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Introduction

The MBIE has asked for interested parties to provide feedback on the recently published Telecommunications Act Review Options Paper with a view to reforming fixed line regulation from 2020. L1 Capital has investments in several NZ telecommunication and media assets and is thankful to the MBIE for the opportunity to present our views.

New Zealand has led the world on structural separation of telecom assets and has achieved a highly cost effective fibre build program which has given New Zealanders a network significantly more advanced than that of most regional peers, including Australia. This is a significant achievement for the NZ government and the NZ people. Having been active participants in the FPP pricing process over the last two years, we have seen first-hand the tremendous complexity of the current TSLRIC regime and strongly agree that New Zealand now needs a new regulatory approach that recognises the new telecoms environment. L1 also endorses the building blocks approach as a replacement for TSLRIC regime, having investments in several New Zealand utilities regulated under this approach.

However, moving to new regulatory regime without providing sufficient guidance to the Commission on key inputs will undermine the NZ Government's objectives, increasing uncertainty for infrastructure owners, undermining incentives to invest and deterring competition in new innovative services. Infrastructure investors have to make crucial decisions about capital investments in fibre and copper in the 2016-2020 period while facing an uncertain regulatory regime post 2020. It's essential that after appropriate review, the Government aims for a policy which helps expedite investment by focusing the parameters of the Commission's work on a few key work areas rather relying on broad policy statements which have to be interpreted by the Commission.

A good example of the danger of broad policy guidance can be found in the TSLRIC process itself which ran well over proscribed legislative timelines. In drafting legislation around structural separation of Telecom NZ, the government attempted to guide the Commission to take into account the risks facing infrastructure owners by inserting Section 18(2A) requiring the Commission to consider the *"incentives to innovate that exist for, and the risks faced by, investors in new telecommunications services that involve significant capital investment and a determination that undermines incentives to invest would deter future investment and so would likely undermine competition over the long-term benefit of users."* The resulting two-year regulatory process highlighted the difficulty the Commission had in interpreting the high level guidance in the Act and strongly suggests the need for a much more prescriptive approach.



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Following the final FPP decision, the telecommunications industry now has high level of visibility around the assumptions which Commission has adopted to model the network. This has given the industry the confidence to start to accelerate some investment in copper, fibre, content and wireless internet infrastructure in 2016. **L1 believes that the Government in moving to a new regime must endeavour to give the industry at least the same level of visibility for post 2020 regime as is available under TSLRIC today. This means that certain decisions must be made by Government today to present a robust set of legislation to the Commission which can be adopted quickly and lead to an expedited regulatory regime. This will provide sufficient regulatory stability and transparency to enable business to make long term investments for benefit of end users.**

Below we have outlined the key principles that L1 believes should form the basis of new regulatory regime and have then responded to the detailed questions posed by the Options Paper.

Principles of New Framework:

Building block (BBM) utility-style regulatory framework for fixed line services has the potential to provide win-win outcome by lowering the risk premium for utilities, simplifying regulatory regime for the Commission and encouraging infrastructure owners to innovate, invest and compete in next generation of products and services. The key will be a framework that respects the following principles:

- (a) **New legislative framework should be consistent with other utilities regulation:** L1 strongly agrees with MBIE that the new legislative framework should stick closely to the utility price regulation which is well regarded by investors and users and widely adopted by the Commission. Importantly the TSLRIC approach differed materially to the Part 4 regulatory approach to utilities regulation with no WACC uplift, real building costs not being used in asset value, hypothetical operating expense ratios 40% below real costs measures, no merits review and no regard for precedent in decisions relating to backdating. Future legislation must highlight the need to treat telecommunications as an essential service with the Part 4 Act and ask Commission to justify differences in approach to telecommunications versus other infrastructure.
- (b) **Legislation should prioritise certainty and simplicity:** A legislative framework that leaves a high level of discretion for the Commission will create significant uncertainty just when industry is beginning to accelerate investment and go against the intent of the regulatory review. **For this reason, we strongly endorse the choice of a single RAB regime to simplify what otherwise would be complicated interaction between copper and fibre assets. We also believe RAB valuation approach must be proscribed in the legislation.** Simply put, the Commission, faced with just one regulatory approach in TSLRIC took over 2 years to form an assessment. Giving the Commerce Commission a choice of 3 regulatory paths, each with a highly complicated set of assumptions is equivalent to providing no visibility at all to end users



