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Fibre input methodologies:

Draft decision – reasons paper (regulatory processes and rules)

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CONTENTS

Executive summary

X1 This paper contains the Commerce Commission's (**Commission's**) draft decisions and reasons for the regulatory processes and rules (**RPR**) input methodology (**IM**). The IMs are the upfront regulatory rules, requirements and processes relating to the regulation of fibre fixed line access services (**FFLAS**) from 1 January 2022.

X2 The RPR draft decisions paper (**this paper**) forms part of the Commission's public consultation process under s 179 of the Telecommunications Act 2001 (**Act**) and should be considered together with the draft decisions we published in November 2019 (**2019 draft decisions paper**).

X3 Alongside this paper we are also publishing a tracked changes version of the draft determination we published in December 2019 (**2019 draft determination**). This revised draft determination (**RPR draft determination**) shows how we intend to give effect to our draft decisions on the RPR IM.

X4 The Telecommunications (Regulated Fibre Service Providers) Regulations 2019 have now been made under s 226 of the Act (**s 226 regulations**). The regulations state that price-quality (**PQ**) regulation applies to Chorus in areas where local fibre companies (**LFCs**) do not operate. This paper and the tracked changes in the RPR draft determination reflect these s 226 regulations only as they relate to RPR IMs. We have not sought to update the original text of the 2019 draft determination in respect of other IM-related matters that could be affected by the s 226 regulations.

Our draft decisions

X5 Chapter 2 of this paper sets out our draft decisions and reasons for the RPR IM.

X5.1 **Specification and definition of price including pass-through costs:** prices will be specified as maximum revenues (defined in nominal terms, exclusive of GST, and after deducting discounts and rebates) in the form of a revenue cap for Chorus. Maximum revenues will comprise building blocks revenues, pass-through costs (telecommunications levies) and the revenue wash-up.

X5.2 **Circumstances in which a PQ path may be reconsidered within a regulatory period:** a PQ path can be reconsidered following a catastrophic event, change event, error event, provision of false or misleading information, a change in generally accepted accounting practice (**GAAP**), or for major transactions (including amalgamations).

X6 We are also taking the opportunity to define regulatory balance dates for IM purposes in order that PQ and information disclosure (**ID**) regulation functions effectively. Chapter 3 sets out our draft decisions and reasons relating to regulatory balance dates.

X6.1 **Regulatory balance dates**: the regulatory balance date for all regulated fibre service providers (**regulated providers**) for both ID and PQ purposes will be 31 December. This date aligns with the implementation date of the fibre regime and will aid interested persons in comparing information disclosed by providers over time.

X7 In Chapter 4 we address other IM-related matters:

X7.1 consequential changes required to the 2019 draft determination in light of our draft decisions on the RPR IM; and

X7.2 an explanation of why other topic areas suggested by submitters are not included in our draft decisions for the RPR IM.

We are seeking your views

X8 We are seeking views from all interested persons on our draft decisions for the RPR IM and the tracked changes to the draft determination.

X8.1 Submissions are due by **5pm 29 May 2020**. Please make your submissions via the Commission's fibre IMs project page which will direct you to a form with instructions on how to upload your submission. Your submission should be provided as an electronic file in an accessible form.

X8.2 You will have an opportunity to provide views on the submissions we receive on our paper by making a cross-submission. You will have until **5pm 19 June 2020** should you wish to make a cross-submission.

X9 The Commission takes the protection of confidential and commercially sensitive information seriously. Our submission process requires you to provide (if necessary) clearly identified confidential and non-confidential versions of your submission.

Next steps

X10 We intend to consult on an updated draft determination covering all IMs after May 2020. We are still reviewing the process and time frames for any further consultation and the publication of our final IMs decisions. This will include taking account of the COVID-19 context and we will update you on this as soon as we can. For further information about our consultation processes please refer to our Letter to Stakeholders.[1]

[1] See Commerce Commission "Fibre Input Methodologies: Letter to Stakeholders" (2 April 2020). Available at https://comcom.govt.nz/regulated-industries/telecommunications/projects/fibre-input-methodologies.

1. Introduction

1. This chapter introduces the RPR draft reasons paper (**this paper**) by setting out:

    1.1 the purpose of this paper;

    1.2 how we have structured this paper;

    1.3 the background to setting input methodologies (**IMs**) for the new fibre regulatory regime;

    1.4 the overall consultation process for determining IMs and the role of this paper in that process;

    1.5 information for interested parties on making a submission; and

    1.6 our next steps for making final decisions.

Purpose of this paper

2. The Commerce Commission (**Commission**) is in the process of determining **IMs** for regulated fibre fixed line access services (**FFLAS**) under Subpart 3 of Part 6 of the Telecommunications Act 2001 (**Act**).

3. We are seeking views from interested persons on our draft decisions and reasons for the IM relating to regulatory processes and rules (**RPR IM**).

    3.1 This paper is part of our consultation process under s 179 of the Act, which has included the publication of draft decisions and reasons for other IMs as outlined below at paragraph 22.[2]

    3.2 The paper is published alongside a draft determination which is intended to give effect to our draft decisions. The draft determination supplements the draft determination previously published;[3] however, the tracked changes we have made to the 2019 draft determination relate only to the RPR IM.

How we have structured this paper

4. This paper is structured as follows.

    4.1 In **Chapter 2** we discuss our **draft decisions and reasons for the RPR IM** for PQ regulation, which includes the specification and definition of prices, as well as PQ path reconsideration circumstances.

    4.2 In **Chapter 3** we discuss draft decisions and reasons for the IM rules relating to **regulatory balance dates** for ID and PQ regulation.

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2 See Commerce Commission "Fibre input methodologies: Draft decision – reasons paper" (19 November 2019).

3 See Commerce Commission "[Draft] Fibre Input Methodologies Determination 2020" (11 December 2019).

4.3 In **Chapter 4** we discuss **other IM-related matters**, such as consequential changes required to the 2019 draft determination, and topics which we do not propose to include rules for in the RPR IM.

Background to the new fibre regulatory regime

5. The Commission is required to determine IMs for regulated FFLAS under Subpart 3 of Part 6 of the Act by no later than the implementation date of 1 January 2022. This section discusses:

   5.1 the regulatory framework we are operating within;

   5.2 the economic framework we use to help guide out decisions; and

   5.3 the impact of the s 226 regulations on our draft decision for the RPR IMs.

6. The IMs are key upfront regulatory rules, requirements and processes that relate to how FFLAS will be regulated under price-quality (**PQ**) regulation and information disclosure (**ID**) regulation. The IMs are intended to promote certainty for regulated providers, access seekers and end-users.[4]

7. Section 176(1)(c) of the Act states that we must set an IM relating to:

   "regulatory processes and rules, such as—

   (i) the specification and definition of prices, including identifying any costs that can be passed through to prices (which may not include the legal costs of any appeals against input methodology determinations under this Part); and

   (ii) identifying circumstances in which a price-quality path may be reconsidered within a regulatory period".

8. As mentioned in our draft decisions published in November 2019 (**2019 draft decisions paper**), we can determine additional IMs when we determine the mandatory IMs.[5] In addition, we may, at any time after the implementation date, determine further IMs.[6] However, we only plan to determine the mandatory IMs for the first regulatory period – see further paragraph 22 below.

9. Consistent with the 2019 draft decision, we are only determining matters for the RPR IM set out in s 176(c). We consider the timeframe we face allows us to set rules for these topics (along with rules for regulatory balance dates and other IM-related definitional matters, as set out in **Chapter 3** and **Chapter 4**). The IMs set out in this paper are necessary to implement PQ and ID regulation, as explained below.

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4 Section 176(2)(a) provides for IMs, as far as reasonably necessary, to set out the matters they cover in sufficient detail so that each affected regulated fibre service provider is reasonably able to estimate the IMs' material effects.

5 Section 176 states that we must set IMs for cost of capital, valuation of assets, allocation of common costs, treatment of taxation, quality dimensions, regulatory processes and rules, and capital expenditure projects.

6 Telecommunications Act 2001, s 178(2).

Regulatory framework

10. The purpose of Part 6 is to promote the long-term benefit of end-users in markets for FFLAS by promoting outcomes consistent with those produced in workably competitive markets. This purpose is set out in s 162 of the Act.

11. When making decisions, we are required to best give effect to the purpose in s 162 and, to the extent we consider it relevant, the promotion of workable competition in telecommunications markets for the long-term benefit of end-users of telecommunications services. This requirement is set out in s 166(2) of the Act.

