Telecommunications Act review: Post-2020 Regulatory Framework for Fixed Line Services

Submission | MBIE

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Exec summary

1. Thank you for the opportunity to comment on the Telecommunications Act Review Framework proposals.

2. The telecommunications landscape in New Zealand has undergone transformational change in the last six years, with the deployment of Government-funded UFB networks, Government-funded RBI networks and commercially-funded 4G and wireless broadband networks. Where New Zealand was once reliant on Chorus' aging copper network as the only solution for home broadband, a growing number of New Zealand houses now have real choice as to which broadband network they want to connect to. As a result, copper connections and investment in copper are falling rapidly as customers and investors shift their attention to modern broadband networks.

3. It is in this context of burgeoning competition that the current legislative review seeks to provide a stable regulatory framework for the period 2020-2023 and beyond – i.e. three to six years into the future. In the intervening years we expect competition will continue to develop – the large majority of customers will be served using fibre or wireless broadband networks, UFB and RBI networks will continue to overbuild the copper network, and the customers remaining on copper will increasingly only do so because they do not have genuine alternatives to it.

4. We will, in effect, have a two-speed market – ultra-fast fibre and wireless networks and the legacy copper network – and each will require different policy approaches.

5. The Ministry has correctly identified this two-speed market in its proposals, which propose very different policy frameworks for each type of fixed line network:

    a. Utility-style revenue caps for fibre: With Commission-set prices for a small number of anchor products to provide pricing certainty for customers; and

    b. Withdrawal of regulation for copper: Wherever fibre is available, to allow Chorus to make sensible commercial decisions about the withdrawal of the copper network.

6. We support the Ministry's decision to treat each network differently. It is an elegant proposal that balances:

    a. Providing guaranteed return on Chorus' fibre investments. This places all fibre demand risk on RSPs and end-users; with

    b. Leaving Chorus to manage the risks of competition to its copper network. This places all copper demand risk on Chorus.

7. Both of those positions are fair, and the balance struck is equally fair.

8. Trying to design a blended regulatory framework that spans fibre and copper networks will unavoidably result in non-transparent cross-subsidies, inefficient incentives and ultimately distort competition in broadband markets. Similarly, using unrecovered actual cost for fibre and shared RAB assets is the only way to avoid a repeat of the years of arguing over theoretical regulatory valuation methodologies such as ODV and TSLRIC.

9. Our comments on the specific fibre and copper regulatory framework proposals are:

Fibre framework: Broadband anchor product not quite right yet

10. We agree with the proposal to create a utility-style BBM framework for fibre investments, and agree that much of the detailed decisions underpinning that framework are better taken and

updated by the Commission rather than set in stone in the Act. Our industry has very recent experience with the damage to industry confidence that can ensue if narrow legislative drafting reduces the Commission's decision-making discretion too far.

11. We support the shift to a revenue cap model for Chorus, and the proposal to augment the revenue cap with a small number of anchor products. However, we recommend two changes to the proposed fibre anchor products:

    a. **Increase the broadband speed profile from 100/20 Mbps to 1Gbps/500Mbps**. We surveyed over 600 of our customers on this issue. 92% said the most popular fibre broadband plan will be greater than 100Mbps in 2020 and 74% said the entry level fibre broadband plan should be greater than 100Mbps in 2020. We fundamentally do not believe wholesale network operators are best placed to determine the optimal price discrimination structures for retail markets and therefore consider a broadband anchor product should be designed to be the broadband speed profile purchased by most customers; and

    b. **Add a Direct Fibre Access Service (DFAS) anchor product**: We support the proposal not to require Chorus to provide a regulated layer 1 unbundled fibre service. We simply do not yet understand how a shift in our policy framework of that magnitude would change market structures and the underlying economics of wholesale-only network providers. However, we recommend that the existing DFAS service also be designated as an anchor product. Mobile network operators use DFAS services today to connect our cell sites to our core network – they are a critical input into our mobile services. As we increasingly offer wireless broadband services over those mobile networks, this gives Chorus control over a key cost for its competitors, and strong incentives to raise the price of that service. As we introduce 5G, which will require much more cell sites, the importance of DFAS will increase.

Copper framework: Extend copper deregulation to areas with two competing networks and use TDL to address any rural copper replacement concerns

12. We support the proposal to de-regulate copper services where fibre networks are deployed. We see no reason why this model shouldn't be extended to all areas where two or more competing networks capable of meeting end-users' reasonable broadband requirements have been deployed.

13. The case is even clearer for the TSO, which only requires the provision of voice and dial-up services. The TSO should also be deregulated wherever two or more competing networks exist.

14. Finally, we note that the difficult question of how to ensure replacement of the rural copper network will continue forward into the proposed framework. Just as today's framework does not solve this issue, nor does the proposed future framework. We note firstly that the Commission has already calculated that, so long as Chorus earns an average of $42 per line across its fibre and copper networks, it will have sufficient funding to replace all of that copper network, nationwide, over time. Unfortunately, though, competing demands for Chorus' capital means rural replacement is unlikely to occur under any model that does not mandate it.

15. Therefore we propose the Government make a clear policy choice now to use TDL revenues, applied through future evolutions of the RBI, to address this funding issue. This policy will ensure that at worse where Chorus identifies areas of its network that require replacement investment that Chorus does not want to fund, RBI funding can be applied to it. In practice, we expect the Government's, and rural New Zealand's, broadband ambitions will trigger this RBI investment before Chorus chooses to.

Introduction

1. Thank you for the opportunity to comment on the Telecommunications Act review framework proposals (**the paper, proposal**).

2. The paper proposes an overarching framework whereby:

    a. Fibre services are subject to utility-style regulation, applying a revenue cap to fibre access services; and

    b. Copper service regulatory settings are effectively grandfathered.

3. We support the proposed approach. Applying BBM regulation to only fibre will not only remove significant regulatory complexity and result in a more predictable regulatory environment going forward, but will also mitigate a number of risks and distortions associated with seeking to apply a single BBM model across both fibre and legacy copper services.

4. The paper also proposes useful legislative guidance on fibre asset valuations which will reduce uncertainty for Chorus, access seekers and end users. Chorus will also have significant flexibility to manage the transition from copper to fibre, and emerging competition from wireless providers provides an incentive to improve performance.

5. The proposed framework recognises that Chorus - and LFCs over time - face limited competition for fibre services. However, it also relies on competition to achieve policy outcomes such as the promotion of fibre services and improved end user service performance in non-fibred areas. While we anticipate that fixed wireless services will provide a competitive constraint on Chorus' pricing behaviour, we should be clear that, if this constraint does not eventuate, the proposed framework leaves Chorus with the ability and incentive to slow fibre uptake and undermine competition if left unchecked.

6. In this submission we propose amendments to the core fibre BBM model that, while making no difference to Chorus shareholder returns, mitigate or check these distortionary incentives. For example, by ensuring that specified anchor products support most end users' needs in 2020 and promote competition.

7. Grandfathering copper regulatory settings for the legacy copper network ensures certainty for Chorus and customers in the transition to modern networks, and appropriately leaves the migration from copper to fibre to the market. Further, the proposals leave Chorus significant flexibility to efficiently manage the transition. The paper proposes to roll back the TSO as fibre is rolled out. We support the proposed approach – we should be looking to transition the legacy TSO to other instruments for ensuring consumer outcomes, i.e. to RBI, UFB or competitive markets. We've suggested a proposed framework in this submission.