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or infrastructure builders. The Historic Cost approach is particularly problematic. There are simply too many assumptions in place which the Commission would have to contemplate for the first time, including all of the past returns of the assets vs their depreciation profile, their existing useful life, how those assets are used in a fibre world, which group of shareholders to take into account (Chorus shareholders versus the Crown which owned the assets for most of the period) to give any visibility as to end outcomes. The ODRC approach at least has the benefit of drawing some prior work on TSLRIC but L1 believes that many of the assumptions would have to be revisited to reflect real world conditions (building cost well below real costs incurred in building fibre, operating costs well below real world) and would not survive a merits review in their current form. The most pragmatic approach is simply to reflect the significant if imperfect work undertaken in setting copper and fibre prices and use these as at least the initial starting point. This approach draws on the expertise of the Commission from the last 2 years and has the benefit to end consumers from fibre prices which benefit from a government subsidy and are below equivalent real world costs of providing fibre services. **In relation to price-quality regulation we agree with MBIE in suggesting a revenue cap with anchor pricing approach, because again we do not believe the extra complexity of setting price caps and having to estimate copper and fibre demand during an uncertain transition period benefits anyone. Finally, we believe that giving Commission power to move to price caps destroys a lot of the stability of the model.** It would be incredibly difficult for infrastructure builders to commit to a certain technology choice if the price regime can change early in the life of the investment.

- (c) **Equal regulatory treatment of public and private investment and fibre and copper investment: Prioritising returns for public capital ahead of private capital or for one form infrastructure over another will raise sovereign risk and worsen outcomes for consumers over the longer term.** Introducing an asymmetric wash up for copper infrastructure raises the risk of Chorus abandoning future investment in dynamic new copper services and providing price competition to local LFC companies to the detriment of consumers. Incremental fibre or copper investment should be treated identically under a classic BBM RAB regime. Similarly, putting in place a RAB regime for Chorus in the 2020-2025 period while leaving LFC's with a backstop model will either force Chorus to abandon copper investment if prices are set too low or retard fibre take-up in those areas, either adversely impacting on private or public capital. Again, the ideal regime should one that is agnostic and applies equally to all parties, including HFC.



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Reponses to Key Options Paper Questions

MBIE Question	Question Number	L1 Response
Do you support a single RAB for copper and fibre?	6	Strongly Agree: Single RAB approach mitigates the very difficult problem of forecasting demand from two services, shared cost allocation and splitting up of common infrastructure. However, single RAB approach must recognise existing investment and respect that investors have earned right to earn a return from both copper assets and the new UFB network. In particular we believe the MBIE should reference implied value of copper network in TSLRIC model in directing commission to look at RAB regime.
Do you agree that decisions on the RAB valuation methodology should be made by the Commission?	7	Strongly Disagree: As we stated above giving the Commission the choice of 3 regulatory approaches with a large number of assumptions will throw the industry into a state of uncertainty. The most pragmatic approach is to recognise significant work done in pricing both fibre (UFB bid prices) and copper assets (TSLRIC) and utilise a line in the sand approach that give the industry significant certainty in planning and budgeting in the 2016-2020 period. We believe the historic cost in particular will throw capital decisions into disarray given the Commission has not opined on any of the assumptions to this model previously. For the purposes of regulatory consistency, any new model should not materially impair value of existing infrastructure that private investors in Chorus's network expect to receive based on TSLRIC regime – we believe a new model that prices copper assets on a completely different basis to TSLRIC regime established just last year will simply raise sovereign risk. In relation to Historic Cost approach, the key issue is that the (a) value of depreciated assets was not captured by private owners of business and (b) that depreciated assets do not reflect useful economic lives of assets
If you think the Government should provide legislative guidance, what form of guidance do you recommend?	8	The Government should proscribe an approach: L1 believes the line in the sand approach is easiest to implement and draws on prior work of Commission and Crown Fibre Holdings.



