TO: Sasha Daniels, Senior Counsel, Competition and Regulation - Spark New Zealand Trading Limited

FROM: Russell McVeagh (Craig Shrive, Sally Fitzgerald and Emma Rae)

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SUBJECT: Legal precedent relevant to regulatory asset valuation

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Introduction and summary

1. In its submission on the draft determination for the final pricing principle review ("**FPP**") of the unbundled copper local loop ("**UCLL**") service, Chorus has endorsed the Commission's use of optimised replacement cost ("**ORC**") asset valuation within its cost model.[1]

2. Chorus refers to its previous FPP process submissions to the Commission on this point. In Chorus' view, the total service long run incremental cost ("**TSLRIC**") pricing principle excludes historical network considerations, and the use of ORC is consistent with past decisions of the Commission and other jurisdictions on TSLRIC. Chorus also supports the Commission's decision not to value "re-useable" assets using a different method.[2]

3. Chorus has submitted, and the Commission has accepted, that the Supreme Court decision in *Vodafone New Zealand Ltd v Telecom New Zealand Ltd* has no bearing on the Commission's decision to use ORC when applying TSLRIC.

4. You have therefore asked us to consider whether recent judicial consideration of ORC methodologies is relevant for the purpose of calculating the TSLRIC of UCLL. In other words, if a Court was considering whether the Commission had made an error of law in interpreting and applying the Telecommunications Act 2001 to set a price for the UCLL service using TSLRIC, would these decisions be relevant?

5. In summary, our views are as follows:

   (a) The Supreme Court has established a clear legal principle that the calculation of efficient costs of assets does not allow sunk assets to be valued at current replacement costs, when it is clear that those assets will not be replaced. It was an error of law to use a model or methodology that artificially inflated costs above their efficient value or included costs that would not in reality be incurred in providing the service.[3]

   (b) In reaching this view, the Supreme Court was influenced by the Australian Competition Tribunal reaching a similar conclusion regarding the application of forward-looking TSLRIC to the Australian equivalent of the UCLL service.[4]

   (c) It is unlikely that a court would now disregard this precedent simply because the relevant statutory provisions are different. Rather, following the approach of the Supreme Court, it is likely to take the view that the core task of

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1 See Chorus Limited *Submission for Chorus in response to draft pricing review determinations for Chorus' unbundled copper local loop and unbundled bitstream access services*, 20 February 2015 at [89].

2 Chorus Limited *Submission for Chorus in response to draft pricing review determinations for Chorus' unbundled copper local loop and unbundled bitstream access services*, 20 February 2015 at [89]-[90].

3 *Vodafone New Zealand Ltd v Telecom New Zealand Ltd* [2012] 3 NZLR 153 (SC).

4 *Application by Telstra Corporation Limited* [2010] ACompT 1.

establishing efficient costs of assets used to provide a regulated service is materially the same under each regime.

(d) A court would therefore require a clear and cogent reason to depart from established legal principle when considering the application of TSLRIC in this case. In particular, it would no doubt examine the statutory language in order to determine whether Parliament intended that TSLRIC should be applied in a manner such that the principle established by the Supreme Court does not apply when TSLRIC is used.

(e) It appears from Chorus' submissions that the use of "forward-looking" in the definition of TSLRIC is relied on as establishing Parliament's intent that ORC must be applied to all assets in the MEA. Although the Commission does not agree that "forward-looking" requires the use of ORC, it nevertheless considers that the Supreme Court's objections to ORC do not apply to the "forward-looking" TSLRIC exercise.

(f) Such reasoning is unconvincing. Considered in light of section 18, a court is unlikely to conclude that those words alone, or the forward-looking nature of TSLRIC, are clear and cogent evidence that Parliament intended the core task of establishing efficient costs under TSLRIC should not be subject to the efficiency constraints identified by the Supreme Court. We think it would be difficult to distinguish the principle established by the Supreme Court simply because a model or methodology, instead of artificially inflating *backward looking* costs, artificially inflates *future* costs above their efficient value or includes costs that would not be incurred in providing the service *in the future*.