8. Finally, the Commission has also paused its study in to backhaul services, awaiting decisions from the Government review. The Government proposals rely on competition to drive Chorus behaviour, and access to efficiently priced regional transmission services remain critical for competition. We recommend that the Minister ask the Commission to consider and report back on a technology neutral service and pricing principle for regional backhaul.

9. The paper also sets out a number of areas where the Government proposes to provide specific guidance to the Commission, and provide for transition matters. Detailed comments on these proposals are attached.

The framework

10. We support the proposed framework which, across legacy copper and fibre services, will produce more certainty for parties and promote the interests of end-users. The framework usefully distinguishes between UFB fibre services and legacy copper services:

    a. The paper proposes to apply a utility-style regulatory framework, with a BBM pricing methodology, for UFB fibre services. Chorus will be subject to price-quality regulation of fibre services, with a regulated revenue cap to apply to its fibre based business;

    b. Meanwhile, copper services will not be included in the utility-style BBM regulatory framework for fibre. The copper regulatory framework will effectively be grandfathered in areas where fibre has yet to be deployed, and regulation removed in areas where has been deployed.

Demarcation between copper and fibre regulatory settings

11. The proposed demarcation between copper and fibre regulation reflects the significant transitions occurring in the market:

    a. Operators continue to roll out fibre networks supported by Government UFB investment, or to meet new demand;

    b. The legacy copper network is aging and in decline as customers transition to fixed wireless and fibre services which offer better performance; and

    c. Parties consider the implications of withdrawing copper services. Chorus has started engaging with retail services providers to agree processes for removing copper where fibre has been deployed in order to reduce costs. We expect the copper network to continue to decline, and customers to continue migrating to modern replacement networks.

12. Meanwhile, we are seeing competition developing for copper based customers and this is delivering beneficial outcomes. For example, Chorus has responded to emerging competition from wireless, encouraging customers to migrate to higher speed fibre and VDSL based services in order to mitigate competition from emerging wireless based providers.

13. Chorus reports that while there is churn from poorly performing low speed ADSL based services to wireless providers, churn from high speed services to wireless is rare[1]. Chorus' best defence against this competition is to rapidly grow the demand for high speed services and invest in its network to improve service performance, and it is presently doing this.

14. The revised proposal appropriately recognises and responds to these market trends:

    a. Focusing the utility-style regulatory framework on important fibre services. This is where Chorus and over time LFCs face limited competition and the regulatory focus is to ensure a fair return on investment;

    b. Grandfathering copper regulatory arrangements will provide the certainty parties need in the transition, leaving Chorus to respond to competition from emerging providers and the market to determine the transition to replacement platforms;

    c. Removing the complexity and opaqueness of a blended fibre/copper RAB - the proposed framework will be significantly less complex to apply over time as it avoids the

[1] 2017: Half year results announcement webcast at 24 minutes https://vimeo.com/204823903.

complexities relating to valuing obsolete and declining copper assets, and predicting migration rates between platforms. Accordingly, it will deliver more predictable outcomes going forward and provide more certainty for Chorus and end-users, as well as for other investors in adjacent and downstream markets; and

d. Creating clear incentives on network providers to respond to competition. A single RAB framework that applied across different networks of different ages and competitive capabilities would distort investment in replacement technologies and uptake of fibre. In splitting the treatment of fibre and copper networks, the model ensures that there are clear incentives on Chorus, and on investors in competing platforms, to manage and price each network efficiently and competitively. The model avoids the risk of cross-subsidies distorting incentives and outcomes.

15. The revised approach goes a long way to minimising the potential distortions and complexity of earlier proposals.

Competition continues to play a role in achieving policy outcomes

16. The framework needs to recognise that competition remains important to achieving policy outcomes.

17. While a BBM methodology is applied to fibre (which inherently assumes that competition is limited), competition remains key for achieving policy outcomes. Without competition, the framework itself will not promote: fibre uptake; the efficient migration of copper based customers onto the fibre network; or investment in residual copper or replacement platforms. These outcomes are driven by the *combination* of the regulatory framework and competition from wireless based access providers[2].

18. And these beneficial outcomes are largely occurring, for example:

    a. Chorus has initiatives to encourage end-users to upgrade to higher speed broadband services supported by VDSL and fibre (fibre being the preference) to mitigate competition from wireless based services[3]. Chorus reports that it sees very little churn if customers are on higher speed VDSL and fibre services, which is why it is motivated to migrate these customers to high speed services as quickly as possible. All churn is occurring on ADSL – Chorus recognises that fixed wireless is in some instances a superior product to the ADSL technology;

    b. Chorus also reports increased investment in copper layer 2 equipment over the past year (the first such increase since separation) to ensure a congestion free broadband service – this is seen as a key differentiator to wireless based networks; and

    c. Chorus is further working with industry to promote the migration to fibre services, and to introduce equipment to improve rural copper broadband service speeds (i.e. new VDSL2 variants and small DSLAMs).

19. It is precisely because this proposed framework provides complementary incentives to those created by emerging competition to Chorus' network that it works. Any backwards steps to, for example, guarantee Chorus' copper revenues, or value shared assets at other than unrecovered actual costs will break this complementarity and lead to unpredictable distortions.

[2] The Cabinet paper discusses this objective at paragraph 32.
[3] 2017: Half year results announcement webcast 24 and 45 minutes https://vimeo.com/204823903.

Fibre settings

20. The Government has proposed a pure revenue cap model, with a wash-up between periods which means that any shortfall or surplus revenues within a period are carried forward. Under a revenue cap model such as this the Commission determines the maximum permitted revenue that ensures Chorus recovers its costs, including a return on its actual investment.

21. This means that Chorus investors are guaranteed a return on their fibre investments. The benefit of that certainty should not be understated: the worst case scenario for Chorus and its investors is that returns are delayed and will be recovered in subsequent periods (with interest). We believe even a delayed return is unlikely as fibre uptake has been higher and faster than anyone anticipated, and Government modelling indicates the BBM model will result in sufficient revenues at forecast volumes such that no price increases (i.e. shortfall) are anticipated[4].

22. The guaranteed return of a revenue cap model is a significant concession for fibre investors, and not something available to investors in other markets. Spark's investors have no such underwriting of Spark's investments in its mobile network. Nor do Vodafone's investors, or 2 degree's investors or Vocus' investors.

23. In this context it is difficult to see a clear policy case for further amendments to provide even greater protection to Chorus and its investors.

Revenue cap incentives

24. In particular, a strength of the proposed framework is that it maximises Chorus' incentives to improve copper performance outside fibre areas, and migrate customers to fibre where available. We are starting to see Chorus doing this to mitigate potential competition from wireless operators.

25. However, the provision of fibre and copper services are not independent and this leaves Chorus the potential to optimise its fibre offers to maximise copper demand and revenue. Chorus copper revenue is determined by demand on that platform, whereas its fibre revenues are guaranteed through the revenue cap irrespective of fibre demand.

26. Accordingly, Chorus copper demand is not independent of the fibre network and, on its own, Chorus has an incentive to manage fibre in particular ways. For example, Chorus could increase overall profits by slowing the migration from copper to fibre or offering unreasonable terms and conditions for wholesale fibre input services used by operators to compete with Chorus' copper network.

27. Any regulatory framework will include incentives that – considered in isolation – will result in poor outcomes and it is the overall incentives that count. Chorus already has an incentive to maximise copper demand at the expense of fibre uptake, yet it is promoting the uptake of fibre in order to mitigate the emerging wireless competition.

