Vodafone Submission

New regulatory framework for fibre:

Submission on Fibre Regulation Draft Decision

Public Version

28 January 2020

Introduction

To date we have provided comment on behalf of our customers as a counter-balance to the self-interested submissions of the LFCs and their investors. In a market where wholesale price changes are passed through to end-users[1] we stand to gain very little as a business. However, we are customer obsessed and want to see end-users get a great service at a reasonable price.

Unfortunately, the Draft Decision appears to be primarily concerned with responding to the LFCs, and has given little consideration of views raised by those representing consumer interests. The end-result is a Draft Decision that moves the balance heavily in favour of the LFCs. A number of concessions have been made that in sum result in a significant bias, including:

- Not attempting to allocate costs between layer 1 and layer 2 services.
- Not attempting to account for double recovery of costs between copper and fibre.
- Simplifying cost allocation to use more proxies and aggregate further, because it causes less work for the LFCs.
- Applying the full asset Beta during the losses period despite Lally clearly identifying that it must be less, and may be closer to zero than the full Beta.
- Rounding up the TAMRP to the nearest 0.5%, increasing it from 7.3% to 7.5%, one of the most material adjustments.
- Applying a TCSD with little evidence that it is necessary.
- Picking a Beta at the top end of CEPAs range.
- Building an entire model to estimate an allowance for the cost of Crown financing.
- Not requiring a verifier for base capex in the first period.
- Not stranding assets unless they are deregulated.
- Providing an allowance for the potential for deregulated assets not being able to earn a return.
- Not accounting for the time value of money for tax losses.

At this stage in the process we have little more to add, but we hope to see a greater level of engagement on some of the points we have raised in previous submissions than we have seen to date. Participating in this process is a costly and time consuming exercise, and it is difficult to justify the effort with the level of engagement from the Commission in the draft decision. As a result this submission largely just re-states views in our previous submissions that have not yet been given proper consideration. We also provide some limited comment on the risk of asset stranding.

[1] Commerce Commission, 21 June 2017, 'How retailers of telecommunications services have passed through changes in regulated wholesale copper prices to retail prices for residential consumers: A study under section 9A of the Telecommunications Act'.

We have also contributed to and support the joint 2degrees, Spark, Vocus and Vodafone submission on quality. Quality is the most important part of the draft decision for us. We ask that the Commission carefully consider the joint submission and engage with industry to make sure this part of the regime operates as effectively as possible.

Finally we'd like to note a number of areas where we support the Commission's approach and hope no further changes are made, namely:

- Applying a set of competition screening questions
- The Commission themselves setting the cost allocators for the pre-implementation period
- Retaining the BBB+ credit rating for the debt premium
- Not applying a percentile uplift to the WACC
- Broadly applying a pragmatic approach to capex approvals that will allow for timely upgrades – although we still hold some concerns about the simplifications allowed in the first period.
- Recognising the tax benefit of losses during the pre-implementation period

Confidentiality is sought in respect of the information in this document that is highlighted and contained within square brackets (the **Confidential Information**).

Confidentiality is sought for the Confidential Information for the purposes of section 9(2)(b) of the Official Information Act 1982 on the following grounds:

- the Confidential Information is commercially sensitive and valuable information which is confidential to Vodafone; and
- disclosure of the Confidential Information would be likely to prejudice unreasonably the commercial position ofVodafone.

Vodafone requests that it is notified if the Commission receives any request under the Official Information Act 1982 for the release of any part of the Confidential Information, and that the Commission seek and consider its views as to whether the Confidential Information remains confidential and commercially sensitive before it responds to such requests.

The risk of asset stranding

The Commission has proposed that the LFCs should be given an allowance for the risk that certain assets may become deregulated, and that those assets may then be stranded. This allowance – even if it can be justified – is overly-generous and is incorrectly applied. Specifically:

- there has not been sufficient justification for a non-systematic risk allowance;
- even if a non-systematic risk allowance were justified, the Commission has over-estimated the risk when you carefully consider the nature of competitive alternatives;
- instead the Commission should allow some simple metrics to remove unused regulated assets from the RAB.

No Justification for a non-systematic risk allowance

The allowance proposed by the Commission is for the non-systematic risk of deregulated asset becoming stranded. It is rare for the Commission to provide an allowance for non-systematic risks. As the Draft Decision itself notes:

> *Stranding risk may not be a systematic risk because the risk can be managed by investors holding a diversified portfolio of assets. This means that if an investor is concerned about a regulated FFLAS becoming stranded, the investor can hedge against this risk by investing in a firm that has a competing technology, e.g. 5G.*[2]

The Commission's assessment should have stopped there.