6. More broadly, the Supreme Court decision also establishes that it is not always the case that the choice of asset valuation is a matter of regulatory or economic judgement - the Commission's choice could demonstrate that the Commission:

(a) must have misinterpreted the statutory definition of TSLRIC; and/or

(b) has applied TSLRIC in a way that is not allowed by the Act.

Background

7. As part of its draft decision on the final pricing principle price review for the UCLL service, the Commission has produced a cost model to determine the TSLRIC of that service. That cost model seeks to determine the forward-looking costs that would be incurred by a hypothetical efficient operator providing the service.

8. As part of its interpretation and application of TSLRIC, the Commission has determined the forward-looking capital costs that should be incorporated into the cost model (and, therefore, the TSLRIC-based price that can be charged by Chorus going forward).

9. The Commission has done so by identifying a notional asset base that would be used by a hypothetical efficient operator to provide the core functionality of the service (the modern equivalent asset, or "MEA"). It has then valued those notional assets at their ORC (ie what it would cost to replace them today). In effect, this means that the capital costs that have been included in the draft TSLRIC-based price reflect the cost of building a new telecommunications network from scratch at today's prices.

10. A particular issue raised by a number of submitters is whether this is an appropriate treatment of some asset costs, such as digging trenches, where these costs are highly unlikely to be incurred again in the future.

The Supreme Court's findings on ORC

11. In *Vodafone,* the Supreme Court found that it was an error of law to use ORC to value legacy telecommunications assets when Parliament had directed the Commission to determine the costs that would be incurred by an efficient service provider. In that decision:

(a) The Supreme Court was asked to consider whether the Commission had erred in law when determining the net cost to an efficient service provider of supplying telecommunications services to commercially non-viable customers.

(b) In order to determine that net cost, the Commission first modelled the hypothetical network of an efficient service provider, and then calculated the asset value of that network using ORC. The majority held that this decision, along with other aspects of the Commission's modelling choices, amounted to an error of law.[5]

(c) In reaching that view, the majority expressed its view on the use of ORC by the Commission, and stated that:[6]

> [70] **The Commission's use of ORC failed to address, however, the distortion caused by artificially revaluing old assets (already wholly or partly depreciated) which were in reality not likely to be replaced and optimised. It is sensible to revalue on an optimised basis, say, a switch by attributing to it the lower value (price) of a new switch which performs the same or better function but is able to be acquired at a lesser price. It is quite another thing to attribute a modern equivalent value to an old asset which is not actually being replaced and for which no replacement would sensibly be introduced. All that does is to artificially inflate the value of the old asset and provide a windfall for the firm in terms of an enhanced return on and of capital employed.** This emerges starkly in relation to the very significant value attributed to installed copper wire in the PSTN, the attributed replacement value of which is in large measure the current cost of putting it in the ground. It cannot be right, where the [efficient service provider] is supposed to be a proxy for a firm which will continue to employ old assets, to attribute a new (2001) value to them, including the cost of work notionally needing to be done if the assets were being newly installed (in the ground). That cost which was not actually incurred included notional current fuel and labour costs. [Emphasis added]

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5 *Vodafone New Zealand Limited v Telecom New Zealand Limited* [2012] 3 NZLR 153 (SC) at [74]-[75]. Note that the minority (Elias CJ and Tipping J in separate judgments) agreed the Commission had committed an error of law, but considered there had been an error in interpretation of the law, rather than application. In doing so, Tipping J also criticised the use of ORC, as discussed further below. Elias CJ decided the case on a more narrow point, and noted that the choice of valuation methodology was left to the Commission provided it asked itself the right questions - which had not been the case.

6 *Vodafone New Zealand Limited v Telecom New Zealand Limited* [2012] 3 NZLR 153 (SC), which involved the Court considering the correctness of the Commission's interpretation and implementation of the "net cost" provisions of the old TSO obligation. In order to determine net cost the Commission first modelled the hypothetical efficient service provider's network and calculated the asset value using ORC.

(d) In other words, if the task is to identify efficient costs of assets, it is wrong to use a model or methodology that inflates costs above their efficient value or includes costs that will not actually be incurred.