28. We expect that the proposed framework, incorporating anchor products and measures to promote competition, will likewise encourage efficient Chorus outcomes. However, to be effective, the anchor product needs to be set appropriately and measures limiting Chorus' use of market power in competitive markets made more transparent. Recommended implementation changes are set out below.

29. Our proposed amendments make no difference to Chorus investor returns, these remain guaranteed by the revenue cap approach, but aim to more effectively mitigate incentives that

[4] Cabinet paper December 2016, paragraph 36.

undermine policy objectives and provide more certain outcomes for investors in wider telecommunications' infrastructure.

30. Further, we recommend making these changes now as the proposed legislative guidance leaves the Commission with few mechanisms to address unintended outcomes through the IM process, and substantive changes are not anticipated until at least 2024. For example, the pure revenue cap approach does not support imposing more general price caps (that create incentives in their own right) and the Commission is not permitted to reset key parameters until at least 2024.

The broadband anchor product

31. The paper proposes that there be two anchor products, a 100/20 broadband service and a voice only input.

32. We agree it is appropriate that one of the anchor products should be a voice only input. However, the 100/20 broadband service is set too conservatively and will be irrelevant by 2023, if not 2020, and therefore won't be able to act as an "anchor" product in the broadband market in any meaningful way.

33. The market is likely to have moved significantly beyond 100/20 by 2023 and we propose that the 100/20 anchor product is replaced with a more appropriate speed of 1Gbps at the 100/20 price in place at the end of 2019.

The anchor product won't reflect most demand in 2020, let alone 2023 when it can be reset

34. Consumers have always demanded ever faster speeds for internet access, dating right back to the days of dial up access. This demand is fuelled by the increasingly bandwidth-hungry applications and services available online. The main drivers today are multiple devices in a household doing high bandwidth activities such as watching high quality on demand video.

35. Illustrating this, our fibre consumers today are demanding more and more speeds. The entry-level 30/10 fibre service has now been replaced as the key entry-level broadband service. Already 84% of Chorus adds in the last half year were on 100Mbps plans or higher, and 62% of mass market fibre plans are now 100Mbps or better[5].

36. End Users expect this this trend will continue: We surveyed 667 Spark customers last week to get their views on broadband speed (attached). 87% of respondents recognised that broadband speed is important to them in ensuring they have a good broadband experience.

37. Looking forward to 2020:

    a. 79% said they will want a faster internet connection at their home by 2020;

    b. 92% said the most popular fibre broadband plan will be greater than 100Mbps in 2020;

    c. 74% said the entry level fibre broadband plan should be greater than 100Mbps in 2020; and

    d. More than half said the entry level broadband plan should be 500Mbps or faster in 2020

38. Chorus sees this trend just as we do, and see it continuing.[6] In February this year the Chorus CEO suggested that 100Mbps services were already too slow for many customers. Noting that Chorus observes a doubling of customer data usage each year:

[5] 2017: Half year results announcement webcast 29 minutes https://vimeo.com/204823903
[6] 2017: Half year results announcement webcast 29 minutes https://vimeo.com/204823903

> "We continue to surprise ourselves by how much more bandwidth is needed and what people find to use it. The proliferation of devices in offices and homes is now so great that it's hard to imagine that households with 4 or 5 people or business with that can make do with 100Mbps for much longer. You'll be seeing those move up to 200Mbps and I'm sure if you've got teenage children in the house you'll understand the impact of the multitude of devices there. So, I think it'll just keep going up. We can look at the trends and there does seem to be a doubling or so in terms of throughput that goes on most years." Mark Ratcliffe, Chorus CEO

39. Reflecting this trend, Chorus is already talking about production trials for 10Gbps[7].

40. It's hardly surprising that all parties expect increasing demand for higher speed fibre accesses. There are a number of indicators of increasing demand:

    a. Chorus' data published[8] last November showed that households and small businesses consumed on average 120GB last October. This was up from 100GB just four month earlies and Chorus predicts the average usage of households on its broadband network will be 170GB by June next year and a 'whopping 680GB by 2020'. The same report noted that the average connection speed on the Chorus broadband network was 'a whopping 60 percent faster than last year'.

       We suspect this may underestimate the level of growth as Chorus NGA homes averaged 200Gbps/month average data usage per connection in January 2017. Chorus' 'better broadband conversation' is designed to increase take up of fibre[9]. This will drive further usage as currently only 19% of Chorus' customer base is on fibre.

    b. We only need to look back a couple of years to see how demand has increased specifically for fibre broadband. As recently as 2015, the majority of Chorus end-users were on entry level 30Mbps fibre products[10]. As above, currently 84% of new fibre connections are for higher speed plans, and Chorus has further initiatives to increase demand. In December 2016 Chorus announced that it was giving a free upgrade to 50Mbps for entry level customers[11]

    c. This is also consistent with what we can see in Singapore where a range of fibre speeds are available today. We expect the minimum speeds will increase considerably by 2020, and even further by 2023.

        i. M1 home broadband has 300Mbps, 1Gbps, 2Gbps, 5Gbps and 10Gbps plans

        ii. Singtel's consumer fibre products are available in speeds of 500Mbps, 1Gbps and 10Gbps[12]

        iii. Viewquest sells 1Gbps and 2Gbps plans

        iv. Starhub's consumer fibre products are available in speeds of 500Mbps, 1Gbps and dual broadband (1Gbps broadband + 100Mbps cable broadband)

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[7] Chorus Fibre and VDSL roadmap 23 February 2017, Page 5
[8] https://blog.chorus.co.nz/kiwis-data-consumption-growing-at-warp-speed/
[9] Chorus Customer event pack –23 February 2017 Consumer Broadband Strategy
[10] "The majority of end-users are on entry level 30Mbps fibre products. During FY15 Chorus introduced new 100Mbps plans at a $40 wholesale price to help establish this speed as the entry level fibre wholesale product. Approximately 30% of Chorus' residential mass market connections are on speeds of 100Mbps or greater." **Chorus Annual Report 2015** https://www.chorus.co.nz/file/69076/219131.pdf
[11] https://www.chorus.co.nz/chorus-free-upgrade-to-50mbps-for-entry-level-fibre-customers
[12] https://www.singtelshop.com/shop/fibre-broadband/fhbComparePlans.jsf (27 Feb 2017)

v. MyRepublic sells 1Gbps services and 'dual fibre broadband 1Gbps' which is 2 x 1Gbps connections to the home.

The importance of getting the anchor product correct

41. In effect, the anchor product is expected to provide end-users price and performance certainty. In itself, with a pure revenue cap model there is no clear incentive for Chorus to offer a lower price or higher performing product. As we see today, competitive threat from wireless providers provides Chorus an incentive to promote fibre uptake through better performing services.

42. If the anchor product is not relevant to consumers – because its base speeds are too low for the bulk of consumers to consider it a feasible option – then the benefit of price certainty will be lost. The effect will be to place all demand risk on consumers, because if demand is lower than forecast even the revenue cap will not act to sensibly constrain Chorus' fibre pricing.

43. Existing copper broadband products will provide some protection for those who have the choice, but only while the copper network remains in place. Retail offers based on layer 1 inputs would also provide a competitive constraint on Chorus' fibre pricing, perhaps encouraging them to offer products at lower prices than the anchor product. However, the regulatory regime does not appear designed to encourage low cost layer 1 investment so this competitive constraint will not exist.

44. As a result, we are concerned at the potential for the interplay between a poorly-specified fibre broadband anchor product and a revenue cap to leave the Commission in a very difficult position in 2023 when it is potentially required to juggle price and revenue objectives. While the risk of the two coming into conflict may not be large, we think the Government should be explicit now that in that situation it expects fibre prices to increase.

