Chorus cross-submission on the Commerce Commission's fibre input methodologies – further consultation draft (initial value of financial loss asset) reasons paper

1 October 2020

EXECUTIVE SUMMARY

Overview

1. This cross-submission responds to submissions on the Commerce Commission's (**Commission**) fibre input methodologies *Further consultation draft (initial value of financial loss asset) reasons paper* (**Reasons Paper**), published on 20 August 2020.

2. We are now at the final stage of consultation on the fibre input methodologies (**IMs**) and the first stages of the Price Quality Determination (**PQD**) process have just begun. The Commission will make a number of judgements across these processes that will add-up to establishing a starting regulated asset base (**RAB**), maximum allowable revenue (**MAR**) and incentives signalled ahead.

3. The Commission is making numerous individual decisions, including on the financial loss asset (**FLA**), which are all part of a holistic set of outcomes that are expected to deliver a transition, without shocks, from a contracted model to a utility model that is sensible, sustainable and workable.

4. The Commission's draft approach to the FLA does not allow investors adequate compensation for the risks they faced when making the decision to invest in the UFB network. This is being closely watched by the investment community – those in New Zealand and those investing in New Zealand from overseas.

5. A failure to compensate investors for real risks they faced to support the build of infrastructure now critical for economic growth, education and social inclusion sends very poor signals about New Zealand and will deter future investment. It would also undermine the delivery of dynamic efficiency benefits for consumers of telecommunications services. The Commission's individual decisions on the key issues underpinning the FLA, when viewed cumulatively, do not deliver on the Commission's economic principles of real financial capital maintenance (**FCM**), efficient risk allocation and recognising the asymmetric consequences of over- and under-investment.

6. For each issue relating to the cost of capital, treatment of Crown financing and reflection of Type II asymmetric risk in the pre-implementation period, the Commission has proposed to ignore all local and international expert advisors that Chorus has provided (Incenta, Sapere, Oxera, NERA and HoustonKemp).

7. Unless the Commission reverses its draft proposals in these areas, it will not meet the stated FCM principle and it will retrospectively under-compensate for the investment in the once in a many generation fibre network that is serving New Zealand. The risks of regulatory error are high. So are the risks of regulatory distortions to strong market, efficiency and innovation incentives already actively working well and hard for investors and consumers alike. This concern is shared by other fibre network providers and the investment community – i.e., those who took on the risks and have long memories.

8. The following illustrates these concerns and the evidence provided to the Commission:

8.1. **Asset beta** – Investors have informed the Commission that the proposed asset beta is out of step with international comparators and too low. We agree. The asset beta should be higher than the asset beta post-implementation to reflect the real investor risks that existed in 2011. Experts suggested 0.65 based on the evidence available, rather than the 0.49 proposed by the Commission.[1]

8.2. **Percentile estimate** – Investors submit that the use of the mid-point estimate doesn't appropriately reflect the risk in the pre-implementation period. We agree. A 75th percentile estimate would properly reflect the reasonable expectations investors would have held in May 2011 of a normal return over time. Further, this estimate should be used to account for the risks of under-estimation in the pre-implementation period, which we show are occurring based on cross-checks with our prevailing cost of debt. This is not a forward-looking decision. Investment was made ahead of demand and it has future proofed New Zealand's digital connectivity. Under-estimation, and retrospectively assuming away real risks, is not something that can be mitigated in any way.

8.3. **Term of the risk-free rate** – Investors submit that the proposal to recalculate financing annually is unorthodox. It does not reflect the reality that finance would be aligned with the project term. We agree. LFCs submit that the pre-implementation period is economically equivalent to a normal regulatory period, justifying a single term for the cost of capital. We agree. The term of the risk-free rate should be aligned with the period of the initial contract with the Government, which is consistent with the decision to invest under the UFB initiative.[2] If the Commission does not accept that the decision was made in 2011, then the term should be 10 years, consistent with commercial practice. The proposal for a 5-year term bears no relevance to the FLA situation.

