Vodafone Aotearoa' cross submission on the draft price-quality path to be applied to Chorus

Public Version
5 August 2021

Introduction and summary

1. Thank you for considering requests for extension and allowing the opportunity to provide this cross-submission on the fibre price-quality and information disclosure draft decision consultations.
2. In this cross-submission we make the following key points:
    a. Accepting Chorus' proposals regarding the treatment of incentives would harm competition and is not in the best interests of consumers.
    b. The Commission's proposed decisions will not result in the regulatory failure that is alleged by Chorus. These allegations have been made previously and have been proven to be unfounded.
    c. If the Commission were to make arbitrary adjustments on the basis of Chorus unfounded concerns regarding regulatory failure, it would materially overcompensate Chorus to the detriment of retailers, consumers and ultimately competition.

Confidentiality

3. This cross-submission contains no confidential information.

Enabling incentives would harm competition

4. Chorus has asked the Commission to adjust its draft decisions so as to allow Chorus to better use incentives to drive demand for fibre. It proposes that $44.4m should be allocated to

incentive payments to drive new fibre connections and network usage by existing fibre connections.

5. As set out in our letter to the Commission dated 9 November 2020, the Commission needs to be alert to the potential for Chorus to distort competition in retail markets through incentive offers and other activities that are expressly intended to lead consumers to choose fibre over other alternative access technologies.[1]

6. While Chorus claim that incentive payments are 'efficient'[2], we have not seen any evidence to support that assertion. In particular, to meet the claim that the payments are efficient the regulations should not result in the discounts being "costless". That means that a level playing field between providers of broadband infrastructure requires that any incentive offered by Chorus to drive fibre demand comes off its bottom line and does not create headroom that Chorus can recoup from captive customers. As Spark has previously noted, there is a risk that this would lead to incentives to exclude or limit alternative access technologies and support price discrimination strategies that have potential to raise switching costs once an end user has adopted fibre and raise prices for lower specification fibre services.[3]

7. The Telecommunications Act 2001 (**the Act**) was amended in 2011 to allow for the structural separation of Telecom into wholesale and retail companies (Chorus and Spark). This was necessary for Chorus to participate in the Ultra-Fast Broadband initiative.[4] Under the Act, Chorus is prevented from re-entering retail product markets as this would recreate the same incentive problems that structural separation was designed to remove.[5] Chorus is subject to three line-of-business prohibitions:[6]

    a. Chorus must not participate in the supply of a telecommunications service at retail (that is, to end-users) (s 69O); and

    b. Chorus must not participate in the supply of fibre services above layer 2 (s 69R); and

    c. Chorus must not provide end-to-end services (that is, it can only provide services between an end-user and an aggregation point) (s 69S).

[1] Letter: Tom Thursby (Vodafone) to Vannessa Turner (Commerce Commission), 9 November 2020.

[2] Chorus, 8 July 2021, *Submission on price-quality path draft decision*, p 6.

[3] Spark cross submission on Fibre ID and PQ draft decisions (8 July 201), paragraph 63 *et seq.*

[4] See *New Zealand Government Ultra-Fast Broadband Initiative: Invitation to Participate in Partner Selection Process* (October 2009) at [13.4(a)]: "In the event that a prospective Partner, or a related or associated entity of the Partner, currently (or at any time while a Partner) owns or controls a business which provides any Telecommunications Service other than the Permitted Services, the Partner must fully divest, or must ensure that the Partner's related or associated entity fully divests, itself of that business."

[5] Ministry of Economic Development *Regulatory Impact Statement: Regulatory Issues Resulting if Telecom becomes a Partner in the Ultra-Fast Broadband Initiative* (16 February 2011) at [120]-[130].

[6] Since 2018, s 69SA has allowed the Commission to grant exemptions from ss 69R and 69S. The Select Committee, however, rejected the repeal of ss 69R and 69S on the basis that this "would leave Chorus with both the ability and incentive to expand into competitive markets, which risks distorting competition and innovation".