An appropriate entry level fibre plan

45. The anchor product sets the baseline for fibre access speeds and encourages take up of services at this speed and faster. It is key therefore to ensuring consumers can benefit from the higher speeds offered by fibre and ensuring New Zealand performs well in international comparisons.

46. Only around a quarter of our surveyed customers considered that the proposed 100/20 product would be an appropriate entry level product in 2020.

47. Based on our current knowledge of the market we would like to see an anchor product of 1Gbps set at the 100/20Mbps price point as at 2019.

48. This speed profile is consistent with the GPON access technology installed in New Zealand and would provide appropriate incentives on Chorus and the LFCs to upgrade to technology capable of supporting higher speeds such as 10Gbps services. Under this scenario Chorus is rewarded for investing in network upgrades which is an efficient regulatory outcome.

49. It's also worth noting that Chorus' CEO recently stated[13] that these upgrades would be relatively minor:

> "I think the answer is we think we've just got a massively scaleable network. The big cost for us was putting holes in the ground and putting the fibre down in the first piece. The electronic upgrades that are needed to shift people is a much more marginal cost." Mark Ratcliffe, Chorus CEO

[13] 2017: Half year results announcement webcast 29 minutes https://vimeo.com/204823903

50. The Cabinet paper proposes that the Commission will determine the price, non-price and quality terms for anchor products prior to each regulatory period (except the first), with criteria included in legislation for these decisions.

51. Accordingly, we propose that the Government either set the anchor product at 1Gbps or, provided the principles and criteria are clear, the Commission set the anchor products in 2020 at the time the BBM is set by the Commission.

A DFAS anchor product

52. The direct fibre access service (**DFAS**) is used by wireless operators for cell site linking and the service should also ideally be an anchor product. However, while DFAS is a UFB service that we expect will be part of a BBM RAB, it will not on current proposals be an anchor product.

53. The problem is that DFAS is an important input for mobile deployment, yet the proposed framework would:

    a. Result in potentially significant price volatility if the revenue cap and anchor product approach pushes demand risk from all fixed line access services on to non-anchor products; and

    b. Leave Chorus with significant discretion over the provision of an important input service for its direct competitors.

54. We currently use the fibre DFAS service to provide backhaul to cell sites, and expect mobile operators to require significantly more backhaul services with the move to 5G standard technologies. These technologies are expected to drive innovation and bring significant public benefits – to the degree that overseas Governments are developing plans to foster 5G deployment. For example, both the EC and US FCC have specific programmes to promote 5G deployment.

55. In terms of the economics of 5G networks, the more data demand there is the closer the cell site must be deployed to the end customers, and this means more cell sites, and therefore more cell site backhaul services, are required to link cell sites with the core network. We don't know how far operators will go in increasing the density of the network – this will be a function of demand and deployment costs – but conservative scenarios could see at least four times the number of cell sites we have today.

56. While wireless backhaul technologies are being developed, fibre remains the best and (particularly where already deployed) the most cost effective means of providing this capacity. A framework that drives mobile operators to overbuild UFB networks can't be efficient. Therefore, access to DFAS on reasonable terms will remain key and should be an anchor product.

57. As a non-anchor service under the current proposal, DFAS pricing will remain subject to the overall revenue cap. Therefore, with all other things being equal and with perfect knowledge of demand, DFAS prices would be constrained and predictable.

58. However, in this case, all other things will not be equal. Chorus will have an overriding incentive to use any flexibility to set high DFAS prices. This is because while DFAS revenues will remain small in the context of the overall model revenues, they have a significant impact on competition to Chorus from mobile networks. Therefore, Chorus' best approach is to increase DFAS prices - even though this would result in excess revenues to be clawed back in future periods – to inefficiently limit competition for its copper and fibre services.

59. The incentive to use a dominant position in a market to raise a rival's costs is sufficiently strong that it cannot be ignored in designing the 2020 regulatory framework. DFAS should be added as an anchor product, at prices consistent with todays.

Defining the RAB and anchor products to capture associated services

60. The Government proposes to model the definition of "fixed line access services" on the definition of "electricity lines services" in section 54C of the Commerce Act. It is important that the legislation includes a clearer and more detailed definition of the regulated service and reflects the full components that make up anchor products.

61. The definition of "electricity lines services" was contentious during the Commission's recent IM Review because it does not provide sufficient certainty to the sector as to what assets are subject to regulation. For example, it was unclear whether batteries could be included in the definition of "electricity lines services" and therefore included in the RAB.

62. To avoid these lengthy and destabilising debates, Spark encourages the Government to provide a more detailed definition of "fixed line access services" than is currently proposed. Given that the RAB will apply to fibre assets only, the definition will also be important to guide cost allocation decisions.

63. The more detailed service definition should:

    a. Reflect that regulated fibre services is intended to capture access and input services that are used by other operators input services; and

    b. Capture all of the components that make up the anchor product service. The paper proposes to specify a 100/20 and voice service. However, these services rely on associated components such as handover connections. The anchor products need to be complete to provide an effective price cap.

Prohibition on anti-competitive bundling

64. The Ministry does not propose to require further amendments to the open access deeds of undertaking in place for Chorus and LFCs. We support a desire to minimise change and uncertainty but consider it inevitable that changes to these deeds – and at the very least to the Chorus deeds - will be necessary.

65. The current deeds are inextricably linked with today's Act and contractual arrangements with CFH and so will need at a minimum to be updated to reflect the new regulatory access framework. As an example, the Chorus copper deed has at its heart "EOI Input services", which are defined with reference to a list of designated access services that will no longer exist under current proposals. These deeds will not have sense or effect unless they are updated.

66. Further, with de-regulation of Chorus copper services, and increasing competition to those services from fixed wireless services provided by a subset of RSPs, there exists a credible risk that Chorus may engage in pricing behaviour that seeks to discriminate against those fixed wireless providers.

67. This may, for example, manifest itself in "loyalty" offers for customers that commit to serving certain proportions of their customer base with only chorus-provided services, or "bundles" offers which provide fibre discounts to customers that purchase fibre and copper services in certain volumes or that maintain stable or growing fibre+copper customer numbers.

68. We suggest that the Act require that Chorus and LFCs provide updated deeds to the Commission for its approval before 2020.

Grandfathering copper regulation

69. The paper proposes to deregulate copper services inside fibred areas, and to grandfather regulated UCLL services in all areas. Outside fibred areas, Chorus will continue to provide UBA and UCLFS on the same price and terms as at the end of 2019. This will provide Chorus and end users significantly more certainty over the transition period.

70. We support the proposed model – it will be important to provide certainty, and technology neutrality, in the transition. We think the proposed package is right for the stage that copper is at.

71. Further, the proposal quite rightly leaves Chorus to manage the copper network sunset. It would result in significant rents and distortions to build these assets into a BBM and guarantee those revenues. No other firm is guaranteed a return on sunset assets or protection from competition.

Chorus still has incentives to maintain a good quality rural network

72. Chorus has expressed concerns about the residual 15% of customers outside fibre areas, noting the high costs to invest in these areas and obligation to maintain average prices. It proposes to consider these factors in its RBI2 bid due in April 2017[14].