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Do you think Chorus' assets in LFC areas should be excluded from its RAB?	11	Chorus assets should be included for all areas: Again this draws on prior modelling by the Commission in forming TSLRIC. Corollary argument to excluding these assets would be to spuriously argue that LFC assets should also not be regulated as they are subject to competition from Chorus.
Do you agree the Commission should decide on the treatment of UFB financial support?	12	Government should provide guidance: The guiding principle should be to remove uncertainty from an already complicated regulatory regime. Guidance on treatment of UFB financial support by the government should highlight that UFB financial support was necessary for the fibre build to be economic to infrastructure investors and is already incorporated in the subsidised fibre prices under the existing regime. It is also important to note that the support is in the form of an interest free loan – the relevant support is the present value of the difference in interest cost between government loan and a commercial loan. However, a 20-year loan would not have been available in the private market given the significant risks around the build – loan support was necessary for the project to be viable at low prices bid by fibre companies.
Please provide comment on proposed approach to stop Chorus being incentivised to retain copper customers?	13	L1 believes the best approach is a line in the sand price regime where the current relativities between fibre and copper prices are leading to high incentives to switch to fibre in both Chorus and LFC build areas.
Do you agree the Commission should decide on the treatment of UFB initial losses?	14	Government should provide guidance: Again in the name of simplifying the modelling task for the Commission the MBIE should provide guidance in line with the Australian regulatory experience. It is relatively uncontroversial for BBM regimes we have seen that new infrastructure assets have a period of negative returns during build stage of their asset lives and in order to earn normal returns over the life of the asset these start up losses must be recognised in a RAB model.



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Do you agree with our proposed approach to the treatment of networks rolled out under the Government's UFB and RBI programmes?	15	Yes agreed these programs were competitively bid and represent efficient build costs for modelling purposes.
Do you agree with our proposed approach to the treatment of non-standard installations? What threshold do you propose for charging end-users for non-standard installations?	16	Yes, agree with the approach. Thresholds should be in line with those agreed between LFC's and Crown Fibre Holdings in the UFB process.
Do you agree there should be a pre-approval mechanism available to regulated suppliers for future major capital expenditure based on the Transpower model?	17	Yes agree
What is your preferred option for the form of price quality regulation – price caps, a revenue cap, or our preferred option – and why?	19	Strongly favour revenue caps: Given the period of rapid transition from fibre to copper in the 2020-2025 period it will be very difficult to forecast end demand which is one of the key requirements for price caps. Adding a price cap on top of an uncertain regulatory approach to RAB also means creating incredible uncertainty for infrastructure investors who must decide between incremental copper or fibre investment today. We cannot see how Chorus can make capital allocation decisions in that context. In addition, a price cap will result in deadweight loss as uncommercial stagnant prices persist in marketplace.
Do you agree the impact of competition 'at the fringes' should be managed? If so do you agree with our proposal for an 'asymmetrical wash up'?	21	Don't agree. We believe that the RAB model as a whole should be respected. Under a single RAB model there will be a natural depreciation rate for copper and fibre network that will take into account increased competition. Putting an additional asymmetric wash up simply ensures that the regulated entity is unlikely to earn its regulated rate of return over time. This will simply act to raise cost of capital for telecommunication infrastructure



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		owners, increasing costs for end users over the long term. It is also not in line with how other regulated entities are regulated and together with uncertain RAB regime and price caps will create more uncertainty than current TSLRIC regime, which is contrary to Government's intent.
How should anchor products be determined?	27	With reference to 2019 prices; these prices reflect costing work of the Commission in relation to copper and bid prices for fibre prices and are the most sensible starting point for prices.
Should there be a limit on when the Commission can review and update the anchor product set? What frequency of reviews do you recommend?	36	Updating the frequency of anchor products too frequently will destroy the incentives to innovate in new competitive products. Infrastructure owners who invest in new commercial products need a period of time to recover fixed and variable costs and earn a return above the regulated rate to encourage innovation. Updating anchor products at every 5-year review period is likely to retard investment given the payback period for new infrastructure products is significantly longer. We would suggest reviewing the anchor price set at every 2 regulatory periods.
Do you agree the Commission should have the power to recommend changes to the form of price control (including moving to a price cap regime) if certain criteria are satisfied? If so what criteria would you propose?	43	Strongly Disagree: Changing such a material parameter even subject to a high hurdle means infrastructure owners have to consider than long term investment might be subjected to a completely different regime from 2025 onwards. This again make it very difficult to invest and innovate and increases the cost of capital. In L1's opinion the RAB regime already has sufficient flexibility through other parameters to achieve policy outcomes without introducing this new layer of complexity.
Do you support implementing price regulation for Chorus at 2020, or as a backstop? Under a backstop approach, how do you suggest copper services be treated?	47,50,52	Legislative outcomes should be identical for fibre and copper assets: Both assets have elements of pricing power. LFC's will be the only provider of fibre assets and will therefore the sole choice for consumers at very high speed and so will not be constrained by RSP's or Chorus. At lower end plans both LFC's and Chorus will compete with each other, which argues for similar level of market power. If a