8. As noted by Chorus, the effect of the incentive payments is to influence the retail markets, and provide an advantage to RSPs without mobile networks.[7] This is contrary to Parliament's intention for Chorus to operate a wholesale-only business and for competition between RSPs to provide innovation and diversity in retail offerings.[8]

9. Chorus' market behaviour bears out this concern. We have seen Chorus attempting to tilt the playing field in favour of fibre and ultimately reduce the diversity of retail offerings to consumers through actions that include:

   a. A bonus credit offered between 1 September and 31 December 2020 where RSPs received a $350 credit for moving customers on to fibre that are currently not on any of Chorus' networks (i.e. those on competitors HFC or FWA networks). Chorus is now proposing to extend this offer until 30 June 2021.

   b. A direct consumer marketing offer where Chorus sent pre-paid Mastercard payment cards (loaded with sums ranging from $50 to up to $500 in some cases) to households not connected to Chorus' network where fibre or VDSL is available. The cards were activated once the address connected to Chorus fibre or VDSL broadband.[9] (Although our concerns are focussed on Chorus, we note that LFCs have on occasion made similar offers, e.g. an offer by Enable to incentivise RSPs to migrate a customer off Vodafone's HFC network onto Enable's fibre services. Between November 2020 and the end of June 2021, Enable would provide a $250 rebate to RSPs who migrate customers).

   c. A proposed retail offer where Chorus would directly contact customers not on any Chorus network and offer six months free fibre broadband for the 100/20 or Fibre Max services. The customer would elect to take the offer from a participating RSP through the Broadband Compare website. Chorus would then rebate the selected RSP for part of the cost, with the RSP making up the difference for the six months free fibre broadband. The RSP would also pay a success fee to Broadband Compare. This offer was not ultimately implemented but indicates a pattern of behaviour.

10. Accordingly, we have genuine concerns as to how Chorus would employ and allow for incentive payments in future. Chorus' statement that the incentive payments put forward in its expenditure proposal reflect offers that have been developed in consultation with RSPs obscures the reality that Chorus has not engaged at all with genuine concerns about how these might distort the retail market and discriminate between RSPs.

11. We disagree with Chorus that the concerns raised by the Commission about the size of the incentive payments are only 'theoretical'.[10] The PQ and ID determinations should not operate to allow incentives to operate as "costless" fibre discounting for Chorus. In a normal market,

---

[7] Chorus, 8 July 2021, *Submission on price-quality path draft decision*, pp4-5.

[8] This is also supported by the non-discrimination and equivalence of supply obligations in Part 4AA of the Act.

[9] https://sp.chorus.co.nz/product-update/customers-connect-chorus-cards

[10] Chorus, 8 July 2021, *Submission on price-quality path draft decision*, p6.

a rebate or other discount would come off the provider's bottom line. Vodafone seeks comfort that Chorus is not able to use such a discount to create headroom beneath its maximum allowable revenue that can be **recouped from captive customers**. Such a benefit would be an artefact of Part 6 and would be inconsistent with competition on the merits under s 166 of the Telecommunications Act. It would also be inconsistent with Chorus' own view that "*the utility model in the [now enacted Telecommunications (New Regulatory Framework) Amendment Bill] assures consumers* ***that costs are not over recovered****…*" (emphasis added).[11]

12. As shown in the attached expert report from Frontier Economics[12] (**the Frontier report**), this "costless" discounting would result in **substantial over-recovery** of costs by Chorus. Indeed, the Frontier Report finds that "*a revenue cap designed to ensure that Chorus earns only a normal rate of profit* ***may be thwarted through the use of incentive payments*** *– if those incentive payments are allowed as capex for the purposes of determining the RAB (and there is no offsetting reduction in the revenue requirement).*"

13. We therefore disagree with NERA's claim that Chorus would still only be able to earn a normal return on capital despite the incentive payments.[13] We also disagree with NERA that Chorus would not be able to recoup the costs of predatory pricing in the future. The Frontier report shows that there is considerable customer inertia in fibre connections, which gives Chorus substantial market power and entirely confirms justification of price-quality regulation. It also confirms the possibility of predatory behaviour relying on cross-subsidisation between customer groups. There is every chance that Chorus will use its market power to recoup the costs of incentive payments after they have limited the competitive risk they currently face (and be **overcompensated** for this through the *ex ante* allowance mechanism).

