

30 August 2016

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

By email: [telcoreview@mbie.govt.nz](mailto:telcoreview@mbie.govt.nz)

### **Submission to Telecommunications Act Review: Options Paper**

We appreciate the opportunity to make a submission to the Ministry of Business, Innovation & Employment's review into New Zealand's Telecommunications Act. We recognise the many positive changes proposed through the Options Paper, but we believe that they fall short of ensuring that New Zealand maintains a world-class telecommunications industry. Our submission outlines our reasons for this conclusion at a high level, and then addresses just a few of the specific questions asked in the Options Paper.

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). We have been attracted to the good businesses that have developed in New Zealand, which has been possible, in part, because of capital from investors.

The recent Initial (IPP) and Final Pricing Principle (FPP) processes for determining regulated prices for the copper network revealed several problems in the regulatory framework and the way in which that framework is applied. In our view the process was embarrassingly lengthy, left too much discretion and decision-making in the hands of the Commerce Commission and resulted in an outcome that seemed to be divorced from real-world costs (after several iterations that were even more problematic). This was despite clear statements and legislative wording about the importance of the fibre network and related investment.

We applaud some of the very good proposals in the recent Options Paper. In particular, we think explicit provision for a merits review of a Commerce Commission decision is a good idea. We also think having a 'single RAB' for copper and fibre for Chorus is very sensible. Without this, allocation of costs between copper and fibre would be artificial at best. We also think it is sensible to freeze (with appropriate indexation) prices of various products in 2020 should the regulatory process not conclude in time.

But there is more that can be done to address some of the issues uncovered through the last process, while still upholding the Government's goals. We think whatever changes are implemented should strive to make the regulatory process much simpler and should introduce explicit consideration of real-world returns for investors. This is essential to ensure an incentive for ongoing investment in the network.

#### *A simpler regulatory process*

We think the last FPP process could best be described as a hugely costly and time-consuming exercise which delivered a (falsely) precise outcome at the expense of something grounded in reality. Perhaps this will always be the way with such processes but we believe New Zealand has a unique opportunity to start afresh.

To make things simpler, we would like to see something similar to the following:

- A RAB is determined largely by the actual costs to build the UFB network, with some adjustments to account for reuse of existing assets (ducts, pipes)
- This modified 'line-in-the-sand' RAB is agreed early and upfront
- The rest of the network's RAB is back-solved using current copper prices

There are several advantages to these changes.

- **Early certainty around framework in the context of ongoing investment.**  
Given Government wants the UFB network to be extended further and work to commence prior to 2020, it is incumbent on Government to provide a more certain framework earlier. Without this, why should investors allocate capital to a 20-year investment with sub-par returns guaranteed only for the first 3 years?
- **Reduced regulatory expenses.**  
The last FPP exercise was a costly exercise for Government and all industry players. This modified 'line-in-the-sand' approach could save the industry a lot of money, which should result in savings for end-users.
- **Backed by real-world experience.**  
The FPP process highlighted the flaws in coming up with a hypothetical efficient network. For example, trenching costs used did not reflect the experience in New Zealand, operating costs did not reflect reality and the WACC used was just too low given the demonstrable regulatory risks.
- **Minimised risk of price shocks.**  
Our suggestions would ensure there is no bill shock for end-users, while also providing a reasonable level of certainty for industry and investors alike.

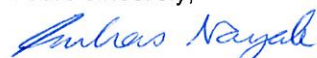
*Explicit consideration of real-world returns for investors*

Large nation-building projects such as the UFB roll-out require patient, long-term capital. This capital will typically only be deployed where there are reasonable returns on offer. The last FPP process highlighted the possibility that those reasonable returns can be eliminated without warning at the stroke of a few keys on a spreadsheet.

The process highlighted how easy it is to 'write down' the value of sunk capital through seemingly reasonable assumptions. In our first submissions to that process, we noted that the implied return from the initial draft decisions were well below the level required to incentivise investment. We worry that most provisions in the Options Paper only add to this risk. For example, the idea of an asymmetric wash-up is one-sided from an investor perspective and would need to be paired with an increase in the cost of capital elsewhere.

Consumers (and taxpayers) do well when patient, long-term capital can be deployed efficiently into needed infrastructure. Any BBM/RAB model needs to stay true to the basic principle that a network operator should make a reasonable return on their capital so as to continue to attract this necessary capital. New Zealand has had a very successful UFB roll-out to date despite the FPP process. We think the new set of regulations after 2020 can improve upon this record.