Instead the Commission goes on to calculate the size of compensation without ever justifying why it should exist in the first place. The s162 purpose statement requires the Commission to promote the long-term benefit of end-users. Contrary to this clear direction, the Commission has exercised discretion in favour of LFCs – without any valid reason or analysis to support such departure. Such approach could only be justified where strong and compelling objective evidence compels Commission to err in favour of LFCs, these circumstances don't exist here.

This approach is also in direct conflict with the precedent set by regulations set under Part 4 of the Commerce Act. In that context the Commission has stated that:

> *Unsystematic risk is not generally rewarded in workably competitive capital markets.*[3]
>
> *...[and]*

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[2] Commerce Commission, 19 November 2019, 'Fibre Input Methodologies: Draft decision – reasons paper, para 3.1307.

[3] Commerce Commission, December 2010, Input Methodologies (electricity Distribution and Gas Pipeline Services): Reasons Paper, para H1.8.

> *no adjustments will be made to the cost of capital for unsystematic or asymmetric risk, including real options.*[4]

The only precedent we were able to find for the Commission ever considering non-systematic risk is the 2005 Draft Guidelines for estimating the cost of capital, and the 2009 revisions. In those documents the Commission makes the following remarks:

> *Making an upward adjustment to firms' WACCs, to account for unsystematic risks, is an approach often advocated by regulated firms. However, the Commission considers that making such adjustments may be arbitrary and ad hoc.*[5]

Despite its own sound guidance, the Commission has nevertheless proceeded here in an arbitrary and ad hoc manner. Although the Commission's document suggest that certain asymmetric risks may be compensated for, they also note that if an adjustment were to be made for such an uncertain risk, this should be done "through adjustments to cash flows, rather than through a margin on WACC."[6].

In any event, to qualify for this treatment, stranding risk must be clearly asymmetric. However, as the Draft Decision notes that "there is some possibility that the economic life of the assets may be longer than first envisaged. There is the historic example of copper networks whose life was extended by the arrival of broadband technologies."[7]

Yet, the Commission has made no attempt to quantify the difference between the upside and downside risk. Instead they have focussed all their attention on a spurious estimate of the downside risk, once again biasing their analysis in favour of the LFCs.

There is simply too much uncertainty in this analysis to come up with a reasonable number. The best estimate of the compensation must be zero.

We also note an inconsistency with the Commission's treatment of unregulated assets. For this allowance the Commission is explicitly considering the profitability of unregulated assets (those that have been deregulated). Whereas elsewhere in the Draft Decision the Commission has said they cannot consider profitability of unregulated assets, such as estimating the return on copper assets during the losses period, or estimating the benefit of tax losses for other parts of an LFCs business.[8] We raised this point in our last submission, but it has been given no consideration by the Commission.[9]

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[4] Commerce Commission, December 2010, Input Methodologies (electricity Distribution and Gas Pipeline Services): Reasons Paper, para H2.3.
[5] Commerce Commission, 2005, 'Draft Guidelines: The Commerce Commission's Approach to Estimating the Cost of Capital', para 34
[6] Commerce Commission, 2005, 'Draft Guidelines: The Commerce Commission's Approach to Estimating the Cost of Capital', para 165.
[7] Commerce Commission, 19 November 2019, 'Fibre Input Methodologies: Draft decision – reasons paper, para 3.1316.
[8] Notably, the Commission only appears to be constrained from considering the impact on unregulated assets when it would favour end-users.
[9] Vodafone, 19 July 2019, "Submission, on Fibre Regulation Emerging Views', P13-14.

The risk of deregulated assets being stranded is zero

The allowance proposed by the Commission is based on two events occurring: certain assets becoming deregulated, and then some of those assets facing competition that means their economic value is reduced. We consider each of these risks below, and show that together they mean the risk of deregulated assets becoming stranded is effectively zero.

Likelihood of deregulation

There are two main competitive risks facing the LFCs: layer 1 unbundling, and fixed wireless broadband.[10] Neither of these competitive threats will result in deregulation.

We have been strong proponents of unbundling as potential competitive threat to the LFCs. It has the potential to bring deep competition at the network level and provide new services better targeted to the needs of New Zealanders.

However, under the current settings commercial unbundling is simply not viable. The prices offered for the layer 1 service by the LFCs are higher than the full bitstream (layer 1 + layer 2) prices. Until the Commission intervenes the risk of unbundling as a competitive threat is zero. Until competition becomes realistic the Commission cannot include this risk in the estimate.

Fixed wireless will be an important competitive threat to the LFCs, particularly with 5G fixed wireless, which will offer a fibre like experience for many customers. However, the nature of this competition means that it will not result in deregulation of fibre assets.