8.4. **Debt premium** – Investors continue to submit that it is not appropriate to use a notional credit rating of BBB+ for calculation of the debt premium in the pre-implementation period. We agree. The Commission has independent expert advice before it that the appropriate credit rating for the debt risk premium in the pre-implementation period is BBB.[3]

8.5. **Treatment of Crown financing** – Investors submit that the Commission's revised proposal for the treatment of Crown financing fails to reflect that Crown financing was not costless, because Chorus bears a residual risk in relation to Crown financing, and therefore it is appropriate that the FLA reflect this. We agree. We do not support the Commission's latest shift in position and consider this is a fundamental error if confirmed.

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[1] Sapere, (27 January 2020), *The cost of capital input methodologies for fibre,* at [74].

[2] Sapere, (8 September 2020), *Cost of capital input methodologies – further consultation initial value of financial losses,* at [13-14].

[3] Sapere, (8 September 2020), *Cost of capital input methodologies – further consultation initial value of financial losses,* at [39].

8.6. **Type II asymmetric risk** – Investors submit that the FLA is subject to stranding risk. We agree. The asymmetric returns and truncation that arises from stranding risks, and that exist for new large infrastructure investments that are potentially subject to regulation, should be recognised in the pre-implementation period. This should be done by an *ex-ante* allowance: based on stranding risks alone, our independent economic experts calculated an illustrative allowance close to 59bps.

9. The Telecommunications Act (**Act**) requires pre-2011 assets be included in the calculation of the FLA. RSPs opportunistically seek an incremental cost approach to exclude pre-2011 assets. This is not supported in law, by regulatory precedent, by what would happen in a workably competitive market or in the real-world situation that exists when standing up a wholesale only, open access listed company, transitioning Kiwis to fibre fixed line access services (**FFLAS**) in a large part of New Zealand.

10. We seek to recover an appropriate risk-adjusted rate of return on and of investment and that we continue to be provided flexibility and investment incentives. This will allow us to meet the ever-changing and fast-paced demands of the end-user and the commercial and technological environment as Parliament intended.[4] We urge the Commission to stand back and ask itself:

10.1. How the decisions it makes at the IM stage may flow through into final outcomes to be determined later next year;

10.2. How its decisions may positively or negatively impact incentives already present and delivering a level playing field to retailers from which to compete, ongoing efficiency and customer experience improvement initiatives, ongoing investment in resilience and market-responsive product innovation;[5] and

10.3. How its decisions will affect, and be received by, real-world investors and consumers in the telecommunications sector and the signals they send about all transformational infrastructure investment in New Zealand.

[4] Telecommunications (New Regulatory Framework) Amendment Bill, First Reading Speech, Minister of Communications https://www.parliament.nz/en/pb/hansarddebates/rhr/combined/HansDeb_20170816_20170816_28.

[5] A snapshot of the Chorus business can be found in our recent annual results presentation http://nzx-prod-s7fsd7f98s.s3-website-ap-southeast-2.amazonaws.com/attachments/CNU/358489/329033.pdf.

1. FCM PRINCIPLE

11. The Commission’s decisions on the cost of capital estimate, treatment of Crown financing, and the allowance for Type II asymmetric risks, must correctly reflect all the relevant risks Chorus faced in making the decision to invest under the UFB initiative. The Commission’s decisions on these issues must, cumulatively, deliver on the Commission’s key economic principles of FCM, efficient risk allocation, and recognising the asymmetric consequences of over-and under-investment.

12. If Chorus is not appropriately compensated for the risks taken, then there is a risk of deterring future investment across sectors. This has implications for realising dynamic efficiency and promoting the long-term benefit of end users in telecommunications and across other infrastructure sectors.

13. This means the Commission’s decisions must reflect the following:

    13.1. Systematic risk is higher in the construction and early growth phase of the investment under the UFB initiative, relative to the steady phase which is expected to be achieved with high fibre uptake post-implementation. This means a higher asset beta in the pre-implementation period than post-implementation;

    13.2. Asymmetric costs of errors in the Commission’s cost of capital estimates are high, even when carried out retrospectively for the purposes of determining the FLA. Given the high risk of error, a reasonableness check may be prudent in this case; and

    13.3. Unsystematic risks that Chorus has faced in making investments under the UFB initiative are high, namely with respect to the potential for asset stranding risk and the residual risk that Chorus bears in relation to Crown financing. This means the Commission’s Discounted Cash Flow (**DCF**) model must include an appropriate allowance for asset stranding and compensation for the residual risk on Crown financing repayment obligations.