73. We accept that, at some point in the future there may come a time where Chorus faces an uneconomic replacement cost for its copper network in a part of the country where it is the only network available to customers. In that very narrow case, we agree that direct subsidy, either through Government funding or the TDL, would be appropriate. But it is entirely unclear now whether, in fact, that scenario will ever crystalize. Firstly, we note that the Government's ongoing UFB and RBI programmes are funding replacement networks covering a very large proportion of customers. Further, it seems likely that commercial incentives set by the wider regulatory regime will ensure the availability of services to many if not all rural customers anyway.

74. Chorus is likely to continue to have an incentive to maintain the rural copper network, even where there are spots of uneconomic demand, because it brings value to the whole network. We experience the same incentives on our mobile network. National providers such as Spark want to offer consistent, national products and so will continue to offer services in rural areas. For example, we estimate that currently around 13% of our LTE mobile sites would be uneconomic if considered in isolation. However, these sites make commercial sense in the wider context because they add value to the network through, for example, ensuring widespread service within a region.

75. Chorus also likely has sufficient funding to maintain the copper network today. It continues to make significant revenues from its copper network, and there is no evidence to suggest the rural network fails to make a contribution to EBITDA. While Chorus is receiving a geographically averaged price for copper services (and this is proposed to continue to apply in higher-cost rural areas), the TSLRIC pricing that this average price is based on is explicitly designed to provide sufficient funding for replacement of the entirety of the network. Accordingly, there is some recognition of the investment necessary to maintain the existing copper network with current prices.

76. In this sense, the proposed framework further gives Chorus significant certainty to manage its transition from its copper network to fibre. The proposal locks in high replacement cost based prices for the copper network for the transition, where a sunset copper platform would otherwise have significantly lower valuations.

[14] 2017: Half year results announcement webcast 18 minutes https://vimeo.com/204823903

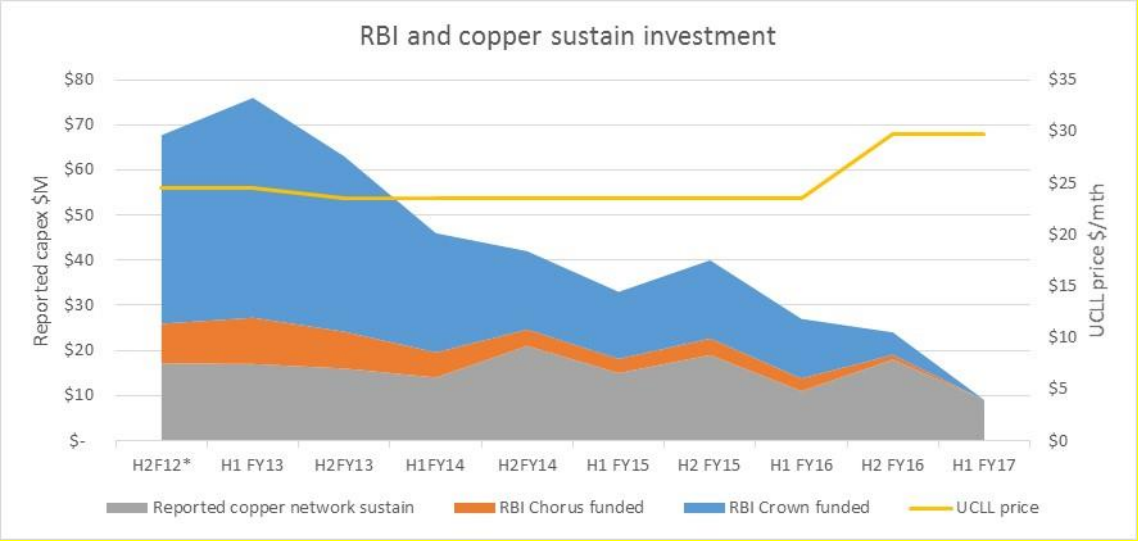
77. Further, lifting obligations will give Chorus a lot more flexibility to manage the transition. The proposed framework will encourage Chorus to manage and/or upgrade the network in response to competition from wireless providers. The proposed approach is a pragmatic way through this period.

Rural network upgrades

78. Of course, neither the current regulatory model, nor the proposed one can solve the real economic issue with replacement of Chorus' rural copper network: it will always be less economic for Chorus to spend its capital on replacing higher cost parts of its network than on other things (or on redistribution of capital to shareholders). Even if replacement cost may be economic, it may still not be the best use of Chorus' capital.

79. In other words, there can only be an issue if Chorus were undertaking a significant network upgrade. However, Chorus has not invested in its rural network for some time. Since separation it has minimised investment and limited itself to mitigating loss of service. Its approach has been to respond reactively as a cheaper option than performing proactive maintenance.

Chorus investment in copper network (RBI plus reported copper sustain investment)[15]



80. So there is no substantive investment programme under the current model to preserve. Chorus has made little investment in rural where all material upgrades are occurring through RBI subsidies.

81. This is why the Government's rural UFB and RBI subsidies are the only reliable means of ensuring provision of the desired service levels to rural customers, and that is why we consider that will continue to be the best mechanism for providing for replacement of Chorus' rural copper network. This is also why we believe the proposal to continue to require Chorus to provide regulated copper services at nationally averaged TSLRIC prices in higher-cost rural areas: because those TSLRIC prices are still well above the maintenance cost for that rural network, which is the only cost Chorus is likely to face.

82. We do not support internalised mechanisms - such as TSO, ODV or valuation based transfers - for funding replacement of the copper network as these are not transparent and have never worked in the past. This is because the business case for a specific rural upgrade will never

[15] From Chorus financial reports. Crown subsidy applied across programme relative to Chorus investment in the period (84% of RBI investment is subsidy). H2FY12 is an estimate based on 7 months reported.

stack up against competing demands for that capital from other Chorus business cases or from Chorus shareholders. These approaches won't result in an upgrade to the network and lack transparency.

Retaining a regulated regional transport service

83. Under the proposal Chorus will be required to continue providing UBA and UCLFS wholesale copper products on the same terms as it is required to do so on 31 December 2019. UBA and UCFLS, offered on efficient terms and conditions, facilitate RSPs offering competitive retail services to customers in rural areas.

84. We support the continued supply of UBA and UCLFS, subject to the following:

    a. The obligations to continue to supply UBA and UCLFS should include the existing obligations to retain associated services such as backhaul. Further, many of the UCLFS regulated terms are embedded in UCLL STDs. The Commission should be directed to refresh the terms of supply for the UCLFS terms to account for the removal of UCLL services in fibred areas.

    b. The Commission is currently reviewing backhaul markets and, following that review, the Crown should include backhaul services within Chorus' obligations.

85. The Government is relying on retail competition in rural areas and this makes it even more important to limit Chorus' ability to use regulated services to undermine this competition.

86. Clearly competition will be a driver for rural – whether this is generally or more specifically through RBI.

87. In either case, competition will be enhanced if competing providers are able to access Chorus regional fibre on efficient terms and conditions.

88. However, the proposal does not set out the approach for backhaul services. In addition to UBA and UCLFS, the Government should retain associated services such as backhaul.

89. The Telecommunications Act already provides for regulated backhaul services, however the Act currently limit these services to supporting other unbundled fixed services. For example, as backhaul for UBA or unbundled copper. Chorus offers a commercial backhaul service for other uses (i.e. mobile, business data) at the regulated price.

90. The Commission has paused its study in to backhaul services, awaiting decisions from the Government review. Accordingly, we recommend that the Minister ask the Commission to consider and report back on a technology neutral service and pricing principle for regional backhaul.

