allowances to reflect more efficient outcomes. We have done this through targeted analysis of specific expenditure categories and the application of an overall adjustment to the allowances”.

The importance of scrutiny of Chorus' expenditure proposals is heightened by shareholder statements about whether Chorus will continue to invest

L1 Capital, one of Chorus' largest shareholders, most recent submission includes statements such as "there is no reason for Chorus and its shareholders to contribute any further investment to the regulated fibre services" and "L1 does not believe that there are incentives today for Chorus to invest in the fibre network and private investors are being taken advantage of through a punitive regulatory regime" .

This highlights it is important, in assessing and approving Chorus' expenditure and capex proposals, that the Commission has surety the intended expenditure will go ahead in light of comments like this, which indicate expectations that are removed from investor expectations and the Commission's draft decision.

The Commission's decisions on the Aurora CPP also provide relevant precedent for managing these kinds of risk and threats. 2degrees considers the Commission could adopt additional reporting measures that would require Chorus to provide a yearly report on its progress on delivering its investment plan, present this report to customers directly, and include additional reporting on service quality at a regionalised level to help identify issues of under-investment etc.

The Part 4 IMs Merit Appeal provides useful guidance in relation to the statutory objective and workable competition

The Commission has appropriately noted the guidance from the Part 4 IMs Merit Appeal decision in its discussion under "Mandatory decision-making considerations that apply for our first PQ determination". The clear emphasis of the High Court is that workably competitive market outcomes include constraint on the level of excessive or supranormal profits e.g.:[8]

> "A workably competitive market is one that provides outcomes that are reasonably close to those found in strongly competitive markets. Such outcomes are summarised in economic terminology by the term economic efficiency" with its familiar components: technical efficiency, allocative efficiency and dynamic efficiency. Closely associated with the idea of efficiency is the condition that prices reflect efficient costs (including the cost of capital, and thus a reasonable level of profit).
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> "… In a workably competitive market no firm has significant market power and consequently prices are not too much or for too long significantly above costs.
>
> "… workably competitive markets have a tendency towards generating certain outcomes. These outcomes include the earning by firms of normal rates of return, and the existence of prices that reflect such normal rates of return, after covering the firms' efficient costs.

[8] WELLINGTON INTERNATIONAL AIRPORT LTD & ORS v COMMERCE COMMISSION [2013] NZHC [11 December 2013], paragraphs [14] – [22].

"The same tendencies towards prices based on efficient costs and reasonable rates of return will lead also to improved efficiency, provision of services reflecting consumer demands, sharing of the benefits of efficiency gains with consumers, and limited ability to extract excessive profits.

"In short, the tendencies in workably competitive markets will be towards the outcomes produced in strongly competitive markets. The process of rivalry is what creates incentives for efficient investment, for innovation, and for improved efficiency. The process of rivalry prevents the keeping of all the gains of improved efficiency from consumers, and similarly limits the ability to extract excessive profits."

Regulatory certainty will develop over-time

We agree with the Commission that certainty will develop "progressively" with "more certainty" provided "as we move through the process to November 2021, when most of the key building blocks will come together as an integrated package of measures". We also agree "Further certainty will come with more time and experience of the new regime – just as it did for the other sectors that are subject to building blocks regulation – along with the greater stability and predictability this form of regulation provides".

This accords with the comments we have made, in various submissions through the development of the new fibre Part 6 regime, that, "Regulatory certainty can mean certainty about regulatory processes (an input) rather than an outcome".

It is important to understand the drivers for service quality

Service quality was a substantive omission from the Chorus proposals.

The reasonable expectation of Chorus' customers and end-users is that service quality will remain stable/improve over-time. It is difficult to meaningfully assess the extent to which the Commission should accept Chorus' expenditure proposals absent information on its relationship with service quality, and the assumptions Chorus is making about its expenditure plans and service quality.[9]

By way of example, the Commission noted "Chorus has included expenditure for asset management improvement within its base capex proposal" but no information is publicly provided on what this should mean for service quality outcomes.

Some of these interrelationships will span regulatory control periods (RCPs) beyond RCP1, e.g. some of the proposed expenditure will presumably impact service quality in subsequent RCPs, and over the medium to long-term. Likewise, given the relatively young age of the fibre network some of the expenditure needed to maintain the network and preserve the fibre network won't be needed until subsequent RCPs (presumably resulting in lower expenditure in the first regulatory period for some expenditure items, and potentially higher expenditure in subsequent regulatory

[9] See, for example, the sections Performance Standard, Service Quality Balance and Appendix 5 in Transpower's consultation document for its RCP3 expenditure proposal: https://www.transpower.co.nz/sites/default/files/uncontrolled_docs/Securing%20our%20Energy%20Future%20RCP3%20Proposal.pdf

periods). This reinforces our view and expectation information about Chorus' expenditure forecasts and asset management should be made public.

Service quality standards should include a focus on end-user outcomes and deliverables

2degrees supports the adoption of quality standards for availability and performance, though we consider this should be extended to include Customer Service, Ordering, Provisioning, Switching and Faults.