(e) The majority therefore considered that the Commission had failed to produce a model of an efficient service provider for the purposes of the Act that was appropriate to the particular circumstances.[7] It went on to note that it was "incumbent upon the Commission to produce a new model using valuations which did not artificially inflate the value of the notional assets of the kind which the [efficient service provider] would be taken to be employing".[8] The majority considered that the Comission had made successive serious errors in applying the provisions of the Act in its determinations and, as a result, its ultimate conclusions were clearly untenable.[9] In the view of the majority, proper application of the Act required a different result, and the Commission had therefore erred in law.[10]

(f) In addition, one of the judges in the minority (Tipping J) was critical of the use of ORC, and considered that the Commission must have misinterpreted the relevant statutory definitions when it allowed Telecom the benefit of revaluing its existing assets on an "as-new" or "cost of replacement" basis.[11] In his view, this failed to reflect the reality that the assets were not new and that they did not require replacement, and allowed Telecom to pass on costs that it had not incurred (and an efficient service provider would not have incurred).[12] Tipping J was also concerned that this approach was inconsistent with section 18 of the Act.[13]

Similar concerns have been expressed in Australia

12. The Supreme Court in *Vodafone* found support in the Australian Competition Tribunal's reasoning in *Application by Telstra Corporation Ltd.* The Australian Competition Tribunal was considering the interpretation and application of TSLRIC to set a price for the unconditioned local loop service (the equivalent of New Zealand's UCLL service).[14] The Tribunal rejected the argument that the ULLS should be priced on the basis of up-to-date costs of replacing the current copper network (which it described as a "historical relic").[15] In its view:[16]

(a) A replacement cost approach would not reflect Telstra's costs of providing the service, would not encourage the economically efficient use of Telstra's

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7 *Vodafone New Zealand Limited v Telecom New Zealand Limited* [2012] 3 NZLR 153 (SC) at [73].

8 *Vodafone New Zealand Limited v Telecom New Zealand Limited* [2012] 3 NZLR 153 (SC) at [73]-[74].

9 *Vodafone New Zealand Limited v Telecom New Zealand Limited* [2012] 3 NZLR 153 (SC) at [65].

10 *Vodafone New Zealand Limited v Telecom New Zealand Limited* [2012] 3 NZLR 153 (SC) at [65].

11 *Vodafone New Zealand Limited v Telecom New Zealand Limited* [2012] 3 NZLR 153 (SC) at [81].

12 *Vodafone New Zealand Limited v Telecom New Zealand Limited* [2012] 3 NZLR 153 (SC) at [81].

13 *Vodafone New Zealand Limited v Telecom New Zealand Limited* [2012] 3 NZLR 153 (SC) at [83].

14 In more detail, Telstra had put forward a proposed access undertaking to the ACCC, including a proposed price for the ULLS based on a TSLRIC+ model. This undertaking was rejected by the ACCC, and the Tribunal was therefore required to consider the reasonableness of the price proposed by Telstra. In doing so, the Tribunal reviewed various aspects of the TSLRIC+ model used to generate that price and raised concerns about various aspects of that model, as well as the underlying TSLRIC approach.

15 *Application by Telstra Corporation Ltd* [2010] ACompT 1 at [238].

16 *Application by Telstra Corporation Ltd* [2010] ACompT 1 at [238]-[246]. The Tribunal also reached the view that the MEA should incorporate unbundleability, which led to a copper MEA. The prospect of setting a price based on replacement of the existing copper network (with some optimisation) led it to the view that TSLRIC was not an appropriate pricing methodology. We note that the Tribunal did not conclude that unbundleability in the MEA was a legal requirement.

network infrastructure, and would not encourage efficient investment either by Telstra or access seekers.

(b) Given that the copper network was likely to be replaced by the National Broadband Network, the long-run costs to the community were not those of a new entrant hypothetically building a replacement copper access network.

(c) In particular, it was concerned that the costs of a hypothetical new entrant building a new network did not provide the basis for a price that would promote the long-term interest of end-users (as required by the legislative framework).