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<p>Please comment on the preferred option of 'freezing' the copper price.</p> <p>Do you support implementing price regulation for Chorus at 2020, or as a backstop?</p>		<p>backstop regime is adopted for the 2020-2025 period while the demand between fibre and copper services is in flux, it should be adopted for both Chorus and LFC's equally. If this is combined with a price freeze regime which locks in the relativities between copper and fibre prices currently then it will lead to a consumer switch to fibre in line with current fibre uptake which is line with the Government's intent of widespread fibre adoption.</p>
<p>Do you agree with the proposed approach to merits review?</p>	59,60	<p>Yes, we agree. A merits review is important for the integrity of the regulatory process and has been adopted successfully in other utilities regulation.</p>
<p>Do you agree with the proposed model of a temporary freeze?</p>	64	<p>A temporary freeze is preferable to a period of extended uncertainty: It's our strong belief that delivering a new regulatory model without providing the Commission with explicit direction on key assumptions in this period of crucial investment will damage both infrastructure owners and consumers. L1 would prefer to see a strong, simplified regulatory regime but believes a price freeze is a pragmatic solution if the Government finds there are too many uncertainties to narrow the regulatory options at this stage.</p>



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Conclusion:

The NZ government has led the world in pioneering the structural separation of telecom networks. It has also overseen a fibre build program that has delivered tremendous value to the NZ economy and people, leveraging a mix of private capital and public long term loans to deliver both an aggressive rate of adoption for fibre and minimise public expense. The end result has been a fibre program that has connected more homes at faster speeds with better technology than the equivalent Australian NBN network at a cost that is 20-25% cheaper per premise.

The regulatory regime now needs to adapt to meet the needs of changing telecom infrastructure. One of the key learnings of the TSLRIC process is that a lot of time is spent debating relatively minor technical points and that broad directions from the Government via policy statements like Section 18(2A) do not help expedite the process. The new regulatory regime that Government wants to introduce is significantly more complicated than the TSLRIC regime. It asks the regulator to choose from three approaches to RAB modelling (DAC, RDC, line in the sand), WACC, choose price or revenue caps, work through impact of UFB start-up costs and government support and potentially commit to different regimes between LFC's and Chorus. This is simply too much for the Commission to work through and will cause uncertainty for the industry all the way to the 2020 period. The Government must legislate a simplified and prioritised set of legislation, which ideally draws on the prior work of the Commission.

Unfortunately, it will be difficult to reach consensus among all the parties given their interests in many cases are diametrically opposed. For retail service providers (RSP's), wholesale prices of copper and fibre are their biggest expense items, and notwithstanding their claims to be consumer champions, they see lower wholesale prices as being key to higher profits. Given the level of concentration in the retail market with Spark, Vodafone and Callplus(Slingshot/Orcon) having a combined 90% market share, the ability for RSP's to not pass on lower wholesale prices to consumers and instead grow margins is extremely high. This was evident during the draft FPP period in 2014/2015 when the Commission introduced significantly lower wholesale copper prices, yet retail prices were largely unaffected. Please see L1 Capital's Feb 2015 submission on the FPP process for more details. Infrastructure owners, conversely, are anxious to recover a return for the current network, to support an investor base which invested on the assumption that the Government would respect prior investment and the need for reasonable investor returns. Infrastructure owners are also keenly aware of the risks in investing significant capital in new fibre and copper assets and are looking for signals that the new regulatory regime will respect their cost of capital, and not leave future investments stranded. This is exacerbated by the nature of the telecoms industry, which is fast paced and where risks of investment are significantly higher than in other sectors.



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The absence of strong industry consensus did not prevent previous NZ governments from passing far sighted, sensible legislation which is currently benefiting all of New Zealand. We would urge the government to consult widely, find the sensible middle ground in the debate and ultimately put forward legislation which is pragmatic and can be adopted quickly so all players in the industry can go back to innovating for the benefit of consumers.

We thank the MBIE for the opportunity to make this submission and look forward to engaging further in the process.

Signed,

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