TSO

91. Finally, the TSO is a legacy regulatory instrument with little practical role in today's market.

92. The TSO is becoming increasingly irrelevant to end users. It is inconsistent with today's competitive market and - in any case - has been largely superseded by other policy initiatives such as UFB and RBI. Accordingly, we support grandfathering the TSO, and rolling TSO obligation back on a geographic and service basis where no longer necessary.

93. The proposed approach moves in the right direction in this respect but does not go far enough. The proposal is overly conservative in that the TSO will only drop away in areas where fibre has been rolled out. We consider this unduly limits the opportunity to roll back regulation, as effective

competition is not limited solely to areas with UFB. The TSO can drop away more widely without consumer harm. In many areas the TSO is now an example of inefficient regulation as it duplicates other more targeted policy interventions.

94. Accordingly, the test to remove the TSO should be extended to include areas covered by RBI funded networks and areas where there are at least two competing terrestrial (i.e. wired or wireless but not satellite) networks offering voice services to end-users. In those areas there is no policy rationale for maintaining a TSO. Both UFB and RBI have service quality measures in place, ensuring end users can access voice and data services within their coverage areas.

95. The Cabinet minute leaves it to the discretion of the Minister to remove the TSO where the Minister is satisfied that fibre is sufficiently widely available in that area. The Ministry should also have the discretion to do this where RBI or commercial platforms are widely available.

96. In our view, the bulk of copper regulation, including the legacy TSO, can drop away. A range of other policy instruments and market incentives exist will ensure the right outcome for end users:

    a. The continued availability of Chorus' UBA and UCLFS services will ensure that retail service providers are still able to offer their services nationwide to end users across the copper network.

    b. UFB and RBI are supporting network upgrades to deliver enhanced services to end users.

97. We are happy to engage with the Crown on consequential changes to TSO arrangements to implement the proposed grandfathering and rolling back.

END

Attachment 1: Legislative guidance and implementation

1. The paper proposes to provide guidance to the Commission on a number of matters.

2. While we support the overall approach, and general proposed guidance, we have proposed some amendments below to better implement Government policy objectives.

Purpose statement

3. The Government proposes a new purpose statement for fibre regulation that mirrors the purpose statement in section 52A of the Commerce Act. This may be appropriate as an overarching guide under BBM regulation for fibre, but it is unlikely to be sufficient in itself to guide and direct all regulatory decision-making.

4. That is because for the telecommunications sector, a key mechanism to promote quality and innovation in regulated services is likely to be actual competition (e.g. in the provision of services from layer 2 and above). This makes it different from sectors regulated under Part 4, where a purpose statement focused on mimicking competitive outcomes is sufficient (because there is no competition in the provision of regulated services).

5. To accommodate this difference, we support specific purpose statements and / or further legislative direction on key matters – such as anchor products.

6. We would also highlight that the current proposed amendment from the Part 4 purpose statement creates potentially substantial differences of approach to that previously taken under Part 4 regulation. In particular, the change from promoting the interests of "consumers" – which includes acquirers of upstream regulated services - to only promoting the interests of downstream "end-users" is likely to require the Commission to apply a fundamentally different lens to its regulatory exercise. In that regard it is unlikely to produce the kind of certainty and consistency sought by adopting almost all of the Part 4 purpose statement.

7. The other point to get right is to ensure that the regulatory decisions recognise the role of competition and the ability of regulated entities to create distortionary outcomes indirectly in related markets that rely on the regulated inputs.

8. In that context, the experience of regulating under the Part 4 purpose statement should inform the design of fibre regulation.

9. Key points include:

    a. In the merits review proceedings, the High Court explained that the various objectives of the purpose statement are best promoted by allowing recovery of efficiently incurred costs, including cost of capital. If a supplier is allowed to recover efficient costs, it will have incentives to achieve all of the purpose statement objectives. For example, a price path based on the recovery of efficient costs will limit excess profits, and in order to increase profitability the supplier will seek to innovate to improve efficiency and reduce costs, and will invest in new services at a quality demanded by consumers if there is the promise of a fair return;[16]

    b. When reviewing airport performance under ID regulation, the Commission stated that it expected Part 4 regulation (particularly the input methodologies) to have a more immediate and noticeable effect on limiting excess profitability, while incentives to

[16] *Wellington International Airports Ltd & others v Commerce Commission* [2013] NZHC 3289 at p 9, para 21.

achieve other Part 4 purpose statement objectives would be weaker and/or it would take a longer period of time to observe whether there was an impact;[17] and

c. Direct incentives to promote quality focus on reliability of the network (which will be important for fibre networks, but does not address the issue of higher quality services to meet end users increasing expectation of what is fit for purpose over time).

10. Applying this experience to a new BBM regime for fibre, it can be expected that the revenue cap will be most effective at limiting excess profits – across the network as a whole. However, there is a risk that the proposed regime will not be as effective in incentivising investment in dynamic service quality and innovation. Given the importance of innovation and quality of services in the telecommunications sector, it will be important for the new fibre regime to include specific and targeted levers to promote those outcomes. Or, as MBIE put it:[18]

> An important goal of the regulatory regime should be incentivising and facilitating the network owner to invest in delivering higher quality and innovative services over time.

11. Therefore, the purpose statements should recognise the utility regulation is applied for the benefit of all end-users (direct and those on networks that rely on fibre inputs) and competition should be a consideration for the Commission in applying the IMs.

Purpose statement for all telecommunications end-users

12. The paper proposes to replace "consumer" referred to in the Part 4 purpose statement with "end-user". Our concern is that the proposed change may direct the Commission, in its decisions, to consider only the interests of end users directly connected to the fibre network, rather than the wider set of end-users on the copper network or indirectly connected to operators' networks that rely on UFB fibre inputs.

13. Therefore, the Government should retain the definition of "consumer" or, if it decides to amend the purpose statement, ensure any replacement definition captures the full set of telecommunications end users as discussed above.

Ensuring Input Methodologies provide certainty for access seekers

14. The Act also provides that the purpose of the IMs is to promote certainty to suppliers and consumers.

> **52R Purpose of input methodologies**
>
> The purpose of input methodologies is to promote certainty for **suppliers and consumers** in relation to the rules, requirements, and processes applying to the regulation, or proposed regulation, of goods or services under this Part.

15. The Commerce Act further defines "consumer" as a person that consumes or acquires the regulated service. This captures a wider set of consumers that both acquire the service directly or consumers of the end service.

16. The paper is silent on whether it will likewise replace consumers with end-user in the input methodologies purpose statement. However, if it retained the consumer definition, this would

[17] See, for example, Commerce Commission: *Report to the Ministers of Commerce and Transport on how effectively information disclosure regulation is promoting the purpose of Part 4 for Wellington Airport, Section 56G of the Commerce Act 1986* at para 2.21.
[18] *Regulating communications for the future*, Ministry of Business, Innovation and Employment (September 2015) at p 64.

leave different focuses between different purpose statements and is likely to create future uncertainty.

17. It is critical that the IMs provide certainty for suppliers and access seekers purchasing inputs from the regulated provider. Therefore, we recommend amending the purpose statement making it clear that IMs promote certainty and this is important for suppliers and "acquirers" in relation to regulated service.

Direction to Commission to consider competition

18. In light of the above, we think the legislation should direct the Commission to promote competition:

    a. When determining input methodologies (as a limb of the IM purpose statement); and

    b. When determining anchor products (if they are not treated as IMs, as a part of the purpose of anchor products).

Allocation of shared costs

19. There will be shared assets that will need to be valued and allocated between copper, fibre and unregulated services. For example, Chorus has deployed UFB in to existing ducts that potentially carry copper and core transport services.