12. The IMs support the two types of regulation that must be in place by 1 January 2022.

    12.1 **PQ regulation:** we are required to determine the maximum revenues a regulated provider is allowed to earn from its regulated FFLAS for the first regulatory period, as well as the quality at which regulated FFLAS must be provided. This regulation is implemented through PQ paths which, in terms of the draft IMs, uses a building blocks model (**BBM**) approach. The s 226 regulations have confirmed that PQ regulation will only apply to Chorus Limited (**Chorus**) in areas where LFCs do not operate.

    12.2 **ID regulation:** each regulated provider will be required to disclose a range of information relating to its provision of regulated FFLAS to ensure that interested persons have sufficient information to assess whether the purpose of Part 6 is being met. The s 226 regulations have confirmed that ID regulation will apply to Chorus and the other local fibre companies (**LFCs**) – Enable Networks (**Enable**); Northpower Fibre Limited and Northpower LFC2 (**Northpower**); and Ultrafast Fibre Limited (**Ultrafast**).

13. We explain in **Chapter 2** that we expect the RPR IM will apply only to PQ regulation for Chorus. However, there may be instances where the RPR IM may be indirectly relevant to ID regulation. For example, ID requirements might cross-reference the definition of 'pass-through' costs in the IM for disclosure purposes.[7]

14. As previously signalled in the RPR topic paper we are also taking the opportunity to define regulatory balance dates in the IMs for both PQ and ID regulation as explained in **Chapter 3**. We consider this desirable in order that the new fibre regime functions effectively.

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[7] Enable and Ultrafast suggested that RPR IMs may be relevant to providers subject only to ID regulation, because the IMs could provide indirect guidance for setting prices, considering consequences of amalgamations, and assessing the future impact of PQ regulation on the providers. See Enable and Ultrafast "Fibre Regulatory Processes and Rules submission" (10 September 2019), page 7.

Economic framework

15. We have developed an economic framework to help guide the decisions we make in developing the new regulatory regime for Part 6, including the fibre IMs. The framework helps us make individual decisions that are consistent with each other, and with the requirement to best give effect to the purposes described in s 166(2) of the Act.

16. The economic framework includes three components:

    16.1 **economic principles**, including real financial capital maintenance, allocation of risk, and asymmetric consequences of under-/over investment;

    16.2 **an incentive framework** to help us evaluate how the regime may interact with the incentives faced by regulated providers and assist us in identifying risks to end-users; and

    16.3 **competition screening questions** to help us assess whether our decisions might be relevant to competitive outcomes in telecommunications markets.

17. We have adopted a BBM approach to developing the IMs under Part 6. Under the BBM approach, we calculate the value of the network (the collection of assets) that is used to supply the regulated services; this forms the regulated provider's regulatory asset base (**RAB**). We then use the RAB, along with the regulated provider's other costs and other allowances—together, the building blocks—as a basis for calculating the allowed revenue.

18. As we explained in the 2019 draft decisions paper, the BBM approach also underpins the assessment of returns for ID regulation:[8]

    We can also use BBM as part of ID regulation to underpin the assessment of returns. Measuring returns is an important aspect of assessing whether excessive profits are being limited, and whether financial capital is being maintained, and therefore assists us and other interested parties in assessing whether the objectives set out in s 166(2) are being met.

Section 226 regulations

19. Since we published the 2019 draft decisions paper and draft determination, the Governor-General has made regulations under s 226 of the Act.[9] These regulations specify the scope of services and regulated providers for the IMs, PQ regulation and ID regulation.

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8 Commerce Commission "Fibre input methodologies: Draft decision – reasons paper" (19 November 2019), paragraph 2.28.

9 Telecommunications (Regulated Fibre Service Providers) Regulations 2019.

20. We note that when we published the 2019 draft decisions and draft determination they did not reflect the final s 226 regulations as only an exposure draft of the regulations had been published at that stage. We instead relied on certain assumptions as to what the final regulations would look like. The final s 226 regulations differ to the exposure draft in that Chorus is not subject to PQ regulation in areas where LFCs operate.

21. We do not consider the change from exposure draft to final regulations has materially impacted our RPR IM draft decisions. As mentioned above, the tracked changes we have made to the 2019 draft determination for RPR IM-related matters reflect the final form of the s 226 regulations only as they relate to the RPR IMs. We have not sought to update the original text of the 2019 draft determination in respect of other IM-related matters that could be affected by the s 226 regulations.

Consultation process and context for this paper

22. We are required by s 170 of the Act to publish draft methodologies for the matters specified in s 176 of the Act. We published an IM draft decisions paper on 19 November 2019 (**2019 draft decisions paper**) and a draft IM determination on 11 December 2019 (**2019 draft determination**) for:

    22.1 valuation of assets input methodology (**asset valuation IM**);

    22.2 allocation of common costs input methodology (**cost allocation IM**);

    22.3 cost of capital and risk input methodology (**cost of capital IM**);

    22.4 quality dimensions input methodology (**quality IM**);

    22.5 capital expenditure approvals input methodology (**Chorus capex IM**);

    22.6 treatment of taxation input methodology (**tax IM**),

23. We received submissions on these decisions from interested persons in January 2020 and cross-submissions in February 2020.

24. As outlined in the 2019 draft decisions paper, we had previously published various consultation documents and held stakeholder workshops in relation to the IMs for fibre. As part of this process we published a topic paper on regulatory processes and rules (**RPR topic paper**) on 19 August 2019, which aimed to:

    24.1 explain our current thinking on the issues relevant to the RPR IM; and

    24.2 seek stakeholder views on the proposed scope and content of this IM.

25. We received submissions and cross-submissions on the RPR topic paper.[10] In general, submitters largely agreed that the RPR IM should cover specification of price, re-consideration off price-paths and arrangements for balance dates. However, there were some differing views on whether the form of control, PQR proposal-evaluation processes, wash-up mechanisms and smoothing should be covered by the RPR IM.

26. Views also differed on what the RPR IM should include as pass-through costs, re-consideration event triggers, and regulatory balance dates:

    26.1 some submitters suggested costs such as those associated with disputes resolution schemes should be included as pass-through costs;[11]

    26.2 other submitters suggested other circumstances that may trigger the Commission to re-consider a price path, such as when capex or opex is overstated,[12] or when a cyber security event occurs;[13]

    26.3 some submitters supported uniform regulatory balance dates for all providers,[14] whereas others preferred that regulatory balance dates align with each provider's financial year.[15]

27. The papers we published in late 2019 did not include draft decisions on the RPR IM we are required to set.[16] As such, we are now publishing this paper, along with the draft determination showing how we intend to give effect to our draft decisions, in order to give stakeholders an opportunity to comment on our draft regulatory processes and rules IM. This paper should not be read as a standalone document; rather, it should be read in conjunction with the 2019 draft decisions.[17] Similarly, the RPR IM determination should be read as amending the 2019 draft determination.

We are seeking your views

28. In the 2019 draft decisions paper we signalled that we intended to consult on our RPR IM draft decisions at a later to give us additional time to develop our views.

29. We now invite submissions on this paper from all interested parties, including regulated providers, access seekers and end-users. We are seeking submissions on all aspects of our draft decisions on the RPR IM. While we have identified some specific topic questions, submitters should not feel constrained on the matters they can discuss in their submissions. If possible, please provide evidence or examples to help justify the points you raise in your submission.

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10 Submissions and cross-submissions on the RPR IM topic paper are available at: https://comcom.govt.nz/regulated-industries/telecommunications/projects/fibre-input-methodologies

11 Chorus "Fibre Regulatory Processes and Rules submission" (10 September 2019), page 2; Enable and Ultrafast "Fibre Regulatory Processes and Rules submission" (10 September 2019), page 3.

12 2Degrees "Fibre Regulatory Processes and Rules submission" (10 September 2019), page 2.

13 Chorus "Fibre Regulatory Processes and Rules submission" (10 September 2019), page 2.

14 Vector "Fibre Regulatory Processes and Rules submission" (10 September 2019), page 4.

15 Enable and Ultrafast "Fibre Regulatory Processes and Rules submission" (10 September 2019), page 5.

16 Telecommunications Act 2001, s 176.

17 See Commerce Commission "Fibre input methodologies: Draft decision – reasons paper" (19 November 2019).

30. Submissions are due by **5pm on 29 May 2020**. Please make your submissions via the Commission's fibre IMs project page which will direct you to a form with instructions on how to upload your submission. Your submission should be provided as an electronic file in an accessible form.

31. You will have an opportunity to provide views on the submissions on our paper by making a cross-submission. You will then have until **5pm on 19 June 2020** should you wish to make a cross-submission.

Confidentiality

32. The protection of confidential information is something the Commission takes seriously and in order to continue to protect confidential submissions we are trialling a new submission process. This will require you to upload your submission via the form on the project page. The process requires you to provide (if necessary) both a confidential and non-confidential version of your submission and to clearly identify the confidential and non-confidential versions.