As part of any deregulation review the Act guides the Commission to consider whether the regulated provider continues to exercise substantial market power (SMP).[11] There is no credible prospect of Chorus relinquishing SMP in the foreseeable future.

European Commission Guidelines highlight a number of factors that are relevant to determining whether a firm holds SMP, including the following four which will prove crucial to any deregulation assessment for FFLAS.[12]

- **Market share –** "According to established case-law, very large market share held by an undertaking for some time — in excess of 50 % — is in itself, save in exceptional circumstances, evidence of the existence of a dominant position".[13] While Vodafone and Spark have ambitions to continue to attract end-users to alternative access technologies, not all operators have this ability. At best, we aim to attract 25% of eligible customers onto fixed wireless,[14] and it remains uncertain if all eligible

[10] There is also a theoretical risk of network over-build. We consider this very unlikely so have not considered it here in any detail, but may be relevant in some cases for the smaller LFCs.
[11] Section 210(4)(b).
[12] European Commission, 2018, 'Guidelines on market analysis and the assessment of significant market power under the EU regulatory framework for electronic communications networks and services'.
[13] European Commission, 2018, 'Guidelines on market analysis and the assessment of significant market power under the EU regulatory framework for electronic communications networks and services', para 55.
[14] https://www.stuff.co.nz/business/116520997/5g-paves-the-way-for-vodafone-to-cut-more-cables

customers would in fact migrate. This will leave the LFCs (especially Chorus) with a market share well in excess of 50%.

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- **Technological and commercial advantages or superiority –** For many customers the technological limitations of fixed wireless will mean it is not a true substitute.[15] While in the future fixed wireless will improve, so will fibre.[16] There is no evidence to suggest that this cycle will break down, or that end-user demands for greater speeds to utilise these advancements is slowing.

- **Application of a 'modified greenfield' approach -** Which means that future states should be considered as well as the current state of competition. So a brief period where LFCs relinquish SMP is not sufficient. The Commission must be convinced that this will be enduring. Trustpower made a strong case in their last submission that this will not occur for fibre assets. This was quickly dismissed by the Commission, but will need to be considered in more detail in any deregulation assessment.

Putting all these factors together, it is difficult to see a situation where fixed wireless competition could result in deregulation. When considering a geographic area suitable for deregulation (such as an exchange footprint), it will not be possible to say that fixed wireless could act as a true substitute for every customer. For many customers fixed wireless may not be available, for many more, it will not be suitable, and even for those it works for, it may only be a short term solution until the next major fibre upgrade.

Figure 2 [CONFIDENTIAL]

[15] Commerce Commission, December 2019, 'Measuring Broadband in New Zealand', p3; Commerce Commission, 19 November 2019, 'Fibre Input Methodologies: Draft decision – reasons paper, para 3.1383.
[16] https://hyperfibre.chorus.co.nz/
[17] [CONFIDENTIAL

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Likelihood of stranding

The magnitude of stranding from fixed wireless competition is also extremely low for two key reasons.

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- Fibre assets can be re-used. In our last submission we demonstrated that many of the LFCs assets do not meet the Commission's own definition of stranding because they have many alternative applications.[18] For example some GPON fibres could be re-sold as small cell backhaul. This is an issue we have raised in every submission to the Commission but is yet to be given any real consideration.[19]

[18] Vodafone, 19 July 2019, "Submission, on Fibre Regulation Emerging Views', p 8-9.

[19] For example see: Vodafone, 19 July 2019, "Submission, on Fibre Regulation Emerging Views', p 8.

Unused regulated assets must be removed from the RAB

Because deregulation of fibre assets is extremely unlikely the risk of assets losing economic value only applies to assets that remain regulated. To really provide the right incentives on the LFCs to manage these assets well and respond appropriately to competitive threats they must be removed from the RAB if unused.

However, the Commission has refused to remove regulated assets from the RAB when they are unused because of practical difficulties. This is not acceptable. Where the Commission faces practical difficulties in completing analysis to support a decision, it is not acceptable to sidestep that difficulty and err in favour of LFCs simply on the basis of convenience. This is particularly unacceptable because this approach ignores clear statutory direction that discretion should be exercised in favour of end users. Yet the Commission's reasoning contains no analysis as to how the decision made for LFCs made here for LFCs would be consistent with this purpose. In short, the proper approach would be i) for the Commission to at least attempt analysis; and ii) if that analysis is inconclusive, to reach a decision on this point that explicitly references and is consistent with statutory objectives.