20. The framework should apply a consistent approach valuing these assets on the basis of unrecovered historic costs incurred.

21. We don't support TSLRIC model or replacement costs methodologies for these assets as they don't reflect the investment made by Chorus in the assets, and is potentially a significant transfer from end-users to Chorus.

22. Further, the TSLRIC model provides no guidance on the investment yet to be recovered by shareholders. TSLRIC seeks to identify efficient prices and, therefore, it is a hypothetical model used to derive the efficient costs of a hypothetical efficient provider, with a hypothetical network. The assets and costs identified can bear no relationship to Chorus' costs or shareholder returns over time, and this is one of the key criticisms of the TSLRIC model, i.e. that it is divorced from the actual costs (recovered) of the regulated firm. Therefore, while providing the costs of a new modern network, it provides no information on actual investment.

23. A utility-style regulatory model is premised on the firm making a return on its actual investment, and consumers can be assured that the firm is not making excessive profits. This is seen as fair – a methodology that doesn't fit this criteria won't be sustainable. We expect the proposed methodology – unrecovered historic cost – and discretion will achieve this. For example, the Commission is able to make an adjustment if Chorus can demonstrate that it has unrecovered costs.

24. We expect that there will be data to establish the unrecovered historic cost for shared assets. As noted in submissions on the 2016 paper, the initial Telecom asset review ensured asset values were consistent with the privatisation price, and Chorus has had legal and operational drivers for maintaining the asset register since then. Nonetheless, if the Government were concerned that specific records may not be available, it may want to clarify that the Commission is permitted to estimate the unrecovered historic investment where data is not available.

Asset value adjustments

25. The paper proposes to provide guidance on adjustments to regulatory asset base values.

Past losses

26. We support the proposed “unrecovered historic costs incurred” test for valuing the initial fibre RAB.

27. The proposed guidance that the RAB valuation methodology will be determined on the basis of the "unrecovered historic costs incurred by the regulated supplier, but only to the extent those costs were efficiently incurred", is important. As the Part 4 experience has demonstrated, the purpose statement in itself is unlikely to provide clear guidance to the Commission on how the initial RAB should be set.

28. The Part 4 opening RABs incorporated historic revaluations, which some interested parties argued allowed windfall gains for suppliers (as it was not clear whether those revaluations had been treated as income). The proposed guidance will make it clear that the opening RAB must not include past revaluations.

29. When determining costs incurred for the RAB, the Government also proposes that the Commission be required to ensure that efficient costs incurred as a result of meeting UFB contracts are included, efficient costs of installations are included and the value of the opening RAB is increased by the financial losses efficiently incurred prior to 2020.

30. Although it is reasonable for the Commission to be required to ensure that suppliers can recover the efficient costs of meeting specific UFB contractual requirements, the proposal to allow recovery of financial losses requires further careful consideration.

31. It is easy for UFB providers to assert that they have incurred losses over the start-up period. However, they presumably entered contractual commitments, including price that they believed would deliver an attractive return over time. On the other hand, it is not clear how the Commission will be able to transparently determine the quantum of losses. Assuming it could, it is not clear that it is appropriate to include such costs in the RAB.

32. Accordingly, the direction that the Commission set the RAB based on "unrecovered historic costs incurred" is sufficient. That will give it power and discretion to ascertain the extent to which any initial losses should be treated as efficiently incurred costs to be included in the RAB. Given that it is likely to be a difficult and contentious issue, any specific direction that requires a particular treatment by the Commission will carry a high risk of error.

Benefits of subsidy and pre-regulatory period adjustments

33. We support proposals that the Commission consider the implication of Government subsidies in the context of general valuation guidance. It would make no sense that end users will pay twice to deploy fibre assets through regulated charges and through taxes, and our expectation is that the level of subsidy will not form part of the regulatory asset base.

34. Further, Chorus receives a capital contribution from a number of other parties, including other upfront payments for the provision of service, which potentially find its way in to Chorus’ asset register. For example, Chorus recognised $6M third party funding to replace or relocate network in the 2016 year, and developers for costs to reticulate new sub-divisions. The degree to which these fund assets, the Commission should be able to ensure they don’t make it in to the asset base.

35. We support the general valuation test which will permit the Commission to make adjustments for third party funding when setting the asset valuations.

Prior period accounting adjustments

36. Further, there is a clear incentive on Chorus to tweak accounting treatment of assets to inflate the RAB value. For example, Chorus recently announced it would capitalise connection costs that were previously expensed (the effect being to increase pre-regulatory period profits, and regulatory period provides through an addition to the regulatory asset base) and signalled further change as it moved to apply new accounting standards[19].

37. The full range of changes that could be made ahead of the first regulatory period in 2020 is unclear. However, there is a clear incentive to take revenues ahead of the first regulatory period, while subsequently building the asset base on which its future period revenues will be determined. Therefore, we recommend that the legislation does not include any direction that could inhibit the Commission's power to adjust the RAB for such prior period accounting or other changes where these are material.

Revenue and price adjustments

Revenue smoothing

38. The paper proposes that the Commission be required to determine the revenue cap in a way that promotes price and revenue stability by spreading revenue increases through altering the asset depreciation path to smooth prices, consistent with criteria contained in 53P(8) of the Commerce Act.

39. We support 53P(8) as an indicator of the relevant principle within a new provision. However, using depreciation should probably be given as one method the Commission can choose to achieve smoothing – but not compulsory or the only method, i.e. should only use alternative depreciation if consistent with what is happening in practice – and not as regulatory tool to achieve smoothing in all cases.

Claw-back

40. A key principle of Part 4 regulation is that it is forward-looking. This is an important part of providing regulatory certainty.

41. There are some limited exceptions to this principle under Part 4. Claw-back is available as follows:

    a. Where an IM changes due to merits appeal, and would have resulted in a materially different price path had it been applied at the time the price path was set, then the price path must be reset and claw-back applied;

    b. A one-off claw-back was also available as part of the transition measures – where IMs were first set after a pricing period had commenced. Again, claw-back could be applied if the price path would have been different if the IMs had been used when it was set.

42. Consistent with the Part 4 position, claw-back should only be available:

    a. If an IM is changed by the court; or

    b. If a revenue path is not set by 2020 (such that a transition regime is necessary).

[19] H1FY17 results presentation, page 13.

43. As above, the Commission should have power to change anchor product pricing at any time during a control period. However, this should not be subject to claw-back.

Commission framework changes going forward

Moratorium on layer 1

44. Given the nature of incentives under Part 4 regulation as described above, the availability (or threat) of layer 1 unbundling is likely to be a key mechanism to promote innovation and quality in layer 2 fibre services.

45. This was clearly recognised when the current regime was introduced. Many industry participants, and the Commerce Commission, argued that layer 1 unbundling needed to be available from the outset to create the competitive pressure that would promote quality and innovation in new services. The Government decided to implement a forbearance period so that CFH would be able to negotiate low fibre prices, with LFCs and Chorus having greater confidence regarding prices and returns during the forbearance period.

46. Previously in this review process, MBIE has reiterated that the availability of a layer 1 service is a key part of promoting innovative and quality new services, and "in the absence of price regulation UFB suppliers may have incentives to set prices for layer 1 services at levels that limit the utility of unbundling for RSPs".

47. The proposal that the Commission only be able to investigate whether a layer 1 fibre service should be price capped as an anchor product after the first regulatory period is complete should therefore be revisited. Practically, this would mean there is no prospect of a price regulated layer 1 service until the start of the third control period (which could be as late as 2028).