33. When including commercially sensitive or confidential information in your submission, we offer the following guidance.

    33.1 Please provide a clearly labelled confidential version and public version. We intend to publish all public versions on our website.

    33.2 The responsibility for ensuring that confidential information is not included in a public version of a submission rests entirely with the party making the submission.

34. If we consider information disclosed in the confidential version to be in the public interest, we will consult with the party that provided the information before any such disclosure is made. This paper does not contain any material from confidential versions of submissions, nor does it contain any other information identified as confidential or commercially sensitive.

Next steps

35. We intend to consult on an updated draft determination covering all IMs after May 2020. Where relevant, that consultation will take account of submissions and cross-submissions received on the RPR IM, bringing all the IMs back onto the same process track. We are still reviewing the process and time frames for any further consultation and the publication of our final IMs decisions. This will include taking account of the COVID-19 context and we will update you on this as soon as we can. For further information about our consultation processes please refer to our Letter to Stakeholders.[18]

[18] See Commerce Commission "Fibre Input Methodologies: Letter to Stakeholders" (2 April 2020). Available at https://comcom.govt.nz/regulated-industries/telecommunications/projects/fibre-input-methodologies.

2. Regulatory Processes and Rules IM

36. This chapter sets out our draft decisions and reasons for the RPR IM:

    36.1 specification and definition of prices discussed in paragraphs 38 to 49;

    36.2 specification of pass-through costs discussed in paragraphs 50 to 64; and

    36.3 reconsideration circumstances discussed in paragraphs 65 to 106.

37. These draft decisions apply in respect of PQ regulation only.

Draft decision: specification and definition of prices

38. Our draft decision is to specify and define prices as maximum revenues in the form of a revenue cap for Chorus. Maximum revenues (defined in nominal terms, exclusive of GST, and after deducting discounts and rebates) for a regulatory year in a regulatory period are comprised of:

    38.1 building blocks revenues determined by the Commission as part of the PQ path-setting process;

    38.2 pass-through costs; and

    38.3 a wash-up amount applicable under s 196(2) of the Act.

39. This specification allows for all relevant components of maximum revenues to be recovered by Chorus for a regulatory period, consistent with the BBM approach to incentive regulation and the requirements of the Act.

Discussion

40. In implementing PQ regulation, the Commission must specify the maximum prices or revenues that may be charged or recovered by Chorus for a regulatory period, together with the quality standards that apply to Chorus. Consistent with the BBM approach, the prices or revenues reflect the building blocks efficient costs calculated on an *ex ante* basis in respect of Chorus's provision of regulated FFLAS.

41. Section 195 of the Act requires that for the first regulatory period the Commission must specify the maximum revenues that apply, rather than maximum prices.[19] In addition, s 196 requires a wash-up mechanism to be implemented that accounts for the over-recovery or under-recovery of revenue in previous regulatory periods. These provisions effectively require a revenue cap with a wash-up to be applied to Chorus with effect from the first regulatory period.

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[19] Section 164 defines "price" to mean one or more of individual prices, aggregate prices, or revenues (whether in the form of specific numbers, or in the form of formulas by which specific numbers are derived). However, maximum revenues (rather than prices) must be prescribed for each period after the first regulatory period which commences before a reset date declared by Order in Council.

42. In light of these requirements, our draft decision is to specify and define maximum revenues for a regulatory year in a regulatory period in the form of a revenue cap, where maximum revenues are the sum of the building blocks revenues calculated by the Commission, any pass-through costs, and amounts from the s 196 wash-up mechanism. In our view, these components capture all necessary elements of maximum revenues required by the Act and are consistent with the BBM approach to incentive regulation and the requirements of the Act.[20]

43. When defining maximum revenues we consider that we should be consistent with the assumptions used for BBM modelling of *ex ante* costs.[21] Accordingly, revenues should be calculated in nominal (rather than real) terms and should be GST-exclusive (as GST is not a cost ultimately borne by providers). Consistent with accounting standards, customer discounts and rebates are taken into account by deducting those amounts from revenues.

44. We note that revenue smoothing within or between periods can be accommodated within the Commission's calculation of building blocks revenues; for example, via altered depreciation,[22] or by including a separate building block. As discussed in Chapter 4, we have not sought to include the rules for applying revenue smoothing under s 197 in the RPR IM.

45. We received a number of submissions and cross-submissions on the RPR IM topic paper on specification of price.

    45.1 Chorus and Enable/Ultrafast submitted that the specification of price IM should prescribe the components of the revenue cap to apply from implementation date.[23]

    45.2 2Degrees submitted that we should not specify the form of control for the first regulatory period since there is no choice between applying a price or revenue cap, but submitted that the form of control should be reviewed after the first regulatory period had commenced;[24] Vocus supported this view in its cross submission.[25]

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20 In practice there is not expected to be a wash-up amount included in maximum revenues for the first regulatory period as any over-recovery or under-recovery of revenues for the first period will be taken account of in setting maximum revenues for the second regulatory period.

21 These assumptions should also apply when assessing Chorus' compliance with the revenue cap.

22 See Commerce Commission "Fibre input methodologies: Draft decision – reasons paper" (19 November 2019), paragraph 3.1352.

23 Chorus "Fibre Regulatory Processes and Rules submission" (10 September 2019), page 8; Enable and Ultrafast "Fibre Regulatory Processes and Rules submission" (10 September 2019), page 3.

24 2Degrees "Fibre Regulatory Processes and Rules submission" (10 September 2019), page 3; 2Degrees "Regulatory processes and rules – Cross-submission" (16 September 2019), page 2.

25 Vocus "Fibre Regulatory Processes and Rules submission" (10 September 2019), page 4; Vocus "Regulatory processes and rules – Cross-submission" (16 September 2019), paragraph 11.

45.3 Enable/Ultrafast argued that "the process and timing for determining whether the form of control and duration of regulatory period should change for subsequent regulatory periods" should also be included;[26] 2degrees supported this view in its cross submission.[27]

46. As stated above, we consider that the proposed specification of prices prescribes all the necessary components of the revenue cap, consistent with Chorus and Enable and Ultrafast's submission.

47. While – as 2degrees highlighted – the Act specifies a revenue cap for the first PQ regulatory period, it does not do so in sufficient detail to be applied in practice (for example, it is silent on matters such as GST and discounts, and on the relationship of pass-through costs to allowable revenue). We consider that to provide sufficient certainty about the revenue cap, it is appropriate to specify these matters in an IM.

48. We consider that the process and timing for determining the form of control in future regulatory periods should not be covered in the RPR IM. Rather, in considering any change to the form of control, eg, from a revenue cap to a price cap, we would follow the process for considering changes to the IMs set out in ss 179 and 181 of the Act. We note that the regulatory context affecting fibre providers is likely to be materially different in a number of respects to that faced by Part 4-regulated firms, and different factors may need to be considered in relation to form of control.

49. For the implementation of our draft decision see the following tracked changes to the draft determination:

49.1 clause 3.1.1 relating to specification of price; and

49.2 definition of "allowable revenue", "building blocks revenue" and "total FFLAS revenue" in clause 1.1.4(2).

Draft decision: pass-through costs

50. Our draft decision is to include telecommunication levies as pass-through costs, as they are costs that are appropriately borne by end-users and are outside the control of regulated providers. We do not propose to include any other costs as pass-through costs, or to include a separate recoverable costs category.

51. This section discusses:

51.1 the framework we have applied in determining what to include as pass-through costs;

51.2 our reasons for including telecommunications regulatory levies as pass-through costs; and

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[26] Enable and Ultrafast "Fibre Regulatory Processes and Rules submission" (10 September 2019), page 4.

[27] 2Degrees "Regulatory processes and rules – Cross-submission" (16 September 2019), page 2.

51.3 our reasons for not including other costs proposed in our RPR topic paper and in submissions in response to it.

Discussion

52. Prices or revenues are expected to reflect the building blocks efficient costs calculated on an *ex ante* basis in respect of Chorus' provision of regulated FFLAS. Section 176(1)(c)(i) of the Act provides, however, that the RPR IM must include rules for identifying costs that can be directly passed through to prices or revenues.

53. As stated in the RPR topic paper, our view is that the costs which should be directly passed through to end-users are those which one could expect a provider to be able to pass through to prices in a competitive market; those which are faced by all its competitors and which they have no control over. If regulated providers could pass through all costs faced in providing FFLAS, it would mean providers would have little or no incentive to minimise those costs and improve efficiency.

