Submission to the Commerce Commission on the Scoping and Issues Discussion Paper for UCLL TSLRIC

14 February 2014

EXECUTIVE SUMMARY

1. Regulated suppliers and access providers should be able to have confidence the prices the Commission determines under Part 4 of the Commerce Act 1986 and Part 2 of the Telecommunications Act 2001 will enable them to recover their efficiently incurred costs, including cost of capital.

2. Vector considers that this is important for the long-term interests of consumers. The ability of regulated suppliers and access providers to recover their costs can impact on future investment and expenditure and on: (i) provision of services at a quality that reflects consumer demands; (ii) the safe operation of networks; (iii) provision of service to meet new consumer demand; and (iv) facilitation of new and innovative services.

Asymmetric cost

3. To achieve reasonable certainty that regulated suppliers and access providers will be able to recover their costs it can be a good idea to take a cautious approach to price setting and err on the side of price determinations for regulated services that are 'too high' rather than 'too low'.

4. To that end, Vector agrees with the Commission "there are higher costs in underestimating the price than over-estimating the price (i.e., asymmetric costs)"[1] and "the risk to dynamic efficiency of a low access price is asymmetric and that the balance of risk favours setting a price that errs on the high side. Consequently, we believe some adjustment is appropriate to take account of asymmetric [cost]."[2] We consider this position is valid for both Part 2 of the Telecommunications Act and Part 4 of the Commerce Act.

5. It appears that the Commission has been inconsistent in its approach to asymmetric cost between Part 4 of the Commerce Act and Part 2 of the Telecommunications Act. The Commission has rejected asymmetric cost arguments under Part 4, beyond the adjustment in WACC, which it has relied on under Part 2.

6. The Commission has rejected submissions on the need to make an allowance for asymmetric cost in its Part 4 default price-quality paths (DPPs) on the basis that if prices are too low, regulated suppliers can apply for a customised price-quality path (CPP). The Commission has not applied the same reasoning to telecommunications even though access providers can apply for a final pricing principle (FPP) determination if the initial pricing principle (IPP) determination is too low.

7. The Commission has also applied a 75th percentile approach when setting the IPP price determinations, under the Telecommunications Act, which can be thought of as analogous to an uplift on all building block costs. In contrast, the Commission has limited a 75th percentile approach to WACC under Part 4 (and effectively only a 75th percentile approach to some WACC parameters) and may be considering further adjustments to the WACC.

8. Vector believes the Commission should adopt a consistent approach to asymmetric cost, and recognise it as a valid concern, under both the Commerce and Telecommunications Acts.

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[1] Paragraph 10, Commerce Commission, Unbundled Bitstream Access Service Price Review, 5 November 2013.

[2] Paragraph 231, Commerce Commission, Unbundled Bitstream Access Service Price Review, 5 November 2013.

Expectations about regulated price changes

9. The Commission's decision to require Chorus to reduce the prices for its copper services, in the IPP price determination, was unsurprising and widely anticipated. The Government provided Chorus with a three year moratorium on its copper prices in anticipation that the Commission would require Chorus to set its copper prices closer to cost-based prices.

10. There have been a lot of claims made, from Chorus and others, about the impact the Commission's price reductions would have on Chorus' ability to complete the UFB build. Chorus has provided no evidence the Commission's decisions would unreasonably impair its profits or are below cost, despite making claims to this affect.

11. Vector calculates the Commission's initial pricing determinations would allow Chorus to extract 19 - 23% return on investment (ROI) from its copper network between 2014 and 2019. While it is important to ensure regulated suppliers are able to earn a reasonable return on their investment the Commission does not permit other regulated suppliers to earn returns of this size. The Commission applied a WACC of 8.77% (2009) for the electricity distribution default price-quality path (DPP) and 7.44% (2012) for gas pipeline services. The Commission also applies a WACC of 7.01 - 8% (for disclosure year 2014) in relation to Airports for information disclosure purposes.[3]

12. Vector forecast Chorus' copper network returns by adopting the Commission's Information Disclosure Schedule 2 ROI methodology. Vector's modelling has been independently reviewed by Network Strategies to ensure the assumptions and methodology are reasonable.

Pass-through issues

13. One of the issues the Commission will need to address is how to treat a change from the IPP price determination to the FPP price determination, regardless of whether the price goes up or down. This could include what date to apply the price change from, including the possibility of applying them retrospectively, and whether to allow claw-back of the price change i.e. future adjustment to prices that compensates for IPP prices that were either excessive or inadequate.