It is important the quality standards prevent or limit Chorus' ability to cut or cap its costs and increase profitability by operating a low quality of service, and to ensure supply of FFLAS is of a quality that reflects end-user demands. We agree with Vodafone, for example: "As near monopolies, the fibre providers may not have strong enough incentives to focus on quality where there is a cost associated with meeting a particular service standard." We similarly agree with Spark: "Quality is a key component of incentive regulation and is increasingly seen as means to drive beneficial regulatory outcomes. Sections 194(3) and (4) reinforce that the Commission may apply quality incentives to maintain or improve quality of supply and this suggests greater reliance can be put on quality incentives driving outcomes (relative to implementations that rely on the price path alone achieving this outcome)." [footnote removed]

End-user requirements must be at the forefront of any discussion regarding wholesale service quality. An effective wholesale quality regime is critical to the quality of service our customers receive. As the Commission has noted "under the retail service quality provisions some aspects of quality are more easily controlled by the wholesaler, rather than the retailer".[10]

We do not consider it valid to exclude the optional quality dimensions on the basis that: "Given the serious enforcement consequences of a breach of a quality standard, we do not consider that it is proportionate to impose quality standards for the optional quality dimensions at this stage".

We welcome though that the Commission has "proposed quality metrics and performance measures for provisioning, faults, availability, performance, and customer service under ID regulation" and consider that disclosure requirements should be included for all of the optional elements e.g. including ordering and switching. We consider this to be a 'least regrets' approach and would help identify whether there are wider potential areas of concern that may require regulation for future PQP resets.

[10] Commerce Commission, New regulatory framework for fibre: Invitation to comment on our proposed approach, 9 November 2018, paragraph 7.110.

Existing service quality arrangements are an appropriate starting point

We agree with the use of “the service levels under the UFB contracts as a starting point in setting the proposed availability standard” and “it is … appropriate to preserve this standard for PQP1”. This appropriately accords with the Commission’s “aim … to achieve a smooth transition to the new regime, by retaining features of the previous contractual and regulatory arrangements that have made UFB a success”. We consider preservation of these standards, even though service quality should improve over-time, should be sufficient “to account for the more serious consequences of a breach of a Part 6 standard, relative to the UFB contract”. This is reflected in Figures 5.1 to 5.3 which show improvements in service quality overtime.

We do not consider “a ‘buffer’ above the UFB contract levels” is needed. It is also unclear how the UFB buffer “is consistent with the one we have taken when regulating quality in other sectors under part 4 of the Commerce Act”. This is asserted but not explained. There are no comparable arrangements to the UFB contracts under Part 4.

We also query the Commission’s proposal that “for PQP1 there should only be one possible contravention of the quality standards per service layer per regulatory year. That is, even if there are multiple exceedances in a given regulatory year this will only constitute one quality standard breach”. This would essentially provide Chorus with a ‘free pass’ that once it has breached a service quality standard there is no incentive to ensure it isn’t breached again in the same regulatory year. It is unclear how this would protect service quality or be to the long-term benefit of end-users.

Specific elements of the PQP 2degrees supports

2degrees notes its support for the Commission in relation to the following matters:

- **Base versus individual capex proposals:** The identification and exclusion of capex that “would be more appropriately applied for by way of individual capex proposals” and “Removal of the incentive payments from the connection capex baseline allowance”. We agree, for example, “incentive payments related to new connections [do not] meet the requirements for variable connection costs”. Analogous issues have arisen under Part 4 with capex that most appropriately would be dealt with under a CPP application.
- **Base capex allowance:** “Excluding innovation expenditure that Chorus proposed as part of its Corporate and IT support expenditure category”.
- “Excluding the incentive payments included within base capex installations expenditure”.
- **Chorus' approach to cost escalation:** The “draft decision … to use an alternative to Chorus' cost escalation proposal”.

- **Quality standards:** Though we prefer adoption of all quality standards in the PQP, we welcome that the Commission has "proposed quality metrics and performance measures for provisioning, faults, availability, performance, and customer service under ID regulation", and consider that disclosure requirements should be included for all of the optional elements e.g. including ordering and switching.
- The use of "the service levels under the UFB contracts as a starting point in setting the proposed availability standard".
- The specification of "two separate standards for layer 1 and layer 2 downtime" and that, within these standards, the Commission has also differentiated by POI area.
- **Undue financial hardship:** "In general, our position in Part 4 has been that the burden of proof for claims of financial hardship lies with the regulated provider. We propose the same approach for Chorus."
- **Revenue path:** "In the context of a network where demand is still forecast to grow, we consider a revenue path that grows in line with demand best promotes the long-term benefit of end-users."
- **Reporting requirements for PQP1:** The introduction of requirements to provide an asset management development roadmap by 30 June 2022, a cost estimation/asset data improvement roadmap by 30 June 2022, an annual report on the progress against the asset management development roadmap and the cost estimation/data improvement roadmap, and an updated engagement plan by 30 June 2022.
- **Reporting and compliance:** The requirement that "Where any standard is breached, Chorus would also have to publish a breach report in respect of all exceedances of the quality standards during that year" and for" Chorus … to produce this report following the end of the year where the breach occurred. The report must contain an explanation of the breach, including the cause and action taken to remedy the breach".