In line with the above principles, Vodafone submits that the Commission should adopt the following approach:

- Shared assets such as cabinets, feeder fibres, exchanges, and equipment at the exchange remain in the RAB until deregulated.

- The LFCs report on two numbers for assets specific to individual end users (eg, the ONT and distribution fibre)
  - Number deployed
  - Number in use

- The difference between these two numbers is calculated (based on average cost of these assets)

- A yearly re-opener is established to allow the price-quality path to be amended to reflect changes in the RAB. It is critical that this is done yearly, as some of these assets (such as the ONT), have a very short lifetime of about 3-5 years. It would be ineffective to wait until the next 3-5 year reset.

While specific assets may come in and out of use, the aggregate number out of use will remain fairly stable over time, making it simple for the Commission to administer.

The Commission appears to gain comfort in retaining these assets in the RAB on the belief that competition may limit the LFCs from earning excessive profits anyway.[20] If this were true there would be no need for any price or quality regulation. Legislators knew that this would be insufficient, and so should the Commission. As we have discussed above there will be many users where fixed wireless is not suitable, and will be burdened with picking up the additional costs.

[20] Commerce Commission, 19 November 2019, 'Fibre Input Methodologies: Draft decision – reasons paper, para 3.1371.1.

Finally we want to address the Commission's argument that this would increase uncertainty.[21] This is not credible. No business in a workably competitive market has the level of certainty that the Commission appears to be seeking to provide for LFCs. Absence of such complete certainty and protection for LFCs will not adversely affect consumers. In fact this arrangement is likely to make the LFCs more responsive to end-users, better aligning them to the statutory purpose.

[21] Commerce Commission, 19 November 2019, 'Fibre Input Methodologies: Draft decision – reasons paper, para 3.1371.2.

Views that need further consideration

We are disappointed that many of the views we have given in our past submissions appear to have been given little consideration in the Draft Decision. We have little further to add on these issues, but would like to see a greater level of engagement from the Commission than we have seen to date. Below we simply restate the most critical parts of our past submissions that have so far been overlooked.

Unbundling

We continue to have ambitions to leverage the full capability of the UFB fibre networks by gaining access to an unbundled layer 1 service. This will allow us to break free from the product constructs and upgrade paths set out by the fibre providers, and provide targeted and truly differentiated services to New Zealanders.

Unfortunately, under the current settings there is no prospect of commercial unbundling actually occurring at any scale, which is why we have asked the Commission to intervene to help ensure that this critical part of the regime can become a reality.

One of the tools the Commission has at its disposal to help enable unbundling is to dedicate a specific part of the IMs to ensure the right information is being disclosed. We are therefore deeply disappointed that the Commission has given no further consideration to our last submission on this topic.

As stated in our last submission, we do not disagree with the Commission's interpretation that the input methodologies must relate to price-quality or information disclosure regulation. What we have not seen from the Commission is a justification for why unbundling is not relevant to the regime, and information disclosure in particular.

In fact the Commission appears to agree that unbundling is critical to the new regime.

> *We consider that the declaration of a point-to-multipoint layer 1 services supplied to end-users' premises or building as an unbundled fibre service may also be a tool to enhance quality*[22]

We therefore continue to ask that the Commission seriously consider setting specific requirements for the LFCs to disclose key information on unbundling. In the first instance this would be information disclosure only, but it will provide the information basis to make further regulatory recommendations.

Losses asset

We are extremely disappointed that the Commission has chosen to calculate the losses asset in a way that will maximise its value for the LFCs, and cause fibre prices to sky-rocket. Again, however, we have little appetite for continuing to comment on this matter given the lack of serious engagement from the Commission. We make the following final comments:

[22] Commerce Commission, 19 November 2019, 'Fibre Input Methodologies: Draft decision – reasons paper, para 3.1208.1.

- It is entirely unacceptable to dismiss proposals from consumer advocates for minimising double recovery simply on the basis of the workload it creates for the Commission and the LFCs.[23] In our view, this is the most material decision the Commission will make through this entire regulatory process. It also stands in stark contrast with the additional complexity added elsewhere (eg, an entirely separate model for calculating the cost of Crown financing, calculating a TCSD, etc).

- We are unsure why the Commission has rejected the basic economic principle of indifference to guide their decision making on the nature of the losses asset.[24]

- We are unsure why assets built before 2011 are considered part of the UFB initiative. Chorus' claim that they were required to acquire these assets as a pre-requisite for participating in the UFB initiative makes the bold assumption that Chorus should be treated an entirely new and standalone entity in the relevant period, not a continuing part of Telecom. There was nothing compelling them to participate in UFB in the first place.