14. The Commission should consider the implications for pass-through of any regulated price changes for any of the options it considers. Retrospective access price changes could be particularly problematic in this respect, regardless of whether the price change is an increase or decrease. It may be better for any adjustment to prices to compensate for over or under recovery to be done on a forward-looking basis by applying claw-back, as the Commission has done under Part 4 of the Commerce Act, rather than through retrospective price change.

[3] As determined in the 2014 cost of capital determination, http://www.comcom.govt.nz/dmsdocument/10912. The Commerce Commission's Airport WACC is for Information Disclosure purposes and not for price setting.

INTRODUCTION

15. Vector welcomes the opportunity to submit on the Commerce Commission's "Scoping and issues discussion paper for UCLL TSLRIC" (UCLL TSLRIC Issues Paper), dated 22 November 2013.

16. Please find attached "Vector's Submission to the Ministry of Business, Innovation & Employment on Review of the Telecommunications Act", dated 13 September 2013. This submission details Vector's views on the appropriate price level for copper services (UCLL and UBA), including the relativity between fibre and copper service prices.

17. No part of this submission is confidential and Vector is happy for it to be made publicly available.

18. Vector's contact person for this submission is:

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APPLICATIONS FOR FPP DETERMINATION

19. The applications from CallPlus, Chorus, Kordia, Telecom and Vodafone for an FPP Determination reflect differing views as to whether such determination would or should result in a higher or lower price than under the IPP Determination.

20. Chorus has expressed concern "The price set in Decision NZCC 37/2012 for the UCLL Service will … under-compensate Chorus for the forward-looking costs of the UCLL service, undermining infrastructure investment incentives and dynamic efficiency in the telecommunications sector".[4]

21. Vector advocates adoption of an approach to price determination, under both Part 4 of the Commerce Act and Part 2 of the Telecommunications Act, which places emphasis on ensuring incentives to invest, enables regulated suppliers/access providers to recover their efficiently incurred costs (including cost of capital) to meet consumer needs and errs on the side of setting prices 'too high' rather than 'too low'.

22. The purpose statements in section 18 of the Telecommunications Act and section 52A of the Commerce Act both require the Commission to promote the long-term benefit of end-users/consumers. Vector believes these purposes mean the Commission should ensure incentives for efficient investment in network infrastructure are protected and maintained. This is crucial to the long-term welfare of consumers because such investment provides for:

    a. Continuation of service quality and performance reliability;

    b. The safe operation of networks;

    c. Provision of service to meet new consumer demand; and

    d. Facilitation of new and innovative services.

23. Vector's analysis of the copper prices set by the Commission indicates Chorus will be able to extract an ROI of 19 - 23% on its copper network between 2014 and 2019. That being the case, there is no cause for concern that the Commission's IPP determinations have set copper prices too low or the prices would undermine incentives to innovate or invest. Rather it would suggest the UBA and UCLL prices set under the IPP determinations are substantially above cost-based levels. These calculations were based on the Commission's Information Disclosure Schedule 2 ROI methodology[5] and publicly available information in relation to Chorus' asset valuation, forecast capex etc.

24. The Commission does not permit other regulated suppliers to earn returns of this magnitude. The Commission applied a WACC of 8.77% (2009) for the electricity distribution DPP and 7.44% (2012) for gas pipeline services. The Commission also applies a WACC of 7.1 - 8% (for 2013 - 2017) in relation to Airports for information disclosure purposes.[6]

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[4] Paragraph 11, Chorus, Application for pricing review determination under section 42 Telecommunications Act 2001", 5 February 2013.

[5] Commerce Commission, Electricity Distribution Information Disclosure Determination 2012, 1 October 2012.

[6] The Commerce Commission's Airport WACC is for Information Disclosure purposes and not for price setting.

Independent review of Vector's calculation of Chorus' copper ROI

25. Vector undertook a calculation of Chorus' copper business ROI in response to MBIE's consultation on the review of the Telecommunications Act which indicated the Government's proposed copper pricing intervention would have allowed Chorus to earn returns of 20 – 25% between 2015 and 2020.[7]

26. Vector has had the calculation of Chorus' copper business ROI independently reviewed by Network Strategies to determine whether the assumptions and methodology are reasonable, and whether the assumptions used would result in under/over-statement of Chorus' returns.