14. In addition, NERA claims that information provided to the Commission as the independent verifier is already consistent with the test proposed by the Commission (i.e. that marginal revenue must exceed marginal cost).[14] We have not had visibility of this information but note that the assessment of revenues and costs must take account of the following issues:

    a. We agree with NERA that incremental revenue must account for the fact that some customers offered the incentive would have joined or upgraded regardless.[15] Vodafone deals with this issue frequently in our internal processes for approving our own discounts. In evaluating the business case for any incentive-based campaign we will assume that a percentage of customers would purchase the relevant

[11] Letter: Vanessa Oakley (Chorus) to Jonathan Young MP (Chair, Economic Development, Science and Innovation Select Committee), 13 April 2018

[12] Frontier Economics "Incentive payments" Report for Vodafone New Zealand (28 July 2021)

[13] Nera (on behalf of Chorus), 7 July 2021, *Customer incentive payments and the long-term benefit of end-users*, p 10.

[14] Nera (on behalf of Chorus), 7 July 2021, *Customer incentive payments and the long-term benefit of end-users*, p4.

[15] Nera (on behalf of Chorus), 7 July 2021, *Customer incentive payments and the long-term benefit of end-users*, p14.

services regardless of the campaign. The revenues from these customers must be netted off the assessment of marginal revenue.

b. Chorus must also identify the appropriate marginal cost associated with these connections. There are two key marginal costs that need to be considered:

- Changes in variable costs, such as overheads due to increased connections.
- The costs of connection. While Chorus is targeting in-tact connections from their pre-installation campaign, it would be misleading to not capture the installation costs in the marginal benefit / marginal cost test. An analogy may be the treatment of inventory. The pre-installed connections are in effect stock of goods awaiting sale. Typically, stock will be recorded as an inventory asset. Only once it is sold (or in this case used to create an active connection), is it moved to the income statement as a cost of goods sold. Taking this approach allows a proper accounting of the full costs incurred.

17. As importantly, the approach taken by Chorus in connection with recent incentives appears inconsistent with regulatory obligations, including the requirement not to discriminate in connection with fibre services. To illustrate this, in its information pack *RSP Incentives for Consumer Fibre and Hyperfibre Connections 01 Jul-31 Dec 2021* Chorus included a requirement that specific "fibre-focussed" advertising **must be adopted** by any retailer who wishes to be eligible for credits.[16] While we accept that Chorus is entitled to link credit payments to the promotion of the fibre services, we are concerned by an approach that compels retailers to:

a. promote fibre **over and above** other alternative access technologies that are available to consumers; and

b. avoid any discussion in advertising of the relative merits of different access types. The importance of not favouring a specific technology type, and instead providing consumers with information on **all** access technology options available to them to help them make informed decisions about alternative telecommunications services 'best suited to their needs', is emphasised in the Commission's open letter to industry on 4 August 2021[17].

18. By default, Chorus' requirement unfairly advantages retailers that sell fibre only and disadvantages those who offer alternative broadband access types and cannot promote fibre

---

[16] See pages 10-14 of the information pack provided in Email: Tom Thursby to Ben Oakley (11 June 2021). Chorus says at page 13 of the pack: "*Whilst we understand different RSPs employ different strategies and some will call for a technology agnostic approach, this particular offer requires the promotion of Fibre –so No "broadband" messaging does not qualify.*" It also says that Chorus will "*work with you to assign a monetary value in order to calculate your cap*", i.e. Chorus will attribute a value to the amount of eligible credits based on how effectively advertising promotes fibre.