54. To assess this, we apply three criteria:

54.1 it must be appropriate that end-users bear the cost;

54.2 the regulated provider must have almost no control over the cost (whether to incur it and the amount it incurs); and

54.3 the driver of the cost must be foreseeable when the IMs are determined.[28]

Telecommunications levies

55. Consistent with our emerging view in the Topic Paper we propose to include the telecommunications development levy and the telecommunications regulatory levy as pass-through costs.[29] This is because, in our view, these costs are outside the control of regulated providers and are the types of costs which are appropriately borne by end-users.[30] This proposal was supported in submissions by Chorus, Enable and Ultrafast, and Northpower.[31]

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28 PQ path reopeners provide us with the ability to respond to costs that are beyond the control of a regulated provider, but that cannot be foreseen. This is discussed below in paragraphs 65 to 106.

29 As set out in the RPR draft determination at clause 3.1.2, this includes levies made under sections 11 or 12 of the Act (such as the telecommunications regulatory levy) and the telecommunications development levy, as determined by the Commission under sections 87 and 88 of the Act.

30 Consistent with s 176(1)(c)(i), levies do not include the legal costs of any appeal against IM determinations.

31 Chorus "Fibre Regulatory Processes and Rules submission" (10 September 2019), page 9; Enable and Ultrafast "Fibre Regulatory Processes and Rules submission" (10 September 2019), page 3; Northpower "Fibre Regulatory Processes and Rules submission" (10 September 2019), page 2. Vector also supported our emerging view on pass-through costs generally, while not specifically mentioning levies. See Vector "Fibre Regulatory Processes and Rules submission" (10 September 2019), page 3.

56. Since the levies relate to regulation of a range of telecommunication activities (eg, fibre, copper, mobile) we are interested in submitters' views as to whether the full amount of the levies should be permitted as pass-through costs. If it were not appropriate for some portion of the levies to be borne by Chorus' fibre end-users, for instance, then levies could be made subject to cost allocation rules.

57. In its submission on the RPR topic paper, Chorus also sought clarity from the Commission about the treatment of levies prior to the implementation date.[32] Our understanding is that levies incurred prior to implementation date will be treated as operating expenditure for accounting purposes. As such, they will be included in the calculation of the initial financial loss asset under s 177.[33]

Costs of disputes schemes and industry forums

58. Chorus and Enable and UFF proposed extending the definition of pass-through costs to include costs such as participation in disputes resolution schemes (such as Utilities Disputes) and industry forums (such as the Telecommunications Forum).[34]

59. This was opposed in cross-submissions by Spark, who highlighted that regulated providers have some ability to influence these costs: participation in these schemes is (or will be) voluntary, and that these schemes benefit both Chorus' regulated FFLAS services and its unregulated business.[35]

60. We have not proposed to include the costs of disputes schemes or industry forums as pass-through costs. This is because regulated providers have a greater degree of control over these costs, and so should be subject to incentives to ensure their participation is efficient and that the schemes are run efficiently. These costs can instead be considered as part of setting *ex ante* operating cost allowances under the BBM approach.

Local authority rates

61. After further consideration, we do not propose to include local authority rates as pass-through costs because regulated providers have a degree of control over their rates obligations. This is a change in approach from the one suggested in the RPR topic paper. Inclusion of rates as a pass-through cost was supported by Chorus, Enable and UFF, and Northpower.[36]

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32 Chorus "Fibre Regulatory Processes and Rules submission" (10 September 2019), page 9.

33 Clause 2.2.3(27) of the draft determination.

34 Chorus "Fibre Regulatory Processes and Rules submission" (10 September 2019), page 9; Enable and Ultrafast "Fibre Regulatory Processes and Rules submission" (10 September 2019), page 3.

35 Spark "Regulatory processes and rules – Cross-submission" (16 September 2019), page 3.

36 Chorus "Fibre Regulatory Processes and Rules submission" (10 September 2019), page 9; Enable and Ultrafast "Fibre Regulatory Processes and Rules submission" (10 September 2019), page 3; Northpower "Fibre Regulatory Processes and Rules submission" (10 September 2019), page 2.

62. Rates obligations may be affected by the decisions to rent rather than own property, or where to locate buildings or other installations. We consider it better that regulated providers face an incentive to control the whole cost of any property, including rates. Allowance for payment of rates may still be included as part of an *ex ante a*llowance when setting a PQ path.

Recoverable costs category

63. We do not propose including a separate recoverable costs category (as provided for in IMs set under Part 4 of the Commerce Act 1986 (**Commerce Act**)) in the fibre RPR IM requiring, for instance, an approval process for passing some or all costs through to prices or revenues. A recoverable cost category is not needed to implement our draft decision since the only category of pass-through costs that we propose is telecommunications levies for which no approval process should be required.

Implementation

64. For the implementation of our draft decision see the following tracked changes to the draft determination:

    64.1 clause 3.1.2 – relating to pass-through costs.

Draft decision: reconsideration circumstances

65. Our draft decision is to provide for the reconsideration of the *ex ante* PQ path for the following circumstances:

    65.1 catastrophic events;

    65.2 legislative and regulatory change events;

    65.3 error;

    65.4 false or misleading information;

    65.5 major transactions; and

    65.6 GAAP changes.

66. The reconsideration for these events is consistent with the purposes of Part 6, including the economic incentives applying to regulated providers under PQ regulation. We consider the benefits of reconsidering the PQ path for these circumstances are likely to outweigh the expected costs.

Discussion

67. Under PQ regulation the Commission sets maximum prices or revenues for a regulated provider for a regulatory period and specifies the quality standards that apply. Prices or revenues are set on an *ex ante* basis using cost forecasts and other estimates and assumptions. Compliance with these settings is then assessed on an *ex post* basis against actual prices/revenues and quality outcomes.[37]

68. The setting of an *ex ante* PQ path implicitly involves the allocation of risk between regulated providers, end-users and other parties and affects the incentives for providers to act efficiently.[38]

69. Reconsidering (or reopening) a PQ path after it has been set to account for new events or information that differ to the forecasts and assumptions originally used can change the allocation of risk and alter incentives faced by providers.[39] Reopeners affect most directly incentives for providers to invest (s 162(a)), to improve efficiency (s 162(b)), and the ability to extract excessive profits (162(d)).

70. Reconsideration can also indirectly affect the promotion of competition in telecommunications markets. For example, if a catastrophic event destroys assets that support competition in a market (eg, DFAS links to cell towers), then failure to reopen the path to allow for the required additional expenditure to rebuild those assets could not only delay investment in replacement assets (s 162(a)), adversely affect quality for fibre (s 162(b)) and dissuade future investment in assets (s 162(a)), but negatively impact competition in mobile markets (s 166(2)(b)).

71. We have applied the economic framework described in paragraphs 15 to 16 in considering whether providing for a reconsideration event would best give effect to the purposes of Part 6 described in s 166(2) of the Act. In practice, we consider that a balance needs to be struck between:

    71.1 the need to ensure that a PQ path can be reconsidered consistent with the long-term benefit of end-users if an event is so material in terms of its effects that the existing path is no longer appropriate in terms of the purposes of Part 6;[40] and

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37 See paragraphs 2.217 to 2.223 of the 2019 draft decision paper for an overview of PQ regulation.

38 For instance, regulated providers are incentivised to innovate and act efficiently because some or all of the benefits (such as cost savings) achieved within a regulatory period can be retained by the provider. Reconsideration events also work in conjunction with other processes and rules (such as provision for pass-through costs) and other input methodologies (such as capex approval mechanisms) to address uncertainty inherent in setting *ex ante* PQ paths.

39 The short three-year initial regulatory period is likely, all other things being equal, to mean that the need for reopeners is less than, say, under a five-year period. This is because the probability and consequences of getting forecasts that inform the PQ path for the first regulatory period wrong is lower.

40 Chorus noted that reconsideration events provide a method for dealing with contingencies that are unlikely, unpredictable and too material to address through in-period substitution of expenditure. Chorus "Fibre Regulatory Processes and Rules submission" (10 September 2019), page 11.

71.2 the need to appropriately limit the circumstances or events under which a path may be reconsidered. Reconsidering a PQ path could be a costly and time-consuming task. Leaving the criteria too broad could detract from the certainty that the IMs are intended to provide and may give rise to moral hazard.[41]

72. For example, to maximise incentives for regulated providers to behave efficiently, the rules on when a PQ path may be reconsidered should, where possible, be clearly specified. Where the rules are not clear, for instance, providers may be concerned that significant efficiency gains might be viewed as excessive profits and result in pressure for the Commission to reduce prices/revenues. In addition, a provider may not take appropriate action to mitigate risks that it is best placed to manage, as it may assume that consumers will be required to compensate it through increased prices/revenues or by accepting lower quality should the risk eventuate.[42]

73. In our view, PQ paths should only be reconsidered in circumstances where the benefits to end-users and regulated providers of reconsidering the path is expected to outweigh the likely cost (including both immediate costs of reconsidering the path and longer-term costs resulting from the reset path). The benefits and costs should be thought about in terms of promoting the purposes of Part 6.