27. Network Strategies advised that "… Vector had correctly applied the Commission's Information Disclosure methodology to reach these estimates. Vector relied on publicly available information and so, of necessity, included a number of assumptions in its model. As a general rule it appears that conservative assumptions were adopted. In addition, Vector has included in its model spreadsheet income statements for 2013 to 2020 for both the copper and fibre businesses, and for the total business. The input data for these financial statements is drawn entirely from the model. It is possible to reconcile the total business income statement for 2013 with Chorus' published accounts. The individual items in Vector's forecast income statement exhibit reasonable trends over time, and there are no notable discontinuities. This is a good sanity check, indicating that key results from the Vector analysis are reasonable."

28. Network Strategies also "identified issues with some of the key inputs. As a result we have recommended amendments both to correct errors, and to improve the accuracy of the model ... It should be noted that some of the issues we identified indicate that the copper ROI estimates may be over-stated and some indicate under-statement."

29. The calculation that the Commission's IPP Determinations would allow Chorus' copper business to extract an ROI of 19 - 23% is based on a revised calculation which adopts Network Strategies' recommendations in full.

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[7] Vector's Submission to the Ministry of Business, Innovation & Employment on Review of the Telecommunications Act, dated 13 September 2013.

ASYMMETRIC COST

30. Vector agrees with the Commission "there are higher costs in underestimating the price than over-estimating the price (i.e., asymmetric costs)"[8], and "the risk to dynamic efficiency of a low access price is asymmetric and that the balance of risk favours setting a price that errs on the high side. Consequently, we believe some adjustment is appropriate to take account of asymmetric [cost]."[9] We consider this position is valid for both Part 2 of the Telecommunications Act and Part 4 of the Commerce Act.

31. The purpose statements in section 18 of the Telecommunications Act and section 52A of the Commerce Act 1986 both require the Commission to promote the long-term benefit of end-users/consumers.

32. Both purpose statements emphasise investment incentives. Part 4 through the chapeau reference to "long-term benefit of consumers" and the specific subpart reference to "achieving outcomes such that suppliers of regulated services … have incentives to innovate and to invest, including in replacement, upgraded, and new assets". Part 2 implicitly through reference to "long-term benefit of end-users" and "the efficiencies that will result, or will be likely to result", and more overtly through the "to avoid doubt clause" that "in determining whether or not, or the extent to which, competition in telecommunications markets for the long-term benefit of end-users of telecommunications services within New Zealand is promoted, consideration must be given 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 from established services." [10]

Commerce Commission positions on asymmetric cost

33. There are also strong parallels in the construct of Part 4 of the Commerce Act and Part 2 of the Telecommunications Act. Both are based on a two-tier price setting framework.

34. The two Acts start off by establishing a low cost (which is intended to enable quicker price setting for telecommunications) price determination, labelled a DPP in Part 4 and an IPP in Part 2.

35. If the access provider/regulated supplier does not consider the IPP/DPP determination meets its particular circumstances, it can seek an FPP/CPP determination. The Commission's FPP/CPP determination could be lower or higher than the price under the IPP/DPP determination. This involved more intensive (and costly) cost modelling and is designed to be more robust that the initial price setting.

36. The Commission has explicitly recognised it should take asymmetric cost into account when it makes an IPP price determination under Part 2, while it has taken a much more limited view when adjusting the DPP prices for asymmetric cost.

[8] Paragraph 10, Commerce Commission, Unbundled Bitstream Access Service Price Review, 5 November 2013..

[9] Paragraph 231, Commerce Commission, Unbundled Bitstream Access Service Price Review, 5 November 2013..

[10] Section 18(2) of the Telecommunications Act was added to the Act in 2012. Prior to that the purpose in the Telecommunications Act made no explicit reference to investment or investment incentives.

37. The Commission, for example, when setting the IPP price determinations has tended to select the 75th percentile point in the price range (effectively an uplift on all costs). This is reflected in the Commission's UBA IPP determination:

> … we conclude that there are higher costs in underestimating the price than over-estimating the price (i.e., asymmetric costs) an assessment of the margin of error in our setting of the price is highly relevant.
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> …
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> We also consider that a price point above the median is appropriate to minimise the risk to investment and to avoid the dynamic efficiency losses that could arise from incorrectly setting a price below the forward-looking cost for the UBA service. This has been considered recognising that these benefits need to be balanced with the costs to end-users of raising the price above the median.
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> …
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> Having taken into account s 18 considerations, our approach results in a price point selection at the 75th percentile for asymmetric costs. This results in a price that is the same as the price we derive from the two country benchmark set. Thus we conclude we have a robust result.[11]
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> In previous decisions, the Commission has selected the 75th percentile as an appropriate point from within a range of the benchmark prices to address asymmetric risk. For example, in Decision 477, the Commission stated … he Commission has been unable to identify any rigorous and quantifiable means of accounting for the risk to dynamic efficiency, while recognising that the risk should induce the Commission to set a price at a level that minimises the possibility of undershooting. The Commission has accordingly decided to shift the price point from the median point of the range to the 75th percentile of the range.[12]

38. In contrast to telecommunications regulation, the Commission has limited its price adjustment to selecting the 75th percentile point for WACC only, and no other cost inputs, in the DPP price determinations.