Yours sincerely,



Suhas Nayak, Ph.D.  
Senior Investment Analyst



**Responses to selected questions**

Question No.	Question	Our response
6.	Do you support a single RAB for copper and fibre?	We believe a single RAB is the only sensible way forward for Chorus as alternatives would only introduce more complexity and greater likelihood that actual costs are shifted between the assets or excluded through the process. We also think it is the best way to encourage efficiencies throughout the transition from copper to fibre.
7.	Do you agree that decisions on RAB valuation methodology should be made by the Commission?	<p>No. We believe more guidance needs to be provided to the Commission by Government. Given the poor handling of the recent FPP process, investors like ourselves are justifiably wary of leaving too much decision-making in the hands of the Commission. The timeframe of decision-making has also been proven to be too long, even while capital is currently being deployed. We do not believe there is justification in forcing another lengthy process onto the industry. Government can provide adequate guidance to let everyone just 'get on with it'.</p> <p>As it currently stands, there is little in the Commerce Act that ensures adequate returns are available to investors. The only provision is that suppliers of regulated services should have 'incentives to invest'. This has proven to be too broad and too easily subsumed by the other priorities given the sunk nature of the capital in question.</p>
8.	If you think the Government should provide legislative guidance, what form of guidance do you recommend?	The Government should be very clear on what approach the Commerce Commission is to apply so as to ensure a smooth transition. After the price shocks and delays that occurred during 2011-2015, this needs to be more definitive than the various 'signposts' and statements Government has made in the past. The mooted form of regulation is not new and we believe Government is well-placed to provide greater guidance.
9.	Do you agree with our proposed approach to enable the commission to determine the scope and treatment of assets in the RAB?	<p>No. Recent history has shown that while the Commission has tried to get ranges for various inputs, on almost every occasion, the Commission has chosen the low end of the range. Doing that repeatedly has resulted in a 'hypothetical' network that is so far removed from real New Zealand conditions as to risk deterring further investment. We worry this could be repeated in the determination of the initial RAB. This will only result in poorer outcomes for consumers.</p> <p>Enough of the network has been built and there are numerous local and overseas precedents for regulation of these sorts of utilities. Government therefore can provide the necessary guidance from the outset. Our preference is for a modified 'line-in-the-sand' approach to the RAB, one that is based on actual costs incurred and adjusted (upwards) to take into the reuse of existing assets.</p>

Question No.	Question	Our response
15.	Do you agree with our proposed approach to the treatment of networks rolled out under the Government's UFB and RBI programmes?	<p>No. While we acknowledge that it is suggested that the Commission will be required to take into account Government economic policy statements, we do not think this goes far enough to provide predictability or reflect the real world roll-out of this critical infrastructure.</p> <p>We believe the default should be that the networks currently being built are efficiently deploying capital. To do anything else without proper and quantifiable evidence to the contrary would allow further deviation from reality on the ground. This seems to always result in further deterioration of returns to investors, which will eventually imperil further infrastructure builds in New Zealand. We strongly urge that the sunk capital of the UFB and RBI networks be treated as both sunk and efficient.</p>
19.	What is your preferred option for the form of price-quality regulation – price caps, a revenue cap, or our preferred option – and why?	<p>While we don't have a strong view on this, we caution against putting too many constraints that may make recovery of investment impossible. For example, suppose anchor products are regulated to have a certain price cap. It is quite possible that if those same anchor products end up being the most popular, and the prices are not set high enough, there could be significant under-recovery by the suppliers as they would not have enough flexibility in practice in setting prices of other products.</p>
22.	Is there any way to make sure that the UFB provider is not wholly insulated from competition under a revenue cap model? For example, could an asymmetric wash-up be applied?	<p>As a general comment, we worry that these proposals again tilt in just one direction: delivering lower than adequate returns for investors. If that is the case, why should a rational investor support further roll-outs of fibre?</p> <p>The only way we believe an asymmetric wash-up could make sense is if the discount rate set initially adequately reflects the risk that future cash flows could well be lower. This means the discount rate needs to be higher than it otherwise would be, as otherwise the investor is not truly compensated for this risk. That is undoubtedly hard to do as there are few comparables for this kind of stranded asset risk. We therefore believe that there should be no asymmetry in these wash-ups.</p>
27.	Do you have any comments on the principles for anchor products?	<p>The three outlined principles miss one important element as mentioned in the response to Question 19. There has to be enough practical flexibility for the supplier to allow them to earn an adequate return on capital through non-anchor products. This means those other services would need to have enough demand at a commercial price for the supplier to recoup its investment.</p>



Question No.	Question	Our response
47.	Do you support implementing price regulation for Chorus at 2020, or as a backstop?	<p>We believe regulation should apply equally to all providers. The argument that LFCs should face a 'backstop' approach while Chorus should not is not particularly strong.</p> <p>Our preference would be for all providers to be subject to a 'backstop' approach. The threat of intervention (and the subsequent regulatory costs) should be enough to keep all providers in check. Starting from prices that deliver sub-economic returns (as is the case with 2019 pricing currently) and requiring increases to be phased and gradual will also keep pricing in check.</p>
59.	Do you agree with the proposed approach to merits review?	Yes. We think there needs to be an additional check on the process, given what we saw during the recent IPP and FPP processes.
61.	Do you agree that mandatory claw-backs should be introduced for utility-style regulation of fixed line services under the Telecommunications Act?	<p>Yes.</p> <p>The FPP decision which recommended no backdating set an extremely poor precedent for all future regulatory processes. It gives incentives for companies to prolong the process and not face any consequences from that decision.</p> <p>The decision not to backdate also did not benefit consumers in any way. It just robbed one group of investors of a dividend and gave it to another group of investors, with end-users no better off. We fail to see why this should be able to be repeated in the future as it does not help meet any government objective.</p>
63.	Do you agree that a transitional arrangement should be in place in case the new framework is not able to be implemented with enough notice before 2020?	Yes, but we believe the Government's objective should be to make the framework clear and prescriptive enough so that a smooth transition can occur <u>before</u> 2020.
64.	Do you agree with the proposed model of a temporary freeze? Are there any other risks or benefits of this approach?	<p>Yes. Frozen with CPI indexation seems a very practical way of moving forward should the regulatory process not conclude in time.</p> <p>We disagree that the indexation should be set at CPI-1%. There is no evidence to support this level and it is unclear that any network business could sustainably invest in their network with such a regime in place.</p>