74. In addition, reconsideration is typically reserved for exceptional circumstances that are unforeseen or that have consequences that are difficult to estimate. There are other situations, such as where the PQ path was set in error or based on false or misleading information, which, having regard to the purposes of Part 6, should be corrected.

75. In our topic paper we suggested that a PQ path should be reconsidered in the following situations (which are largely based on the reopener events applying to PQ regulation for Transpower Limited under Part 4 of the Commerce Act):[43]

75.1 **catastrophic event**, meaning an event beyond a regulated provider's control that could not have been reasonably foreseen;

75.2 **change event**, meaning a change in a regulated provider's legislative or regulatory environment;

75.3 **error**, meaning incorrect data, clearly unintended by the Commission to be included, that impacts the price path; or

75.4 **false or misleading information** has been knowingly provided by a regulated provider to the Commission.

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41 Commerce Commission "Input methodologies (electricity distribution and gas pipeline services) – reasons paper" (22 December 2010), paragraph 8.4.8.

42 Ibid., paragraph 8.4.1.

43 See Commerce Commission *Transpower Input Methodologies Determination 2010* (Consolidated January 2020), subpart 7.

76. No submitter disagreed that reconsideration of a PQ path for these circumstances should be provided for. Various suggestions, however, were made as to how the definition of the relevant events could be modified, as discussed below.

77. We consider that characteristics of PQ-regulated FFLAS are similar enough in materials respects to the context of services regulated under Part 4 for the same reopeners to be appropriate:

    77.1 fibre is essential infrastructure whose continued provision at a given level of service quality is of significant benefit to end-users; and

    77.2 PQ-regulated providers are restricted by price or revenue caps in their ability to pass on unforeseeable increases in continuing to deliver the same service.

78. Some of the reopener events have a materiality level specified which must be met in order for a reconsideration event to be triggered. For instance, the costs of responding to a catastrophic event must be at least equivalent to 1 per cent of the maximum revenues for the regulatory years to which the costs relate.[44] We are interested in submitters' views as to whether the various materiality thresholds specified in the draft determination remain appropriate in a fibre context.

Catastrophic event

79. As mentioned above, the catastrophic event reopener is modelled on that applicable to Transpower in IMs under Part 4 of the Commerce Act. However, our draft decision is to extend the catastrophic event reopener for fibre to apply to situations:[45]

    79.1 which include a "credible and specific threat" of adverse consequences materialising;

    79.2 where costs are incurred "to respond to, mitigate or prevent" those consequences; and

    79.3 where such action "requires or required" expenditure.

80. In our view this is appropriate because it provides additional flexibility in the range of urgent responses to catastrophic risks that could qualify for a reopener for the long-term benefit of end-users. Specifically, allowing for unforeseen *threats* of catastrophic risks to be responded to within the regulatory period encourages firms to pursue efficient and least-cost solutions to avoiding breaching quality standards. A firm does not necessarily need to wait for those adverse consequences to materialise, and expenditure to "prevent" or "mitigate" the consequences may instead provide the optimal response. To allow for these actions, urgent expenditure incurred before an application for a reopener is made should be eligible for consideration. We welcome views from submitters on whether the determination drafting achieves this intent. Alternatively, submitters may have views on whether a different approach to catastrophic events is appropriate.

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44 Clause 3.9.1 of the RPR draft determination.

45 Ibid.

Change event

81. Chorus submitted that the change event reopener should be broadened to include changes in government policy to allow for scenarios such as further government tenders for network build.

82. We have not broadened the definition as suggested by Chorus. We note that if the change in policy resulted in a change in legislative or regulatory requirement then that event would be captured by the existing definition.

83. In our view, a change in the FFLAS regulated under PQ regulation resulting from regulations under s 226 of the Act (eg, deregulation of some services or geographic areas) would constitute a change in legislative or regulatory requirement under the existing definition.

Error

84. After considering the requirements for an error event, we have decided to omit the 1 per cent materiality threshold applying to that reconsideration event. This will allow all errors in the setting of a PQ path to be considered by the Commission, subject to the other criteria applying to that reopener being met.

False or misleading information

85. 2degrees and Vocus submitted that the reopener requirement for false or misleading information to be "knowingly" provided or disclosed should be removed.[46] Spark noted what it saw as the "already strong incentives for access providers to use information asymmetries to influence regulatory outcomes".[47]

86. In its cross-submission, Chorus submitted that the error event reopener addresses these concerns and that to reopen a path for any incorrect information (including, potentially, where actual capex or opex spend is less than forecast allowances in the PQ path) removes incentives for providers to outperform allowances through efficiency gains.[48]

87. We have not removed the "knowingly" provided requirement. In our view the error event reopener adequately provides for situations where incorrect information is inadvertently relied upon, including information provided or disclosed by a regulated provider, consistent with the purposes of Part 6. We agree that allowing all underspend in capex or opex to be adjusted for through a reopener, without considering appropriate incentives under PQ regulation, could undermine the incentives to improve efficiency that setting an *ex ante* PQ path is intended to provide.

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46 2Degrees "Regulatory processes and rules – Cross-submission" (16 September 2019), page 2; Vocus "Fibre Regulatory Processes and Rules submission" (10 September 2019), page 3; Vocus "Regulatory processes and rules – Cross-submission" (16 September 2019), page 3.

47 Spark "Regulatory processes and rules – Cross-submission" (16 September 2019), page 4.

48 Chorus "Regulatory processes and rules – Cross-submission" (16 September 2019), page 4.

Other matters raised by submitters

88. Submitters also raised a number of more general points about the four categories of reconsideration events above.

89. Chorus submitted that reopeners should apply to quality standards set as part of a PQ path, not just price or revenues.[49] Enable and Ultrafast suggested that we take quality into account when specifying the materiality thresholds for reopeners, because reopeners must be suitable to accommodate quality impacts as well as financial impacts.[50] In response to these submissions we note that our draft determination provides for "either or both of the price path and quality standards" to be amended by the Commission following a reconsideration event.[51] We have not sought to specifically define trigger events in terms of quality-only criteria but welcome views from submitters on the circumstances in which this might be appropriate and reasons for these.

90. Enable and Ultrafast submitted that rules for reopener events involving a reconsideration of capital expenditure should be included in the RPR IM, not as part of PQ-setting, and no additional reopeners be included in the capex IM. As outlined in Chapter 4, we have clarified in our draft determination that reconsideration of a price path due to increased needs for capex will not necessarily require the application of rules under the capex IM.[52] This is because we expect the events that reconsideration is intended to cater for will be extraordinary and likely to require urgent action. Those events may therefore not be suited to the existing process requirements for approving *ex ante* capex allowances which are designed to feed into traditional calculations of building blocks revenues or the revenue cap wash-up.

91. Additionally, it is unclear at this stage whether the evaluation criteria in the capex IM would be appropriate for all reconsideration situations. However, we welcome submitters' views on whether additional IM rules are required for reconsidering a price path involving increased capex needs, including whether the requirements of the draft capex IM, *are* appropriate to deal with reconsideration events, or could be appropriately modified.

92. Our draft decision is therefore to provide for the reconsideration of the *ex ante* PQ path for the four events outlined above: catastrophic events, legislative and regulatory change events, error, and false or misleading information.

93. In addition, our draft decision is to provide for two other reconsideration events:

    93.1 **major transactions**, meaning transactions, whether contingent or not, where end-users are acquired or services are no longer provided; and

    93.2 **GAAP changes**, meaning a material change in generally accepted accounting practice (**GAAP**) that affects a PQ path.

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49 Chorus "Fibre Regulatory Processes and Rules submission" (10 September 2019), page 11.

50 Enable and Ultrafast "Fibre Regulatory Processes and Rules submission" (10 September 2019), page 5.

51 See RPR draft determination, clause 3.9.7(1).

52 See RPR draft determination, clause 3.7.1(4).

Major transactions

94. The major transaction reopener is modelled on that applying to electricity distribution and gas businesses under Part 4 of the Commerce Act. It allows us to reopen PQ paths, if necessary, to ensure that they remain appropriate where significant changes in assets, rights or obligations are involved.[53] For instance, if a regulated provider were to dispose of a significant number of assets during a regulatory period then revenues under the PQ path would appear excessive relative to costs. Conversely, if a provider were to acquire significant assets then it is likely that the PQ path would not allow FCM to be achieved relative to that period.

95. We consider that this reconsideration provision is necessary because there are many ways that transaction could occur, and it is not feasible to establish upfront rules that can account for all situations.