39. Further, as discussed in more detail below, the Commission has largely rejected the need to make any further allowance for asymmetric cost in its DPPs on the basis that if prices are too low regulated suppliers can apply for a CPP. The Commission has not applied the same reasoning to telecommunications under Part 2 of the Telecommunications Act even though access providers could apply for a FPP determination if the IPP determination was too low.

40. Regulated suppliers under Part 4 of the Commerce Act have submitted to the Commission that an allowance should be included in the DPP determinations to guard against the asymmetric cost of the DPPs containing errors that could result in suppliers earning less than a normal return under the DPP.

41. The Commission rejected these submissions, in relation to Part 4 of the Commerce Act, on the basis that "Consumers are … protected against the risk of investment being deterred, because[, if the DPP is set to low,] suppliers can propose a customised price-quality path if below normal returns are expected under the default price-quality path".[13] The Commission has also elaborated on these points stating:[14]

> In our view, it would not be appropriate to place significantly greater weight on the costs associated with setting the DPP too low relative to the costs associated with setting the DPP too high. This

[11] Paragraphs 10, 13 and 15, Commerce Commission, Unbundled Bitstream Access Service Price Review, Decision [2013] NZCC 20, 5 November 2013.

[12] Paragraph 257, Commerce Commission, Unbundled Bitstream Access Service Price Review, Decision [2013] NZCC 20, 5 November 2013.

[13] Paragraph 118, Commerce Commission, Revised Draft Reset of the 2010-15 Default Price-Quality Paths, 21 August 2012.

[14] Paragraphs 2.36 – 2.37, Commerce Commission, Draft Decisions Paper, 2010-15 Default Price-Quality Path for Electricity Distribution, July 2011.

> contrasts with some submissions, which have argued that the risks of regulatory error in relation to the DPP are asymmetric.
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> Those submitters have argued that EDBs' incentives to invest may be damaged if the DPP is set too low, and that this would have more severe consequences than if returns were set too high. We disagree with this view. While the risk of error is usually asymmetric in a regulatory context, default/customised price-quality regulation has unique features that mitigate this risk. In particular:
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> - EDBs have the option of applying for an alternative price-quality path if the DPP is set too low
> - the IMs allow EDBs to pass on the costs involved with verification and audit of proposals (paragraphs 1.57-1.58) so the costs to an EDB of applying for a CPP are limited.

42. It appears the Commission is taking an inconsistent approach by rejecting arguments that only very limited adjustments should be made for asymmetric cost in DPPs under Part 4 of the Commerce Act, on the basis that regulated suppliers can apply for CPPs, when it provides for asymmetric cost in IPPs under Part 2 of the Telecommunications Act even though access providers can apply for FPPs if the IPPs are set too low.

43. Vector urges the Commission to consider whether or not the apparent difference in approach to asymmetric cost under Part 2 of the Telecommunications Act and Part 4 of the Commerce Act is appropriate and based on differences between the two jurisdictions.

44. In particular, Vector urges the Commission to consider the applicability of the analysis in "Attachment H: Why we have not included any additional allowances" in the explanatory paper "Resetting the 2010-15 Default Price-Quality Paths for 16 Electricity Distributors", dated 30 November 2012, to telecommunications and whether applying the same analysis would result in the same conclusions for telecommunications.

45. Attachment H provides a framework which the Commission applied to determine the appropriate allowance for asymmetric cost. The Commission's framework essentially states that the allowance for asymmetric cost should be capped such that the allowance is no higher than the saving to consumers from a lower probability of a regulated supplier applying for a CPP. Notably, given the large size of access providers under the Telecommunications Act, the Attachment H favours providing an allowance for asymmetric cost to smaller regulated suppliers only.

46. The analysis under the Telecommunications Act could be made slightly more complicated given both access seekers and access providers can apply for a FPP. This means that reducing the probability of FPP determinations requires the Commission to ensure the IPP is both not 'too low' (in which case access providers would apply for a FPP) but also not 'too high' (in which case access seekers would apply for a FPP). Under Part 4 it is simply the case that the higher the DPP price the lower the likelihood of a CPP application.