The decision in *Vodafone* remains persuasive in the current context

13. In its draft determination, the Commission states that it has considered the decision in *Vodafone* but that, in its view:

(a) It agrees with Chorus that the decision in *Vodafone* was made in a different context and related to determining the TSO costs, which was a backward-looking exercise. The Commission goes on to note that it considers a historic cost approach to asset valuation would be inconsistent with its forward-looking approach in the TSLRIC context.[17]

(b) The use of a replacement cost methodology does not afford Chorus an unjustified windfall gain in this context, but is consistent with its task to model the network of a hypothetical efficient operator on a forward-looking basis.[18]

(c) It is difficult to talk about windfall gains in a TSLRIC context.[19] The fact that Chorus may have accumulated gains from providing UCLL over time is not a TSLRIC issue and so is not relevant to its forward-looking TSLRIC modelling exercise.[20]

14. We of course accept that the statutory terms are different. In *Vodafone*, the Commission (and the Court) was tasked with identifying the net cost of providing the service in question.[21] Here, the Commission is tasked with setting a price for the service that meets the section 18 purpose, by using TSLRIC.

15. In more detail:

(a) When setting a price for the TSO service, the Act required the Commission to determine the unavoidable net incremental costs to an efficient service provider of providing the service required by the TSO instrument to commercially non-viable customers. To do so, the Commission modelled the costs that would be incurred by a hypothetical efficient service provider.

(b) When setting a price for the UCLL service by applying TSLRIC, the Act requires the Commission to determine the forward-looking costs over the long

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17 Commerce Commission *Draft pricing review determination for Chorus' unbundled copper local loop service*, 2 December 2014 at [657]-[658].

18 Commerce Commission *Draft pricing review determination for Chorus' unbundled copper local loop service*, 2 December 2014 at [660].

19 Commerce Commission *Draft pricing review determination for Chorus' unbundled copper local loop service*, 2 December 2014 at [642].

20 Commerce Commission *Draft pricing review determination for Chorus' unbundled copper local loop service*, 2 December 2014 at [643].

21 See the provisions of Part 3 and s 5 of the Telecommunications Act 2001 in force prior to 1 July 2011.

run of the total quantity of the functions and facilities that are directly attributable to, or reasonably identifiable as incremental to, the service. To do so, the Commission is currently modelling the costs that would be incurred by a hypothetical efficient service provider.

16. As will be evident from the above, common to both these tests is the concept of identifying the efficient costs of providing a regulated service. It is apparent from the Supreme Court's reliance on *Telstra* that it was not concerned by differences between the statutory terms or the regulatory model being considered.

17. Given this common underlying purpose and the Supreme Court's reasoning, we think that the High Court would need to proceed on the basis that Supreme Court's decision in *Vodafone* is relevant and persuasive when determining the lawfulness of the Commission's approach to applying TSLRIC to determine a price for UCLL.

18. In that context, we think the Commission's justifications for simply putting the Supreme Court decision to one side are unconvincing.

19. In our view, the Supreme Court's reasoning in *Vodafone* is relevant and persuasive to determining the lawfulness of a TSLRIC decision for a number of reasons:

    (a) The majority of the Supreme Court in *Vodafone* draws support for its decision from the *Telstra* decision.[22] As discussed above:

        (i) the Tribunal expressed considerable concern about whether the use of a replacement cost methodology in the context of a TSLRIC exercise could promote the long-term interest of end-users - a legislative purpose akin to section 18; and

        (ii) the Supreme Court would have understood that the Tribunal was considering the application of TSLRIC when drawing support from that decision.

    (b) The Commission itself has previously identified similarities between the TSO and TSLRIC modelling exercises.[23] As we understand it, a large part of the reason for the Commission's preference for ORC in the current TSLRIC process was to be consistent with its preference for that valuation methodology in a 2004 draft principles paper.[24] In that paper, the Commission noted that there are a range of asset valuation methodologies consistent with forward-looking costs and TSLRIC. But, it had a preference for ORC, including because it saw substantial similarities between the exercise it was required to carry out for TSO and TSLRIC, including the asset valuation approach. As the Commission then noted:[25]

> The first common issue between the TSO and TSLRIC is the construction of a core network model. [...] In building this model, the Commission has been required to consider and make decisions on a range of issues relating to the design of the core network that also need to be addressed when building a TSLRIC model.