[17] https://comcom.govt.nz/__data/assets/pdf_file/0026/260792/Marketing-of-alternative-services-to-consumers-during-copper-and-PSTN-withdrawal-Open-letter-4-August-2021.pdf

exclusively over and above other access types. This dynamic directly affects retail market competition in a context where fibre-only RSPs make up a substantial portion of the New Zealand broadband market and can access Chorus credits without materially changing their advertising approach. In this way, Chorus eligibility conditions differentiate and discriminate in how wholesale services are provided to fibre only retailers vs. others – and have clear potential to distort downstream retail competition.[18]

19. The Commission cannot adjust its position on incentive payments without engaging with questions about Chorus' practical compliance with existing regulatory rules and the effects of discrimination. Moreover, in Vodafone's submission, allowing Chorus to include incentive payments within the RAB would contrary to the purpose of Part 6 of the Telecommunications Act because this would allow Chorus to thwart the very purpose of the revenue cap, which is to limit its ability to extract excessive profits.

There is no risk of regulatory failure

20. Chorus suggests that the Commission's draft decisions risk understating its starting RAB such that it will "…*never have the opportunity to make a normal return*". However, as the report by New Street Research[19] makes clear, it is shareholder' disappointment that Chorus' share price has under-performed against a notional expectation that is the motivation for allegations of regulatory failure. This disappointment cannot justify any departure from the approach the Commission has taken to date.

21. Indeed, the pessimism expressed by Chorus and in the New Street Research report does not reflect any universal view from analysts. For example, only a few weeks before Chorus made this claim, Forsyth Barr noted that the Commission's draft decisions enhanced its confidence that Chorus could deliver a strong lift in free cash flow and dividend over the medium-term, and that the Commission's MAR range was consistent with its assumptions.[20]

22. Ultimately, even if it were accepted that there is a mismatch between Chorus' historically anticipated performance and investors' current views on its equity value, this can't simply be attributed to 'misregulation' without examining other factors that have contributed to this

[18] To date the richest incentive payments have been available for promoting Hyperfibre. There are virtually no consumer use-cases for Hyperfibre and we are concerned, therefore, that the credits being offered by Chorus may lead to significant overselling to consumers. To the extent that incentive payments enable an outcome where consumers are offered products for which there is no demand, we think this is inconsistent with the s162 purpose to promote the long-term benefit of end-users in markets for fibre fixed line access services by promoting outcomes that are consistent with outcomes **produced in workably competitive markets**. We note the concern expressed in the Commission's open letter *Marketing of alternative services to consumers during copper/PSTN withdrawal*, published on 4 August 2021, that "*consumers do not experience an acceptable level of RSQ if their understanding of their needs is inaccurate…this can result, for example, in consumers purchasing a higher priced service than needed*." We also note that the Commission identified concerns about Hyperfibre incentive payments in its updated Draft Decision (16 June 2021) at paragraph G48.

[19] New Street Research *Chorus and New Zealand Broadband Policy* (18 June 2021).

[20] Forsyth Barr "Chorus Cost Debate Mars Long-Term Outlook" 28 May 2021.

mismatch – including overly optimistic *ex ante* assessments of Chorus' future prospects, Chorus' own commercial and operational performance, and advances in technology which have the potential to create genuine, innovative access alternatives to fibre.[21]

23. This is not the first time that Chorus has asked to change rules of the game and argued referee is unfair when its investors have faced disappointment. In 2013, Chorus criticised the outcome of the Commission's process for determining regulated copper prices, saying that it "…*believes the benchmarked prices are below the cost of providing a national broadband service in New Zealand, will discourage further network investment and that the price decreases are unlikely to be passed through to consumers. The reduced aggregate price also significantly undermines the fibre prices agreed under the ultra-fast broadband (UFB) public-private partnerships and implies a $1 billion funding shortfall for Chorus.*"[22]

24. As we know, the consequences that were predicted in 2013 did not eventuate and it is not credible for Chorus to claim that these will now occur in 2022 simply to try to persuade the Commission to change its analysis and conclusions.