14. Chorus’ submissions, as well as all the expert reports presented on Chorus’ behalf, clearly state that the Commission’s decisions should be consistent with the FCM principle, i.e. an *ex ante expectation* of earning a normal return over the lifetime of the assets constructed or used under the UFB initiative. This is not the same as saying that Chorus should be given a guarantee of earning a normal return, which is what Spark implies in its submission.[6]

Cost of capital estimation

15. To best give effect to the economic principle of an *ex-ante* expectation of earning a normal return, consistent with the FCM principle, the Commission should apply a single cost of capital estimate as at May 2011. We agree with Enable and UFF that the

[6] Spark, (10 September 2020), *Further consultation draft (initial value of financial loss asset) – submission,* at [7].

pre-implementation period is economically equivalent to a normal regulatory period, justifying a single term to the implementation period for the cost of capital.[7]

16. Using a single cost of capital estimate to calculate the present value of the unrecovered returns over the pre-implementation period is consistent with the Commission's approach to carry forward the wash-up balance with the cost of capital as the time-value of money, which we understand will be based on a single cost of capital estimated at the beginning of the period. As the Commission explains, this approach is consistent with its 'expectation of a normal return' principle.[8]

17. We also agree with Enable and UFF that if the Commission insists on applying a variable annual cost of capital with a fixed term in its DCF model (which we have earlier noted is inconsistent with standard practice in DCF valuation[9]), it should use a 10-year rather than a 5-year term of the risk-free rate.[10] A 10-year term for the risk-free rate is common commercial practice, and is recommended by the Body of European Regulators for Electronic Communications[11] and also many Australian regulators,[12] to match the long-life of the essential infrastructure.

18. We don't agree with Spark's and Vodafone's submissions that the Commission should adjust its DCF model to account for refinancing that is based on a 5-year term.[13] The term of the risk-free rate that the Commission adopts for the pre-implementation period should be based on the "investment decision" rather than the "financing decision". A 10-year term would more accurately reflect the expectations of investors assessing whether to make a commercial investment in a fibre access network. If the Commission maintains its view that the financing decision is relevant, the balance of evidence presented by the Commission does not suggest that the decision to adopt annual financing with a term of 5 years is appropriate. As Sapere notes, the debt financing for Chorus is in the range of 7-10 years.[14]

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[7] Enable Networks Limited and Ultrafast Fibre Limited, (10 September 2020), *Submission on fibre input methodologies further consultation draft (initial value of financial loss asset) – Reasons Paper 13 August 2020,* at [5.2].

[8] Commerce Commission, (15 September 2020), *Fibre information disclosure and price-quality regulation – Proposed process and approach for the first regulatory period,* at [5.87].

[9] Chorus, (10 September 2020), *Submission on fibre input methodologies further consultation draft (initial value of financial loss asset),* at [49-56].

[10] Enable Networks Limited and Ultrafast Fibre Limited, (10 September 2020), *Submission on fibre input methodologies further consultation draft (initial value of financial loss asset) – Reasons Paper 13 August 2020,* at [5.10].

[11] BEREC Report on WACC parameter calculations according to the European Commission's WACC Notice – available at https://berec.europa.eu/eng/document_register/subject_matter/berec/reports/9364-berec-report-on-wacc-parameter-calculations-according-to-the-european-commission8217s-wacc-notice.

[12] For example, the ACCC, AER and IPART (New South Wales) all use 10-year terms for the risk-free rate.

[13] Spark, (10 September 2020), *Further consultation draft (initial value of financial loss asset) – submission,* at [60-62]; Vodafone, (10 September 2020), *Vodafone New Zealand submission on further consultation draft (initial value of financial loss asset),* pages 7-8.

[14] Sapere, (8 September 2020), *Cost of capital input methodologies – further consultation initial value of financial losses,* at [30].

19. L1 Capital referred to the highly respected corporate finance textbook by Brealey, Myers and Allen as a guide to why the binding capital expenditure commitments under the UFB contract in the pre-implementation period (i.e., construction period) is expected to result in higher asset beta than post-implementation (i.e., post-construction period).[15] This is consistent with the evidence presented from economic experts, Oxera and Sapere.[16]

20. L1 Capital submits that the Commission appears to be inconsistent in its justification of the use of a BBB+ benchmark for the credit rating.[17] As L1 Capital explains, the Commission's rationale for applying a BBB+ benchmark (to signal to firms like Chorus the need to improve their credit rating to reduce their bankruptcy risk) is at odds with the reality that the Commission is setting a credit rating for a past period. The FFLAS UFB providers cannot change their credit rating for a past period and it is unreasonable to invoke an incentive justification for the proposed approach to setting the credit rating. We agree.