48. The Commission should have the power to subject a layer 1 service to regulated pricing from 1 January 2020. This is not to say it should be immediately implemented - but a credible threat of intervention is needed to influence supplier conduct.

49. If the Government remains of the view that the Commission will not be able to classify a layer 1 fibre service as an anchor product for the start of the first regulatory period, then:

    a. The Commission should have the power to commence an investigation from 1 January 2020. That is in contrast to the current proposal that the Commission only be able to commence an investigation after the first regulatory period is complete. It would allow control to be in place (if required) for the commencement of the second pricing period in 2024; and

    b. The Commission should have power to establish (and change) prices of anchor products at any time during a control period, i.e. not just at the commencement of a period. This should not be problematic, as the revenue cap will remain set and suppliers will be adjusting their service prices during control periods in any event. Further, such an approach will be important to ensure that the threat of price capping provides appropriate incentives during a control period, and will also ensure capping can be implemented as soon as it is shown to be justified.

Process for new anchor products and changing form of control

50. The Government proposes that a statutory test would need to be met following an investigation in order for the Commission to be able to classify a layer 1 fibre service as an anchor product, and that the Minister would make the final decision. Market thresholds must also be met before the investigation could commence, and the Commission would need reasonable grounds to

commence the investigation. The same process is proposed for changing the form of control (eg from revenue to price caps).

51. Essentially, the process mirrors the existing process for designated access services under the Telecommunications Act. However, it is not clear that is the right approach. It appears there is a choice to be made:

    a. Anchor products are treated as a mechanism available to the regulator to promote the purpose statement within price-quality regulation; or

    b. They are treated as being akin to designated access services and are a mechanism to provide regulated access.

52. Given the shift to a BBM approach, the following factors point towards the first option:

    a. Regulating for access is not really the issue any more. It is about ensuring services are provided consistent with the purpose statement.

    b. Part 4 input methodologies include pricing methodologies. Arguably setting prices for specific services is something the Commission can do by way of a pricing methodology IM. If there is any doubt about this, the new legislation could make it clear that the Commission has power to set prices for specific services as an IM. If pricing of anchor products is an IM, then it will be subject to merits review.

53. Allowing the independent regulator, subject to review by the High Court, to make these types of regulatory decisions is an orthodox regulatory approach. On the other hand, the regime risks being undermined if regulatory decisions that are key to achieving the purpose of regulation are sent to the Minister. Under Part 4, Ministerial power is reserved to those cases where an Order in Council is required to implement the decision – essentially, imposing regulation on a service for the first time, or changing the form of regulation, i.e. from information disclosure to price control. Here, the decision to subject fibre services to regulation will have already been made.

54. Accordingly, it may assist to preserve confidence in the independence of the new regime if the legislation provides for the Commission to have power to identify and set prices for anchor services, including layer 1 (after 2023 if that remains the Government's position).

55. The same reasoning above applies to the form of control: the Commission should have the power to consider changing the form of control in time for implementation at the 2023 reset, and it should not be a Ministerial decision. As with Part 4, (from 2023 if the Government retains that position) the form of control should be an IM, subject to merits review.

Statutory criteria for anchor products

56. The scope of the anchor product is important to provide incentives to invest in higher quality services. This is especially the case given, as described above, a standard BBM approach with a revenue cap may otherwise struggle to provide these incentives.

57. Therefore, the proposed anchor product needs to be adaptable to ensure it provides the quality demanded by consumers over time. The Commission must have power to change the service description, and price, over time. This should apply from the start of the first regulatory period – there is a signification risk that the Government's decision on anchor products today will be severely outdated by the time regulation commences.

58. The Cabinet paper proposes "including a set of criteria, or a formula, in legislation for the Commission's updating of anchor products".

59. Such an approach should be treated with caution. It is important that the Commission is provided with sufficient flexibility to establish and update anchor products to better reflect the service level customers demand, which will evolve over time. The purpose statement provides a sufficient overarching statutory test - but it will likely be helpful to provide further direction by specifically directing the Commission to focus on promoting quality at a level demanded by consumers.

60. This could be achieved by including a specific statutory purpose for anchor products, which the Commission would need to apply when making its decisions. For example, a statutory purpose for anchor products could incorporate the concepts of promoting competition and (as per the MBIE papers):

    a. Providing an upper limit on pricing for a product that is attractive to a large number of end-users; and

    b. Providing a price and quality 'anchor' for the other 'non-anchor' products provided by regulated suppliers.

Mechanism and threshold for Commission to impose price-quality regulation if ID regulation is not effective for non-Chorus LFCs

61. The Government proposes that the Commission have the power to recommend price-quality regulation if evidence emerges that information disclosure regulation is not effective at deterring monopoly behaviour by non-Chorus LFCs. It is proposed that the intervention test be based on an equivalent intervention test for introduction of price-quality regulation to consumer-owned electricity lines businesses in section 54H(2)(b) of the Commerce Act.

62. The proposed threshold is suitable: that the purpose of the Part would be better met if price-quality regulation were imposed. However, the section 54H process is not the correct process to mirror, as it requires petitions by consumers (for reasons that are unique to consumer-owned electricity suppliers being exempt from price control regulation).

63. The more appropriate process to consider is section 52H, with modifications to ensure a fast-tracked process. Section 52H is the full inquiry process that can be used to impose new regulation for the first time. It will be too slow and cumbersome to use when considering changing the form of regulation (for example, it requires the Commission to consider a competition test, which is already satisfied for entities subject to regulation). In addition to changing the substance of the test (to more squarely focus on the benefits of price control in meeting the purpose statement), the legislation should include statutory deadlines for the Commission to conduct the process once commenced.

64. The legislation should also make it clear that the IMs established for LFCs for information disclosure purposes can also be used in an inquiry and /or subsequent price control – to remove any potential for arguments that separate IMs must be established.

Merits review

65. The Government further proposes to mirror the merits review rights contained in Part 4 for the UFB fibre framework. The availability of merits review rights will be an important feature of the new regime. The presence of appeal rights can be an effective accountability mechanism and improve the quality of regulatory decision-making.

66. However, there is an opportunity to learn from the difficulties encountered under Part 4, and make improvements for the telecommunications regime. In particular:

a. Section 52ZA(2) requires that an appeal be conducted solely on the basis of the information that was before the Commerce Commission when it made its determination – no new evidence may be introduced to the court. This was intended to prevent gaming and ensure interested parties put their best foot forward during the Commission process. The costs of that approach outweigh the benefits. During the merits review proceedings, the High Court struggled with not having the most up-to-date and relevant information and evidence before it, and there is no suggestion that parties will realistically seek to game the Commission process. To the extent it is a risk, it will be mitigated by the knowledge that the court has discretion to decide whether or not to accept new evidence provided by the parties. Ultimately, it should be for the court to decide what evidence to accept;

b. Section 52Z(4) requires that an amended or substituted input methodology is or will be "materially better" in meeting the purpose of Part 4. This caused difficulty for the court (it is not clear what "materially better" means), and is an unnecessarily high threshold to meet. Following the merits review proceedings, there is a real risk that the perception of "materially better" being a threshold that cannot be met has reduced the efficacy of merits review as an accountability mechanism. Accordingly, parties should only be required to prove that an amended or substituted input methodology is "better" in meeting the purpose of the Part. That is a more certain threshold for parties to seek to meet, and will therefore mean merits review provides a more effective accountability mechanism.

Attachment 2: Consumer research

Provided as a separate document.