96. Enable and Ultrafast, and Northpower, submitted that a major transaction reopener would not provide sufficient guidance on the treatment of providers subject only to ID regulation which are amalgamated with providers subject to PQ regulation. Those submitters suggested that the amalgamating company should remain subject to ID-only during remainder of the PQ regulatory period. In response to this, however, we note that the entities and services that are subject to regulation under Part 6 are prescribed by the Governor-General under s 226 of the Act. As such, it would not be appropriate for us to determine these matters in the IMs.

GAAP changes

97. In our 2019 draft decisions paper we noted that we often rely on accounting standards and rules set under GAAP where they are consistent with regulatory objectives.[54] Our draft decision is that a change in GAAP standards with a material effect occurring after a PQ path is set can allow that PQ path being reopened. The change must not have been contemplated, implicitly or explicitly, by that PQ path.

98. A recent example of GAAP changes that the Commission has considered in respect of Part 4 of the Commerce Act is raised by a new financial reporting standard New Zealand Equivalent to International Reporting Standard 16 Leases (NZ IFRS 16). We consider that a GAAP reopener will allow us to respond to unforeseen changes to important rules we relied on in setting PQ paths.

99. We have included a materiality threshold relating to 1 per cent of revenues in the relevant determination clause.[55] We welcome submitters' views on whether that threshold is appropriate.

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53 We have clarified that company amalgamations can constitute a major transaction.

54 Commerce Commission "Fibre input methodologies: Draft decision – reasons paper" (19 November 2019), paragraph 3.48.

55 Clause 3.9.3 of draft determination.

Reconsideration in other circumstances

100. Submitters suggested that that various other events should be included in the RPR IM as reconsideration events.

101. Chorus submitted that the Part 6 fibre context is potentially different to that under Part 4 of the Commerce Act, and that some types of uncertainty or contingency exist for Chorus for which *ex post* adjustments to opex and capex allowances via reopeners could be warranted.

102. Two telecommunications-specific reopeners were suggested by Chorus:

102.1 cyber security events (a step change in the prudent level of cyber-security investment); and

102.2 market change (changes affecting the FFLAS market that involved material impacts on expenditure levels or quality standards).[56]

103. In response to Chorus's suggestions, 2degrees cautioned that reopening for a range of risks, such as those influenced by FFLAS take-up and copper-fibre transfer are matters that Chorus can influence and it is better placed to manage the risk than end-users. 2degrees considered changes affecting the FFLAS market to be too open-ended, and reopener circumstances should be deliberately limited to avoid creating a de facto one-year regulatory period. Spark queried whether the catastrophic or change event reopener would address some of these situations.

104. As noted above, we have extended the catastrophic event reopener to apply to situations where costs are incurred in response to a "credible and specific threat" and "to respond to, mitigate or prevent" adverse consequences. It is therefore possible that a step change in the prudent level of expenditure to deal urgently with a specific unforeseen cyber-security risk with catastrophic implications could qualify for a reopener. However, the other requirements of the reopener would need to be met, including that the expenditure was not explicitly or implicitly provided for in the PQ determination. We welcome submitters' views on whether this is appropriate.

105. For other types of uncertainty, such as those identified by Chorus, we would need to be satisfied that shifting attendant risks away from regulated providers via a reopener would be consistent with the purpose statements in the Act. Our draft decision is not to include any further reopeners at this stage, but we remain open to evidence as to why these risks are not best placed to be managed by providers in conjunction with setting *ex ante* building block allowances under a revenue cap. We note that reopeners are typically reserved for exceptional circumstances, and that any reopener events need to be tightly defined.

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[56] Chorus "Fibre Regulatory Processes and Rules submission" (10 September 2019), page 2; Chorus "Regulatory processes and rules – Cross-submission" (16 September 2019), page 5.

Implementation

106. For the implementation of our draft decisions see the following tracked changes to the draft determination.

106.1 Insert new Subpart 9 of Part 3 relating to reconsideration events.

106.2 Clause 3.7.1(4) amended to clarify that a capex allowance during or after a regulatory period or a 'connection capex variable adjustment' is used to calculate a wash-up amount, not for an in-period reconsideration.

106.3 Additions to the interpretation section relating to the reconsideration events, such as definitions of reconsideration event triggers (see **clause 1.1.4(2)**).

3. Regulatory balance dates

107. This chapter sets out our draft decisions and reasons for specifying rules for regulatory balance dates.

Draft decision: regulatory balance dates

108. Our draft decision is that the regulatory balance date for all regulated providers will be 31 December. This date aligns with the implementation date of the new fibre regime and will aid interested persons in comparing information disclosed by providers over time. This draft decision applies to both ID and PQ regulation.

Discussion

109. As explained in the RPR topic paper, it is necessary to agree on the relevant annual regulatory balance dates for the purposes of implementing fibre regulation:[57]

109.1 the BBM approach tends to rely on calculations performed for discrete annual periods consistent with financial accounting conventions;

109.2 ID and PQ determinations are required to set out relevant timeframes including the regulatory periods that must be complied with or apply; and

109.3 the implementation date for both ID and PQ regulation is 1 January 2022, and the duration of the first regulatory period for PQ regulation is 3 years.

110. The concept of annual regulatory calculations is embedded in the draft IMs through the definition of "disclosure year" and "regulatory year" which are used in several IMs.[58] Disclosure year is defined in relation to ID IMs and regulatory year is defined in relation to PQ path IMs. The regulatory year term is only used in the for PQ paths. The disclosure year term is used in both information disclosure IMs and the PQ IMs, including:

110.1 the asset valuation IM which establishes an initial value for assets at the implementation date and rolls-forward this value to the start of each subsequent disclosure year, adjusting for additions, disposals, depreciation and revaluations for the intervening disclosure year;[59]

110.2 the cost allocation IM in choosing causal allocators defined as a "circumstance in which a cost driver leads to an operating cost being incurred

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57 Commerce Commission "Fibre input methodologies – Regulatory processes and rules topic paper" (19 August 2019), page 9.

58 "Disclosure year" was defined in the December draft determination as "a 12-month period ending on the date specified in an ID determination". Similarly, "regulatory year" was defined as "a 12-month period ending on the date specified in a **PQ determination**". See Commerce Commission "[Draft] Fibre Input Methodologies Determination 2020" (11 December 2019). See pages 19 and 33 of the RPR draft determination for our amended definitions.

59 Commerce Commission "Fibre input methodologies: Draft decision – reasons paper" (19 November 2019), page 109.

during the 12-month period terminating on the last day of the disclosure year";[60]

110.3 the cost of capital IM, where the regulatory weighted average cost of capital will be published "within one month of the start of the disclosure year".[61]

111. The specification of regulatory balance dates is therefore a fundamental definitional matter that affects the functioning of the IMs. Our view is that including arrangements for regulatory balance dates in our draft decisions for IMs will help promote certainty, as set out in s 174 of the Act. In particular, the rules will promote certainty for regulated providers and help them prepare for fibre regulation (eg, by making any required adjustments to their financial reporting processes).

112. In the RPR topic paper we asked whether the RPR IM should include arrangements for balance dates so, for example, that:[62]

112.1 each regulated provider's disclosure year lines up with their financial reporting year which could reduce reporting and compliance costs; or

112.2 all regulated providers have the same disclosure year so interested parties (including the Commission) can assess performance more easily.

113. Section 187(2)(b) states that the Commission:

…must, as soon as practicable after any information is publicly disclosed, publish (on an Internet site maintained by or on behalf of the Commission) a summary and an analysis of that information for the purpose of promoting greater understanding of the performance of individual regulated fibre service providers, their relative performance, changes in their performance over time, and their ability to extract excessive profits.

114. We noted that a variety of approaches have been used in Part 4 of the Commerce Act,[63] for example:

114.1 for electricity transmission, Transpower's IPP defines the regulatory control period as the year ending in 31 March but the disclosure year as the year ending 30 June;[64]

114.2 electricity distribution companies must disclose information and are PQ regulated on an annual basis with 31 March as the regulatory year end, irrespective of their financial reporting balance dates;[65] and

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60 Commerce Commission "Fibre input methodologies: Draft decision – reasons paper" (19 November 2019), page 172.

61 Commerce Commission "Fibre input methodologies: Draft decision – reasons paper" (19 November 2019), page 213.

62 Commerce Commission "Fibre input methodologies – Regulatory processes and rules topic paper" (19 August 2019), page 10.

63 Commerce Commission "Fibre input methodologies – Regulatory processes and rules topic paper" (19 August 2019), page 11.

64 Commerce Commission *Transpower Individual Price-Quality Path Determination 2015* (consolidated 26 November 2018), page 11.