21. We disagree with Vector's submission that a real cost of capital should be applied in the pre-implementation period, and the assumption that the nominal return Chorus and other LFCs require on average is around 80bps lower than the nominal cost of capital estimated for each year from 2012 onwards.[18] We agree that decisions should be consistent with the real FCM principle. However, we note that the prices for UFB services were fixed in nominal terms over the pre-implementation period, which means Chorus has had to bear inflation risk. We also note that the Act specifically prescribes an unindexed valuation for the initial value of a fibre asset based on generally accepted accounting practice.

22. We have supported the change to a DCF approach to calculating the FLA on the basis set out above. Should this change again, the Commission must provide an opportunity to review and comment on the proposed changes before any final decision is made in relation to this matter.

Crown financing

23. As we have previously submitted, we do not support the Commission's latest shift in position and consider this is a fundamental error if confirmed. The November draft views of the Commission clearly recognised that the funding provided to Chorus was fundamentally debt-like, meaning that Chorus has carried a residual risk in relation to Crown financing, which the Commission's own expert, Dr Lally, agreed with.

24. We agree with investors' submissions that the Commission's revised proposal for the treatment of Crown financing fails to reflect that Crown financing was not costless,

[15] L1 Capital, (10 September 2020), *Submission on consultation draft (initial value of financial loss asset),* page 3.

[16] Oxera, (15 July 2019), *Compensation for systematic risks*, at [2.54-2.58]; Sapere, (27 January 2020), *The cost of capital input methodologies for fibre,* at [63-74].

[17] L1 Capital, (10 September 2020), *Submission on consultation draft (initial value of financial loss asset),* pages 6-9.

[18] Vector, (10 September 2020), *Vector Submission on Fibre Input Methodologies – Further Consultation Draft (Initial Value of Financial Loss Asset),* at [27].

because Chorus bears a residual risk in relation to Crown financing, and therefore it is appropriate that the FLA reflect this.

25. We agree with L1 Capital's submission that the terms and conditions of the Crown financing – the onerous network delivery requirements, take-up milestones, control rights and penalty provisions – are a part of the "actual financing costs". These must be taken into account when assessing the benefits of the Crown financing to Chorus.[19]

26. We agree with Investors Mutual that the CFH securities add leverage and consume debt capacity in the same way as other debt sources. The Commission's proposed use of the post-tax cost of capital as a measure of the avoided costs of Crown financing largely overestimates the notional benefit of Crown financing. As Investors Mutual explains, the Commission's proposed treatment leaves Chorus in the untenable position of owning assets which carry downside risk but earn no upside return.[20]

27. We also agree with River Capital that the Crown financing does not compensate investors for the risks they assumed under the project. River Capital explains that to suggest that assets funded with Crown financing will effectively attract no return on capital for about 15 years, feels like a deviation from the principles of certainty and fairness that underpinned the original funding of the project.[21]

Cost of capital percentile and Type II asymmetric risk

28. We agree with investors that the use of the mid-point estimate doesn't appropriately reflect the risk in the pre-implementation period. A 75th percentile estimate would properly reflect the reasonable expectations investors would have held in May 2011 of a normal return over time.

29. Investors Mutual submits that the cost of capital should be set at a percentile that reflects the risk of underestimating the cost of capital. Investors Mutual explains that underestimating the cost of capital in the pre-2022 period is a very real risk, as Chorus has demonstrated with its chart showing actual versus implied cost of capital / debt.[22] We agree. A 75th percentile estimate should be used to account for the risks of under-estimation in the pre-implementation period, which we show is occurring based on cross-checks with our prevailing cost of debt. This is critical given that this is not a forward-looking decision and a risk of under-estimation is not something that Chorus can seek to mitigate in any way.