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22 *Application by Telstra Corporation Ltd* [2010] ACompT 1.

23 Commerce Commission *Implementation of TSLRIC pricing methodology for access determinations under the Telecommunications Act 2001: Principles Paper*, 20 February 2004 at [39]-[40].

24 Commerce Commission *Implementation of TSLRIC pricing methodology for access determinations under the Telecommunications Act 2001: Principles Paper*, 20 February 2004 at [39]-[40].

25 Commerce Commission *Implementation of TSLRIC pricing methodology for access determinations under the Telecommunications Act 2001: Principles Paper*, 20 February 2004 at [39]-[40].

> The other common area between the TSO and TSLRIC is the economic approach to asset valuation, treatment of depreciation, and the cost of capital of telecommunications assets.

(c) This demonstrates that the Commission itself sees substantial similarities between the approach to asset valuation in a TSO and TSLRIC context. On that basis, judicial criticism of the approach to asset valuation in the context of a TSO exercise under the Act is equally relevant to a TSLRIC exercise.

(d) We think the concept of "windfall" or "artificial" gains and "accumulated" gains discussed by the Supreme Court would remain persuasive to the High Court in a TSLRIC context. In our view, the term "windfall gains" in *Vodafone* appears to be used by the majority as a shorthand expression to describe the profits that a monopoly supplier would be able to earn where prices are artificially increased beyond efficient costs (including where prices are charged on the basis of artificially inflated asset values).[26]

(e) The concept of "windfall gains" has also been considered by the High Court in the context of Part 4 of the Commerce Act 1986. In *Wellington International Airport Ltd v Commerce Commission* it was generally accepted that the effect of new replacement cost valuations would be to produce a materially higher asset valuation for suppliers' existing assets. In this decision (which was not an appeal confined to a point of law):

(i) The Court considered that high prices and profits resulting from this higher valuation would be a windfall gain rather than a reward for superior performance, which would be contrary to the long-term benefit of consumers.[27]

(ii) Although this concern was expressed by reference to the term "windfall gain", the Court's use of that term again appears to be a shorthand way to describe its concern that regulated monopoly suppliers should be prevented from legitimising price increases simply through a higher asset valuation without any increase in investment or efficiency - a concern shared by the Commission at that time.[28]

(f) In other words, we think that previous judicial concern about windfall gains remains relevant to the correct interpretation and application of TSLRIC to set a price for the UCLL service consistently with the Act, in circumstances where that interpretation or application artificially increases the price for the service beyond efficient forward-looking costs.

20. Again, we accept that a TSLRIC methodology is different to the TSO statutory provision considered by the Supreme Court and the approach to regulation under Part 4 of the Commerce Act.

21. However, to conclude, our view is that:

(a) The Supreme Court has established a clear legal principle that an economic cost model based on a hypothetical efficient operator should not artificially increase or inflate either the notional costs in that model or the real world costs that will be incurred by the regulated supplier.

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[26] *Vodafone New Zealand Limited v Telecom New Zealand Limited* [2012] 3 NZLR 153 (SC) at [70].

[27] *Wellington International Airport Ltd v Commerce Commission* [2013] NZHC 3289 at (for example) [383], [390].

[28] *Wellington International Airport Ltd v Commerce Commission* [2013] NZHC 3289 at (for example) [395], [569].

(b) Similar concerns have been expressed in the context of regulation under Part 4 of the Commerce Act, where the High Court was concerned to prevent regulated monopoly suppliers from legitimising price increases simply through asset valuation without any corresponding investment or efficiency benefit for consumers of the regulated service.

(c) Given the express and clear efficiency considerations contained in section 18 of the Act, the High Court would require a clear and cogent reason before accepting that TSLRIC, as applied consistently with the section 18 purpose of efficiency and the long-term benefit of end-users in New Zealand, allows Chorus to recover costs that evidence shows it *will not incur* on a forward-looking basis (efficiently or otherwise).

(d) The use of the words "forward-looking" in the definition of TSLRIC are themselves insufficient to establish that Parliament intended such outcomes from a correct interpretation and application of TSLRIC to set a price for the UCLL service.