114.3 gas distribution companies have varying disclosure years for ID, aligned with their financial reporting years.[66]

115. This illustrates that, subject to any specific legislative direction, potentially any regulatory balance date could be accommodated if needed for fibre,[67] although different options could be expected to come with advantages and disadvantages. This was reflected in the variety of views in the submissions and cross submissions we received from stakeholders, as summarised below. The main options seemed to be aligning regulatory balance dates for the purposes of ID and PQ regulation or across all regulated providers. We also considered the advantages of aligning the regulatory balance date to regulated provider's financial reporting years.

116. In reaching our draft decision on this matter we considered which option was most consistent with legislative directions and requirements, such as the need to implement ID and PQ regulation from 1 January 2022,[68] as well as the purpose statements in the Act.[69] We also considered the likely reporting and compliance burden of each option, such as the potential consequences of regulated providers being required to prepare financial reports for two different periods, or having to undertake additional reporting processes at financial year end.

117. Our draft decision is that the regulatory balance date for all regulated providers for both ID and PQ purposes should be 31 December for the following reasons.

117.1 This is consistent with the implementation date and initial regulatory period length of three years. It allows roll-forward values or allocated costs for even periods of 12 months. It avoids having to calculate or roll-forward values for part years and needing to adjust the IMs for that (eg, part year depreciation or revaluations).

117.2 If each regulated provider has the same disclosure year for ID regulation, this will facilitate interested persons (including the Commission) to compare financial and other information about the performance of regulated providers.

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65 Commerce Commission *Electricity Distribution Information Disclosure Determination 2012* (consolidated April 2018), page 15.

66 Commerce Commission *Gas Distribution Information Disclosure Determination 2012* (consolidated April 2018), page 13

67 Chorus noted in its submission "the approach with Transpower's IPP where the ID disclosure year is 30 June and revenue control balance date is offset to 31 March". Chorus "Fibre Regulatory Processes and Rules submission" (10 September 2019), page 19.

68 Section 172 of the Act states that we must determine PQ and ID regulation for the first regulatory period before implementation date. Implementation date is 1 January 2022 – see Notice of Deferral of Implementation Date Under the Telecommunications Act 2001 (12 December 2019) *New Zealand Gazette* No 2018-go220.

69 The purpose of Part 6 of the Act is set out in s 162; matters to be considered by the Commission and Minister are set out in s 166.

118. The submissions on the RPR topic paper favoured specifying arrangements for regulatory balance dates in the IMs in the interest of certainty. Submitters' views differed on the regulatory balance date that should be applied. For example:

118.1 2Degrees, Vector and Vocus agreed that there are benefits for interested persons in aligning the disclosure year for all regulated providers for the purposes of ID regulation;[70]

118.2 Chorus supported having a 31 December balance date for its first regulatory period for PQ regulation "given the constraints with an implementation date of 1 January 2022", but a 30 June balance date for ID purposes;[71]

118.3 Northpower, Enable and Ultrafast disagreed with the suggestion of aligning all regulated providers' balance dates.[72] Their preference would be to align regulatory balance dates with financial reporting balance dates in order to reduce reporting and compliance costs.[73]

119. On balance, we have concluded that the benefits outlined in paragraph 117 for consistent balance dates across all regulated providers for both ID and PQ outweighs the potential disadvantages raised by submitters, as outlined in paragraph 118. Consistent balance dates and information across providers and services allows increased transparency and scrutiny of information by the Commission and other interested persons. This best gives effect to the purpose of the of the Act under s 162 and it promotes workable competition for the long-term benefit of end-users under s 166. We consider this is the best way to promote certainty in relation to the rules, requirements and processes applying to regulation under Part 6.[74]

120. We are aware that Chorus, Enable and Northpower Fibre all have 30 June balance dates for financial reporting purposes, whereas Northpower LFC2 and Ultrafast have 31 March company balance dates. However, we understand that these companies routinely prepare half year accounts and that for those companies with a 30 June balance date these can be combined to assist with the preparation of calculations for a 31 December year.

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70 2Degrees "Fibre Regulatory Processes and Rules submission" (10 September 2019), page 2; Vector "Fibre Regulatory Processes and Rules submission" (10 September 2019), page 4; Vocus "Fibre Regulatory Processes and Rules submission" (10 September 2019), page 3.

71 Chorus "Fibre Regulatory Processes and Rules submission" (10 September 2019), page 16; Vocus "Fibre Regulatory Processes and Rules submission" (10 September 2019), paragraph 4.3.

72 Chorus made the point in their submission that they currently report in accordance with their financial year and would "have difficulty reporting in accordance with a disclosure year that isn't aligned with our financial year." Chorus "Submission on Fibre input methodologies – Draft decision – Appendix C" (30 January 2020), page 5.

73 Northpower submitted that "[t]he regulatory regime should achieve its purpose without creating unnecessary increases in compliance costs", Northpower "Fibre Regulatory Processes and Rules submission" (10 September 2019), page 2; Enable and Ultrafast argued that "this will minimise cost and complexity for FFLAS providers and help to ensure disclosure data is robust and consistent over time", Enable and Ultrafast, "Fibre Regulatory Processes and Rules submission" (10 September 2019), page 10.

74 Section 174.

121. We agree that it is important that regulated providers are able to comply with regulatory requirements and acknowledge that there are some costs involved in meeting the regulatory reporting obligations set by the Commission. As we develop ID and PQ regulatory requirements we will consider further how to minimise reporting and compliance costs for providers.

Implementation

122. For the implementation of our draft decision see the following tracked changes to the draft determination:

122.1 definitions of “disclosure year” and “regulatory year” in clause 1.1.4(2).

4. Other IM-related matters

123. This chapter covers consequential amendments required to the 2019 draft determination in light of our draft decisions on the RPR IM. It also explains the other topic areas suggested by interested persons that have not been included in our draft decisions for the RPR IM.

Consequential amendments

124. In the RPR draft determination we also made several consequential amendments that were necessary for the IM to function effectively, including:

124.1 deleting "recoverable costs" from the definition of "core fibre asset", "operating costs", "right-of-use asset" and "UFB asset" (see the interpretation section from **clause 1.1.4(2)**);

124.2 deleting the definition of "recoverable cost" and amending the definition of "pass-through cost" to refer to clause 3.1.2 of the RPR draft determination (see the interpretation section from **clause 1.1.4(2)**);

124.3 deleting the square bracketed phrase "[Regulatory Processes and Rules]" where it appeared in the document, including **clauses 3.2.1(4)(b), 3.3.1(4)(b)** and **3.4.1(3)(b)**;

124.4 consequential renumbering of subparts and clauses in Part 3;

124.5 clarifying that reconsideration of capex allowances as a result of a reconsideration event is not subject to the rules under the capex IM (see **clause 3.9.7(5)**); and

124.6 clarifying that approval of additional capex allowances under the capex IM will be addressed by the wash-up under s 196 of the Act (see **clause 3.7.1(4)**).

Other topic areas not included

125. Various submitters suggested that processes or rules for other topic areas be included in the RPR IM. We discuss those areas below, together with reasons for why those matters have not been included in our draft decisions for the RPR IM.

Rules on wash-up mechanism and revenue smoothing

126. Many submitters requested that rules for calculating wash-ups and for revenue smoothing should be clarified as part of the RPR IM, including any restrictions or constraints applying to the calculation of wash-ups and the circumstances in which smoothing would be applied.[75]

[75] Chorus "Fibre Regulatory Processes and Rules submission" (10 September 2019), page 4; Vocus "Fibre Regulatory Processes and Rules submission" (10 September 2019), page 3; 2Degrees "Fibre Regulatory Processes and Rules submission" (10 September 2019), page 2; Enable and Ultrafast "Fibre Regulatory

127. In our view the approach to calculating wash-ups and revenue smoothing required under ss 196 and 197 of the Act should be addressed at the time that our approach to setting PQ paths is developed. Wash-ups and smoothing are not matters we are required to address in the RPR IM under s 176(1)(c) of the Act and we consider that the design of these mechanisms is best considered in the context of overall decisions on the allocation of risk and incentives under PQ paths.

128. Spark submitted that it is unclear how the wash-up could be considered in isolation from other IM decisions that deal with risk allocation.[76] However, in our 2019 draft decisions paper we noted that the detail of how a wash-up will apply is unlikely to change our draft decisions with respect to asset stranding risk.[77] In that context it is the existence of a wash-up rather than the mechanics which matter most.

PQ process and evaluation criteria

129. Submissions received from 2degrees, Enable and Ultrafast, and Chorus suggested that the RPR IMs should include details of the proposal process and evaluation of PQ paths.[78] These rules could include information to be provided by the regulated provider, pre-submission verification of proposals, certification and assurance requirements, and criteria to be applied when assessing a PQ path proposal.[79] Chorus submitted that stipulating clear evaluation criteria for forecast expenditure would support the preparation of high-quality proposals.[80]

130. We note that we have made draft decisions on capex projects as required by s 176(1)(d) of the Act, but that rules for the PQ path proposal process and evaluation of PQ paths are not matters that we are required to address in the RPR IM under s 176(1)(c) of the Act.