30. We also agree with L1 Capital that the FLA is subject to stranding risk and, to the extent the losses accrued are in an area that is deregulated in the future, there is a risk those losses will not be fully recovered. Further, as L1 Capital explains, the FLA still has the possibility of not being recovered if the MAR is not achieved, which means

[19] L1 Capital, (10 September 2020), *Submission on consultation draft (initial value of financial loss asset),* page 5.

[20] Investors Mutual, (9 September 2020), *Submission on consultation draft (initial value of financial loss asset),* page 3.

[21] River Capital, (8 September 2020,) *Submission on consultation draft (initial value of financial loss asset),* page 2.

[22] Investors Mutual, (9 September 2020), *Submission on consultation draft (initial value of financial loss asset),* page 3.

the FLA is subject to all the usual risks that are present in the post-implementation period.[23]

31. We reiterate the above concerns that the cumulative impact of the Commission's decisions means there is a real risk that investors will not be appropriately compensated for investing ahead of demand to build the network that is now critical for supporting New Zealand's productivity. In the absence of modelling data, the Commission is not able to cross-check the impact of its decisions against its own assumptions, those of analysts and against Chorus' business forecasts.

2. COST ALLOCATION

Section 177

32. We continue to support the Commission's draft decision to include pre-2011 assets in the calculation of the FLA. A plain reading of section 177 requires the Commission to include in its calculation of the value of the FLA any accumulated unrecovered returns on assets used to meet Chorus' UFB obligations, which includes pre-2011 assets.

33. Some RSPs argue that section 177 of the Act does not permit the inclusion of pre-2011 assets.[24] We disagree. RSPs have not raised any new arguments in the FLA submissions – all their arguments on the interpretation of section 177 have already been comprehensively addressed by the Commission.[25]

Incremental costs approach

34. We continue to support the Commission's draft decision not to adopt an incremental cost allocation approach to the FLA.

35. Some RSPs argue the Commission should adopt an incremental costs approach when determining the FLA and argue this would largely exclude the pre-2011 assets.[26] We disagree. Again, RSPs have not raised any new substantive arguments in the FLA submissions – their arguments for an incremental costs approach have already been largely addressed and dismissed by the Commission.[27]

36. A purely incremental cost approach would be inconsistent with the purposes of the Act and reality, would be inconsistent with the post-implementation treatment of pre-2011 assets in section 177 of the Act, and would add unnecessary complexity to the cost

[23] L1 Capital, (10 September 2020), *Submission on consultation draft (initial value of financial loss asset),* pages 5 and 7.

[24] Two Degrees, (10 September 2020), *Commerce Commission Fibre Input Methodologies Further consultation draft Initial Value of Financial Loss Asset (Reasons Paper) 2degrees Submission*, page 2.

[25] Commerce Commission, (13 August 2020), *Fibre input methodologies: Further consultation draft initial value of financial loss asset – reasons paper*, at [2.10-2.40].

[26] Spark, (10 September 2020), *Submission on Consultation draft initial value of financial loss asset,* at [32].

[27] Commerce Commission, (19 November 2019), *Fibre input methodologies - Draft decision paper,* at [3.480-3.487]; Commerce Commission, (13 August 2020), *Fibre input methodologies: Further consultation draft initial value of financial loss asset – reasons paper*, at [2.65-2.84].

allocation exercise. Some RSPs base their arguments on "regulatory precedents" that have no relevance to the Commission's task under section 177 and the policy behind the FLA, which was due to the unique circumstances of the UFB initiative and to compensate LFCs for building ahead of demand.

37. As the Commission has noted,[28] an incremental cost approach would not account for customer migrations from copper to fibre and would lead to under-recovery of shared costs. It is reasonable for FFLAS consumers to contribute to the recovery of their portion of shared costs, including those from the existing assets that are re-used to provide FFLAS. That is, as consumers transition from copper to fibre, they should continue to pay their share of the cost. This ensures the right outcome is achieved, which is consistent with a workably competitive market.

38. RSPs do not explain why it would be appropriate to take an incremental cost approach in the pre-implementation period and then use an accounting-based allocation approach (**ABAA**) in the post-implementation period. It doesn't make sense that the regulatory regime would mandate pre-2011 assets are part of the RAB (and so be treated as part of the cost of providing FFLAS from the implementation date onwards) but not part of the cost of providing UFB in the pre-implementation period. It is also not clear on what principled basis the Commission should be required to apply an ABAA approach to shared assets post-implementation but an incremental cost approach in the pre-implementation period.

