ALLANGRAY
LONG-TERM INVESTING

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Telco Review Team
Communications Policy
Ministry of Business, Innovation & Employment

By email: telcoreview@mbie.govt.nz

Submission to Telecommunications Act Review: Consultation on the Copper Network

We appreciate the opportunity to make a further submission to the Ministry of Business, Innovation & Employment's review into New Zealand's Telecommunications Act. We recognise the many positive changes now proposed in the Discussion Paper on the Post-2020 regulatory framework for fixed line services, but we believe there are improvements that can be made that will achieve Government's policy objectives, maintain consumer protections and deliver appropriate returns to investors.

The current proposals broadly head in the right direction. In particular, we applaud:
- Instituting a building-blocks approach for the pricing of services on fibre
- Deregulation of the copper network in UFB areas
- No further review of copper prices post-2020
- CPI-based price increases for anchor products

We worry, however, that current proposals have an asymmetric risk profile for Chorus (of which we are a substantial shareholder), which could leave New Zealand consumers worse off in the long run. In our view, Government needs to make decisions that achieve its policy goals at minimum cost to the stakeholders involved. That cost needs to include, for example, the implications of Government getting forecasts wrong. Our primary concerns involve the definition of the anchor product, copper pricing outside of UFB areas and the decision-making authority still left with the Commerce Commission. We discuss each of these concerns below and offer some suggestions for improvement.

Anchor products

Setting the anchor product as the most popular product could make it mathematically impossible for Chorus to achieve an appropriate return on its capital. For example, if more than 50% of customers choose that product and that product is priced (as it is currently) well below the level needed for Chorus to achieve its regulated return, then higher specification products would need to be priced at a much higher level. Consumers' price elasticity of demand would likely mean there would be limited take-up at those levels, and the final outcome would leave both Chorus and consumers worse off.

Government could instead still achieve its policy objectives by setting the anchor product as the most basic voice and data product currently offered over fibre. This would ensure consumers have access to reasonably-priced products, with pricing not dissimilar to current levels. It would also ensure that Chorus can achieve its regulated return. In our view, there is no risk to this policy position for Government, consumers or Chorus, unlike the current proposal.

Arguments have been made that the basic fibre product and even Government's proposal of the 100/20 Mbps product will not be good enough for consumers by 2020. It has also been suggested that by then the more popular products will be the 1Gbps offers. While both of these may turn out to be true, setting the anchor product as the most popular product would be an expensive policy proposal which leaves only Chorus investors exposed to the risk that those forecasts are wrong. We believe this is an unfairly asymmetric outcome.

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Copper pricing outside of UFB areas

The current proposal that sees copper priced at current levels with no CPI indexation is very concerning. Most pricing determinations for copper have acknowledged that non-UFB areas cost more to service and, historically, prices have reflected that. The current proposal sees national pricing in non-UFB areas much lower than previous regional pricing levels, but without the corresponding implicit subsidisation from more densely populated areas. As a result, Chorus would effectively be paying for that subsidy on its own.

We also do not think a lack of CPI indexation is warranted. Chorus' operating costs (just to maintain a network they are being forced to maintain) are likely to increase with CPI. If inflation were to be more elevated, then Chorus is left exposed. In general, there is no evidence to suggest that non-indexation would achieve a good outcome.

The impact of this should be concerning for Government. Loss-making services foisted on private companies do not normally result in good service levels. It would not make sense for Chorus to deploy any additional capital on the copper network in those areas.

We believe this proposal could be made better in a number of ways (and thus incentivise the capital spend that will be needed in regional areas):

- Setting up a telecommunications levy ahead of this change to provide clarity for the industry and to appropriately address the losses Chorus would inevitably incur. Not setting up the levy prior to enactment would be destabilising given the levy has not been used before.
- Higher prices in those regional areas, consistent with the geographically de-averaged prices that existed previously.
- Providing further relief from TSO obligations for Chorus in those areas. Examples of such relief could include removal of those obligations when a particular address disconnects from the network (so that reconnection is no longer a Chorus obligation at that address).

At a higher level, we are concerned the Government has adopted a specific (and expensive) technology such as copper as the basis for the TSO, when alternative technologies are readily available in many of those regions. Our view is that those technologies should play a part in the TSO.

Too much decision-making authority still left to the Commerce Commission

While the building-blocks approach is well-trodden ground for the Commerce Commission, we think there are wrinkles in its application to New Zealand's telecommunications landscape which need to be addressed. Specifically, Government should provide more prescription on how the Commerce Commission:

- treats existing and reused assets such as poles and ducts from the copper network in UFB areas. These assets have value as has been practically demonstrated by the deal between Telstra and NBN Co in Australia. After the problematic (in our view) TSLRIC process, we would prefer to see greater direction to the Commerce Commission on this aspect so that real value to consumers is not written down with the stroke of a pen
- treats Crown Fibre Holdings funding to Chorus. This funding is what has delivered fibre to New Zealanders at the prices they are currently enjoying. Incorporating that benefit to Chorus in the building-blocks approach would be flawed, in our view, as it would lock in sub-par returns
- updates UFB pricing as Chorus goes into more expensive areas in which to build fibre. Without this, consumers in non-UFB areas could suffer from a slower build out as returns will not be available to justify the investment

All of these areas are specific to the telecommunications industry and not part of previous Commerce Commission deliberations. In all of these areas, we see all of the downside risk being borne by

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Chorus. To ensure a fair outcome for all stakeholders, we believe Government should therefore provide more prescription to the Commission.

We are also concerned about references being made to efficiency of the fibre build in current proposals. This is highly unusual given the context of other RAB transitions in other industries in New Zealand. Evaluating efficiency in a backwards-looking manner for a build that was competitively tendered by a listed public company would be, in our view, a very inefficient use of Commerce Commission resources and could result in outcomes that would not be grounded in reality, to the detriment of consumers and Chorus.

With a few small changes, we believe the Government can achieve its policy objectives, consumers can get the fibre they want at reasonable pricing levels and Chorus can achieve the returns it needs to continue to deploy fibre in New Zealand. We thank the Government for providing the direction needed in this new telecommunications landscape and hope that it can balance some of the asymmetry we see in current proposals.

Yours sincerely,

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About Allan Gray
Allan Gray is an Australian-based fund manager. We are long-term investors on behalf of pension funds and retail clients. Over the years, we have had a number of significant shareholdings in New Zealand-listed companies (e.g. Fisher & Paykel, Air New Zealand, Nuplex, Guinness Peat and, more recently, Chorus).