47. Vector considers application of the Attachment H framework would, accordingly, be less likely to result in a conclusion that an allowance for asymmetric cost should be applied under Part 2 of the Telecommunications Act than under Part 4 of the Commerce Act. This is the opposite of what is seemingly observable.

48. To ensure consistency on what is fundamentally the same issue in both jurisdictions, Vector believes the Commission should either: (i) make an equivalent allowance for asymmetric cost in price determinations under Part 4 of the Commerce Act; or (ii) cease to provide for asymmetric cost in price determinations under Part 2 of the Commerce Act.

PASS-THROUGH OF COPPER ACCESS PRICE CHANGES AND BACKDATING

49. One of the issues the Commission will need to address is how to treat a change from the IPP price determination to the FPP price determination, regardless of whether the price goes up or down. This could include what date to apply the price change from, including the possibility of applying them retrospectively, and whether to allow claw-back of the price change i.e. future adjustment to prices that compensates for IPP prices that were either excessive or inadequate.

50. As reflected in the discussion above, if the IPP prices have not been adequate to allow the regulated supplier to earn (at least) a normal rate of return, then they should be compensated for this.

51. The Commission should consider the implications for pass-through of any regulated price changes for any of the options it considers. Retrospective access price changes could be particularly problematic in this respect, regardless of whether the price change is an increase or decrease. It may be better for any adjustment to prices to compensate for over or under recovery to be done on a forward-looking basis by applying claw-back, as the Commission has done under Part 4 of the Commerce Act, rather than through retrospective price change.

52. If a retrospective price increase was introduced retailers could not retrospectively adjust their retail prices to offset the price increase which could impact on their ability to recover their costs. The retailers would need to either absorb the cost themselves or try and pass it through into higher future prices. The difficulty retailers would face with trying to recover past costs from future prices is two-fold:

    a. First, the retrospective access price change would not impact on retailers' forward-looking costs or marginal cost of supply and therefore would not impact on their profit maximising retail prices. The retrospective price increase would effectively be a sunk cost to the retailer.

       If a retailer could profitably increase its prices to recover past costs, this would suggest that its prices were not set profit maximising levels. This would mean the retailer could increase its profits by increasing prices regardless of whether or not the retrospective access price change occurred or not.

    b. Second, the cost to a retailer of a retrospective access price change is not a cost a new entrant retailer would incur, or would be incurred by a smaller retailer (that used the access service less). If the retailer attempted to recover these costs through higher (future) prices, it would face the competitive constraint that other retailers would be able to profitably undercut them.

53. As a corollary, if the access price change is downward, regardless of how competitive the retail market for copper services is, it would seem unlikely that a retrospective price reductions would be passed on to consumers. There would be no obvious driver for retailers to pass-through anything other than the reduction in present and future costs.

54. The retrospective access price change would mean that past retail prices were higher than they needed to be to recover cost. The past retail prices may also be higher than the profit maximising retail prices if they were based on the (unknown) FPP access price rather than the (known) IPP price. But there would be no competitive or commercial impetus for retailers to pass on these retrospective access price changes

(effectively a sunk cost) through future retail prices. To do so would create a cross-subsidy from past to future retail prices which would not be profitable for the retailer.

55. Retailers may pass on future access price reductions resulting from a lower FPP determination but Vector would not necessarily assume that competition would result in pass-through of any retrospective access price changes.

56. A related factor that the Commission should consider is the impact of the uncertainty about the FPP determination prices relative to the IPP determination prices, and how the differences will be treated, would have on retailers. In particular, retailers face the risk that the access price will be adjusted upwards retrospectively.

57. Retailers may have to factor in the uncertainty about the final access price, and the possibility that it could be adjusted upwards retrospectively into their retail price setting. The competitiveness of different retailers may then not simply be a function of the quality and cost of their respective services. It could also reflect different judgements about the likely difference between the IPP and FPP prices and what the Commission will do in terms of backdating and retrospective price adjustments. Different retailers may add different risk premiums to their retail prices, depending on their perception of risk, even if they expect the FPP prices to be lower than the IPP prices.

58. A perverse, but entirely plausible, outcome could be that this uncertainty results in higher than otherwise retail prices. Access prices are then retrospectively adjusted downwards following the FPP price determination, and this downward adjustment is not passed on to consumers but is instead a windfall gain to retailers.

59. Vodafone does not believe such outcomes would promote competition, or be to the long-term benefit of consumers, as required by the purpose in s 18 of the Telecommunications Act.