39. For asset allocation, the question is simply how to appropriately allocate the value of shared assets in order to determine the difference between revenue and costs in the pre-implementation period and the forward-looking costs that must be recovered through regulated prices in the post-implementation period. The Commission should apply the same, standard set of regulatory cost allocation calculations during the pre-implementation period to calculate the cost of service as will be applied after the implementation date. There is nothing at all unconventional about that. The Commission has already highlighted that a consistent cost allocation process across pre- and post-implementation periods is preferred to prevent double recovery and to ensure dynamic allocation is recognised in the pre-implementation period.[29]

40. RSPs also mischaracterise the pre-2011 assets as "copper network assets".[30] This is incorrect. As a consequence of the fact they can be used for fibre, these assets are by definition technology-neutral network assets and built on the assumption they would continue to be used to deliver next generation access. The acquisition of pre-2011 assets by Chorus was undertaken as a condition of, and pursuant to, the UFB

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[28] Commerce Commission, (13 August 2020), *Fibre input methodologies: Further consultation draft initial value of financial loss asset – reasons paper*, at [2.64].

[29] Commerce Commission, (19 November 2019), *Fibre input methodologies: Draft decision paper*, at [3.479, 3.529].

[30] See for example Spark (10 September 2020), *Submission on Consultation draft initial value of financial loss asset*, at [23]; Vocus, (10 September 2020), *Submission on Consultation Draft Initial Value of Financial Loss Asset,* at [31].

initiative. Therefore, investors have an expectation of a return on and of capital for pre-2011 assets.

41. Spark suggests that the regulatory regime envisaged a simple approach to determining the RAB, that avoids the need for arguing over whether assets had been recovered, and that this is advanced by an incremental costs approach.[31] However, section 177 already prescribes a value for the pre-2011 assets, so there is no need to assess the extent to which pre-2011 investments have been recovered. An incremental cost approach is much more complex. Vocus has acknowledged that an incremental cost approach would include the opportunity cost associated with the assets (i.e. what Chorus would have done if it did not participate in UFB).[32] This would take some effort to quantify.

42. Vocus suggests that our position on optional variable accounting-based allocation approach (**OVABAA**) supports using an incremental approach for allocating costs to FFLAS.[33] This is incorrect. The use of OVABAA was specifically noted for use when entering unregulated markets, where ABAA might provide a barrier to entering the market. In this case "unregulated services" cannot be substituted for "UFB service".

43. As we have previously submitted,[34] OVABAA is intended to allow regulated businesses to recover shared costs across all services while ensuring the new, unregulated, services are not allocated costs that would make them unviable. We did not advocate just allocating incremental cost to those services. The outcome of a workable competitive market is that the allocation sits between the bounds of incremental and standalone costs.[35]

44. Vocus argues an incremental costs approach to the FLA would be consistent with the previous TSO net cost determinations and consistent with the Commission's adoption of an average incremental cost approach in its investigation into Telecom's residential telephony prices.[36] These "regulatory precedents" are not relevant to the FLA. There is no direct analogy between the approach to estimating costs in the TSO context and the exercise the Commission is currently engaged in. The approach to pre-2011 assets rests on the words of section 177, the Parliamentary intent that underlies it, and the orthodox principles of cost allocation that the Commission has developed in the context of Part 4 regulated utilities.

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[31] Spark (10 September 2020), *Submission on Consultation draft initial value of financial loss asset*, at [24].

[32] Vocus, (10 September 2020), *Submission on Consultation Draft Initial Value of Financial Loss Asset*, at [29].

[33] Vocus, (10 September 2020), *Submission on Consultation Draft Initial Value of Financial Loss Asset*, at [40].

[34] Chorus, (1 February 2019), *New regulatory framework for fibre: cross-submission on Commission's proposed approach*, at [70].

[35] Commerce Commission, (19 June 2009), *Input Methodologies Discussion Paper*, at [5.50]; Commerce Commission, (22 December 2010), *Input Methodologies (Electricity Distribution and Gas Pipeline Services) Reasons Paper*, at [3.2.64].

[36] Vocus, (10 September 2020), *Submission on Consultation Draft Initial Value of Financial Loss Asset*, at [13-20].