131. A key reason for not specifying these matters in an IM is the possibility that circumstances surrounding setting upcoming PQ paths could differ markedly from period to period. Having flexibility to respond to differing circumstances by tailoring our approach to setting PQ paths is in the long-term interest of end-users. Moreover, we intend to provide suitable guidance on process and evaluation of PQ paths to regulated providers and other persons nearer the time of those events.

Processes and Rules submission" (10 September 2019), page 4; Spark "Fibre Regulatory Processes and Rules submission" (10 September 2019), page 4.

76 Spark "Fibre Regulatory Processes and Rules submission" (10 September 2019), page 5.

77 Commerce Commission "Fibre input methodologies: Draft decision – reasons paper" (19 November 2019), paragraph 3.1285.

78 2degrees "Fibre Regulatory Processes and Rules submission" (10 September 2019), page 2; Chorus "Fibre Regulatory Processes and Rules submission" (10 September 2019), page 6; Enable and Ultrafast "Fibre Regulatory Processes and Rules submission" (10 September 2019), page 6.

79 Enable and Ultrafast "Fibre Regulatory Processes and Rules submission" (10 September 2019), page 6.

80 Chorus "Fibre Regulatory Processes and Rules submission" (10 September 2019), page 6; Chorus "Regulatory processes and rules – Cross-submission" (16 September 2019, page 2.

Pricing methodologies and service specifications

132. Spark submitted that we should set a pricing methodology as part of the RPR IM that provides guidance on cost-based prices, such as cost-based prices applicable to anchor services and for unbundled services.[81] Spark also submitted that the Commission should have the ability to clarify or amend service specifications and quality performance of individual services part-way through a regulatory period.[82]

133. Trustpower had previously suggested that we include an IM process for amending price structures and quality dimensions in response to changes in relevant markets and technologies.[83] Enable and Ultrafast submitted that amending price structures and quality dimensions would be inconsistent with a revenue cap form of control.[84] Chorus submitted that it is not the role of the IMs to provide certainty over service specifications and future prices.[85] Vector submitted that an IM for unbundling is needed given the price and non-price terms for unbundled products make it uneconomic to offer.[86]

134. Our response to submissions regarding IMs for these matters is explained as follows.

134.1 **Price structures and methodologies**. We do not intend to determine such an IM for the first regulatory period. As we noted in the fibre IMs emerging views paper, we consider that the legal pricing constraints that the Act imposes on Chorus will, at least in the first regulatory period, sufficiently limit Chorus' ability to set prices in ways that could lead to long-term harm to competition or to detriment to end-users of telecommunication services.[87] As Enable and Ultrafast noted in their submission, it is possible that information about pricing of individual products or types of products could be required to be disclosed by providers under ID regulation.[88]

134.2 **Amending quality dimensions or service specifications.** While the Commission can determine the quality of services provided, it is the legislation that sets out the specifications of any regulated services. Sections 227-229 of the Act prescribe processes for the Governor-General, on the recommendation of the Minister, to declare anchor services, DFAS and unbundled fibre services as must-offer services with descriptions and maximum prices. As we explained in the 2019 draft decision paper, however, setting an IM for fibre services, including unbundled fibre services, would not be consistent with the purpose and function of these provisions.[89]

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81 Spark "Fibre Regulatory Processes and Rules submission" (10 September 2019), page 3.
82 Spark "Fibre Regulatory Processes and Rules submission" (10 September 2019), page 1.
83 Trustpower "Submission on the new regulatory framework for fibre" (21 December 2018), page 3.
84 Enable and Ultrafast Fibre Regulatory Processes and Rules submission" (10 September 2019), page 9.
85 Chorus "Regulatory processes and rules – Cross-submission" (16 September 2019), page 5.
86 Vector "Fibre Regulatory Processes and Rules submission" (10 September 2019), page 3.
87 Commerce Commission "Fibre regulation emerging views – Technical paper" (21 May 2019), page 26.
88 Enable and Ultrafast "Fibre Regulatory Processes and Rules submission" (10 September 2019), page 5.
89 Commerce Commission "Fibre input methodologies: Draft decision – reasons paper" (19 November 2019), page 82.

134.3 **Unbundled services.** In response to Vector's concern about potentially uneconomic offering of unbundled fibre services, we noted in the 2019 draft decisions paper that equivalence and non-discrimination requirements relevant to FFLAS are governed by Part 4AA of the Act and the Fibre Deeds,[90] not Part 6. We do not consider it within our power to set IMs specifically for equivalence and non-discrimination requirements.[91]

Expenditure incentives

135. We have decided not to include specific expenditure incentives such as an incremental rolling incentive scheme (**IRIS**) in the fibre IMs at this stage. This is because we consider that the efficiency-related risks to end-users in the short term are likely to be low. In this context, it is not evident that introducing an IRIS is likely to better promote s 162(b). We outline submissions received on this point and elaborate on our reasoning for not including an IRIS below.

136. We received a submission from Chorus suggesting that expenditure incentives (such as development of a simplified IRIS for opex and capex) could be addressed in the RPR IM or in a broader expenditure IM.[92] In cross-submissions Vocus submitted that expenditure incentives do not necessarily need to be included in IMs.[93] Spark submitted that incentives around opex and capex together could be considered (including a totex approach), however that would need more time to develop than has been available.[94]

137. Expenditure-related incentive schemes such as IRIS aim to promote s 162(b) by adjusting and enhancing the regime's incentives to improve efficiency. By design, the regime already provides incentives to improve efficiency – setting the revenue path against forecast expenditure provides for some financial incentives to operate efficiently consistent with s162(b) with or without an IRIS. More generally, Chorus may also face further incentives to improve efficiency from the threat of competition, although the strength of this threat is currently unknown.

138. Including an IRIS would give us the additional ability to:

138.1 modify the overall incentive strength provided by the initial three-year regulatory period, if we considered it was not appropriate;

138.2 equalise the incentive strength across the regulatory period to eliminate the incentive to strategically (but inefficiently) time expenditure;

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90 It was a requirement of the UFB initiative that fibre providers offering services provided using networks developed (in whole or in part) with Crown funding give undertakings to the Crown. Given under Part 4AA of the Act and defined here as Fibre Deeds. See Commerce Commission "Fibre input methodologies: Draft decision – reasons paper" (19 November 2019), paragraph 2.12.

91 See also Commerce Commission "Equivalence and non-discrimination – guidance on the Commission's approach for telecommunications regulation" (4 March 2020).

92 Chorus "Fibre Regulatory Processes and Rules submission" (10 September 2019), page 3.

93 Vocus Regulatory processes and rules – Cross-submission" (16 September 2019), page 3.

94 Spark "Regulatory processes and rules – Cross-submission" (16 September 2019), page 4. Totex, or total expenditure, is a combination of capex and opex.

138.3 equalise the incentive strength that applies to opex and capex to eliminate the incentive to inefficiently substitute one for the other; and

138.4 eliminate the incentive to game resets by inflating expenditure incurred in the base year (ie, the year used as the base from which to forecast expenditure for the subsequent regulatory period).

139. The following factors will likely mitigate the above incentive risks in the short term.

139.1 Chorus' ability to find efficiency improvements is likely lower in the short term, especially for capex. This is because the network is new, and therefore the need to replace and maintain assets is small. Because of this, even though incentives to find efficiencies are weak given the shorter regulatory period, the potential harm is also likely lower. However, the risk to efficiency will grow over time. This suggests that we should continue to monitor it and potentially consider ways to increase the incentive strength if the need arises in the future.

139.2 The three-year regulatory period also means that the ability to game the timing of expenditure is reduced. Further, there are other targeted tools that we can use to mitigate the risk of gaming the timing of expenditure, like the connection capex mechanism and quality standards under PQ regulation.

139.3 The scope for capex/opex substitution in the first regulatory period is low as a lot of capex has recently been incurred in the ultrafast broadband rollout. Also, the ability to inefficiently substitute connection capex (which will initially be a large capex category) for opex is low.

139.4 The scrutiny of Chorus's capex proposals through the capex IM (and potentially opex through PQ path-setting processes) can mitigate the risk of gaming of the base year.

140. In this context, the question we face is whether these risks warrant the introduction of an IRIS now. On balance, we have decided that not introducing an IRIS at this stage best gives effect to s 162(b) of the Act. Deferring the introduction of an expenditure incentive scheme will allow us to understand how the incentives already built into the regime play out and gather evidence to validate risks. This should allow us, if required, to design a fit-for-purpose IRIS in the future that is informed by evidence and minimises the risk of unintended consequences and unnecessary complexities.