- The Commission has not answered why the FPP price cap should be treated like a revenue cap for the purposes of the losses calculation.[25]

- We continue to be confused why FCM is a useful principle in the calculation of the losses. No additional explanation has been added in the draft decision to address our concerns raised in our last submission.[26]

- The Commission has not answered the issue we raised in our last cross-submission that the losses asset will transfer all risk before 2022 from the LFCs investors on to consumers.[27] As a consequence the cost of equity for that period must be the risk free rate.[28]

- If the Commission continues to apply a basic cost allocation approach to the losses, we support the Commission determining the cost allocators during this period.

- There is no justification for using measures of bandwidth to justify allocation between copper and fibre.[29] There is no part of the network that degrades based on bandwidth, this measure will only serve to inflate the allocation towards fibre. Many RSPs have raised this mistake with the Commission many times, but it continues to be a feature of the draft decision.

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[23] Commerce Commission, 19 November 2019, 'Fibre Input Methodologies: Draft decision – reasons paper, para 3.528.3.
[24] Vodafone, 19 July 2019, "Submission, on Fibre Regulation Emerging Views', p16.
[25] Vodafone, 19 July 2019, "Submission, on Fibre Regulation Emerging Views', p18.
[26]Vodafone, 19 July 2019, "Submission, on Fibre Regulation Emerging Views', p21.
[27] Vodafone, 9 August 2019, 'Cross Submission on Fibre Regulations Emerging Views – Cost of Capital', pp10-11.
[28] We appreciate Dr Lally's clarifications of the risk of estimating the TAMRP. However, these clarifications continue to show that this risk is very small, and estimating Beta at zero is more accurate than applying the full Beta. We are also unclear why this risk is unique to the losses asset, and not treated the same way as other estimation risks though considering a WACC percentile.
[29] Commerce Commission, 19 November 2019, 'Fibre Input Methodologies: Draft decision – reasons paper, paras 3.502.5 and 3.502.6.

Cost of Crown Financing

The Commission has accepted the proposal from the LFCs and their investors that the interest free Crown financing had a cost, while ignoring the cross-submissions from RSPs demonstrating that this is not the case. This has resulted in a lop-sided calculation at a level of spurious accuracy inconsistent with other parts of the draft decision.

As we showed in our last cross-submission, when the errors in Incenta's analysis are removed the magnitude of their own estimate of the cost of Crown financing becomes immaterial.[30] The Commission has ignored this contribution, and created significant additional complexity for little gain. This is inconsistent with other aspects of the cost of capital calculation, such as choosing to round the TARMP to the nearest 0.5%, or only applying Beta to two decimal places. The Commission cannot pick and choose where they add accuracy to create an optimal set of conditions for the LFCs.

This decision is particularly stark in the context of the Commission refusing to do additional work to improve accuracy of far more material parts of the regime. As covered above, the Commission has not attempted to account for double recovery with copper due to its complexity, nor is it willing to consider removing unused regulated assets from the RAB.

However, if the Commission remains determined to apply its limited resource on this calculation (noting that resource constraints and complexity have been cited as reasons for not completing more significant and, frankly, more worthwhile analysis), it must undertake it fully, rather than selectively applying the parts raised by the LFCs and their investors. To fully complete this calculation the Commission must estimate:

- The impact of the countervailing features of the Crown financing that we itemised in our last cross-submission.[31] These concessions were only undertaken to ensure the LFCs were of a sufficient investment grade to make the project a success. In their absence it can therefore be assumed that the UFB project would fall below investment grade, to a BB+ rating or lower. The Commission can estimate the cost of this lower rating compared to the LFCs actual credit ratings.

- It is also inaccurate for the Commission to assume that the Crown financing was at the LFCs actual credit rating (eg BBB for Chorus). Crown financing was required because private capital would not have chosen to invest in the riskiest part of the project. Therefore, the credit rating of the Crown funding must have been below investment grade. We'd suggest it would best fit into the 'highly speculative' ratings group and be estimated as B+ or lower.

It is not for us to supply the Commission with detailed calculations to complete these estimates. We are simply showing that they must be part of the calculation if the Commission proceeds with this approach. We expect that if these are included there will be a negative cost to Crown financing which must then be taken off the cost of capital.

[30] Vodafone, 9 August 2019, 'Cross-Submission on Fibre Regulation Emerging Views – Cost of Capital', p15-20.
[31] Vodafone, 9 August 2019, 'Cross-Submission on Fibre Regulation Emerging Views – Cost of Capital', p15.

However, given the significant uncertainty in this calculation, we support not undertaking it altogether, and assuming the cost of Crown financing at zero. This is a pragmatic approach and fitting with the level of accuracy elsewhere in the cost of capital calculation.