Additional safeguards are not suitable

45. We have previously submitted that the existing cost allocation tools were sufficient to prevent any over-allocation concerns – such concerns are over-stated. The additional measures raised by the Commission are unnecessary and inconsistent with economic principles. In addition, we disagreed with the proposed cap on shared costs as it introduced practical difficulties and imposed considerable uncertainty. We also disagree with the additional caps on the allocation of shared costs and restrictions on cost allocators proposed by some submitters for the reasons set out below.

46. RSPs[37] generally support the three tools the Commission proposed to reduce the likelihood that pre-2011 assets are over-allocated, however don't provide additional arguments to support them. We disagree with adding additional safeguards. As we previously submitted,[38] the existing safeguards are more than adequate.

47. The RSPs downplay or ignore the economic principle that cost allocation should be consistent with recovering costs overall. In the context of FFLAS, calculating the FLA on the basis of only incremental costs would see Chorus fail to recover its common costs in total as these are not being wholly carried by copper.

48. Some submitters also support additional caps to shared costs using connections. Vodafone suggests capping post-2011 shared assets based on the proportion of active FFLAS connections to the total connection volumes assumed in the copper final pricing principle (**FPP**) model.[39] The proposed cap is inconsistent with FCM. Vodafone's suggestion would effectively allocate some shared assets to fixed-wireless access (**FWA**) which would result in these assets never having the *possibility* of being recovered over their lives.

49. Similarly, Spark suggests applying a cost cap to pre-2011 assets based on the proportion of FFLAS connections to total connections.[40] We disagree. It is more suitable to apply causal allocators as per ABAA rather than bluntly apply a cap based on connections. Some costs were incurred in improving the pre-existing assets to make them ready for UFB and this expenditure is not recovered from copper (because it would not have been needed for copper). In this case, applying a cap could result in investments that were driven by the future requirements of the UFB network being excluded.

50. Some RSPs also propose specifying additional conditions for allocators. Spark supports specifying that avoiding double recovery should be a condition for cost

[37] Vocus, (10 September 2020), *Submission on Consultation Draft Initial Value of Financial Loss Asset*, at [13-20].

[38] Chorus, (10 September 2020), *Chorus submission on "Fibre input methodologies – Further consultation draft (initial value of financial loss asset),* at [122].

[39] Vodafone, (10 September 2020), *Submission on Consultation draft initial value of financial loss asset*, page 6.

[40] Spark, (10 September 2020), Submission on Consultation draft initial value of financial loss asset, at [58].

allocator selection for the FLA (in addition to causality).[41] It's unclear what practical effect this suggestion is intended to have, however, it should be noted that this departs from regulatory precedent - the Part 4 definitions of allocators. As we have previously submitted,[42] it is important that the cost allocation approach ensures that all costs can be recovered, and the risk of under-recovery should not be underestimated. Introducing new measures to limit the allocation of shared costs creates considerable risk that costs will be under-recovered.

51. Vodafone suggests the default allocators must be consistent with those chosen for the copper FPP in order to prevent double recovery.[43] It's not clear how this would be implemented given the FPP model did not simultaneously roll out copper and fibre networks and did not require allocation between copper and fibre services.

52. Vodafone proposes capping pre-2011 assets based on a hypothetical opportunity cost.[44] We disagree. Using hypothetical scenarios is counter to the intention of the using a BBM and using actual costs from our accounts. Determining the opportunity cost is a complex process that would create considerable uncertainty. The Commission does not propose this method for valuing pre-2011 assets, rather it notes it as an example of why using incremental costs only would lead to under-recovery.[45] Furthermore, the Commission notes that this method would be a difficult exercise.

[41] Spark, (10 September 2020), Submission on Consultation draft initial value of financial loss asset, at [58].

[42] Chorus, (16 July 2019), *Chorus submission in response to "Commerce Commission's fibre regulation emerging views dated 21 May 2019"*, at [115, 121].

[43] Vodafone, (10 September 2020), *Submission on Consultation draft initial value of financial loss asset*, page 7.

[44] Vodafone, (10 September 2020), *Submission on Consultation draft initial value of financial loss asset*, page 5.

[45] Commerce Commission, (13 August 2020), *Fibre input methodologies: Further consultation draft initial value of financial loss asset – reasons paper*, at [2.82].