25. Chorus' criticism of the fibre regulation process now being applied by the Commission is in stark contrast to its prior support for this model, which it said "… *is widely recognised as providing quality, affordable choices for consumers and confidence for investors. Consumers benefit as the regime ensures regulated firms cannot over recover cost and must maintain service quality. Investors benefit as the regime ensures that over the lifetime of the assets they can recover a fair return on and of their efficient investment. We refer to the principle of quality, affordable choices for consumers and a fair return for investors as a "regulatory compact". The utility model will produce outcomes consistent with those in competitive markets.*"[23]

26. Chorus now also refers to "*repeating the mistakes that were made in the copper pricing decisions*" – conveniently omitting the facts that neither the High Court nor the Court of Appeal found any error or mistakes in the decision making process adopted.[24] As an aside, we note that Chorus' share price closed at $1.76 on 8 April 2014 (the date that High Court judgment on its challenge to copper pricing decisions was given) and $6.26 on 3 August 2021 – an increase over 350%.

27. Finally, we observe that Chorus has previously been prepared to recognise the Commission's function as "the expert regulator" and the need for deference in the context of the current

---

[21] Chorus has previously accepted that "*[u]nknowns are the face of innovation*" (see Letter: Vanessa Oakley (Chorus) to Jonathan Young MP (Chair, Economic Development, Science and Innovation Select Committee), 13 April 2018). It can't now seek relief from innovation just because this isn't moving in the direction that it wants.

[22] Chorus NZX announcement (2 December 2013), https://www.nzx.com/announcements/244624 . See also Letter: Mark Ratcliffe to Hon. Amy Adams (8 November 2013), http://nzx-prod-s7fsd7f98s.s3-website-ap-southeast-2.amazonaws.com/attachments/CNU/243524/184805.pdf

[23] Chorus Submission on the Telecommunications (New Regulatory Framework) Amendment Bill 2017 (2 February 2018), page 6.

[24] See Kos J in Chorus v. Commerce Commission and others CIV-2013-485-9923 [2014] NZHC 690 (8 April 2014) at [174]: "…*I am left unpersuaded that the Commission erred in law in setting the IPP price for UBA.*"

regulatory process.[25] It is interesting to note that Chorus expresses unease with the function the Commission is performing as expert decision maker now that process outcomes are not as it hoped for.

The Commission cannot make arbitrary adjustments

28. In Vodafone's view, there are no reasonable grounds for the Commission to adjust its current approach or to revisit decisions that it has already made in light of concerns raised by Chorus.

29. Much of Chorus' concern appears to be driven by the outcome of the WACC determination, based on the recently concluded input methodologies decision. For example, L1 Capital spend most of their submission relitigating decisions that were extensively consulted on during the setting of the input methodologies.[26] Disappointment in the current cost of capital does not justify uplifts elsewhere in the regime.

30. We disagree with Chorus that past forecasting performance should have any bearing on how the Commission should assess the forecasts for the first regulatory period.[27] Unlike in the past, Chorus now has a strong incentive to over-forecast and under-deliver. The current forecasts must be assessed on their merits.

31. We also note that the approach to innovation capex proposed in Chorus's submission is completely without principle.[28] These costs cannot be re-allocated to fill some conveniently discovered forecasting shortfalls that Chorus has just 'discovered'. We would be extremely concerned with the Commission's processes if this type of horse-trading were allowed – particularly where the Commission has already made a substantial number of decisions that already operate in favour of Chorus.

32. Consumers have a growing choice of services provided across a range of access technologies. RSPs have invested in FWA services expressly to offer consumers a contrasting modern access alternative to fibre. RSPs would be further able to innovate in a scenario where Chorus offered terms for unbundled layer 1 fibre that allowed them to provide genuinely competitive alternative layer 2 services.[29]

33. We understand that this may not be a scenario that was foreseen by Chorus' investors at the outset of the UFB project some ten years ago. But this is the reality of fast changing, dynamic telecommunications markets.

34. While there is no rationale for making adjustments in response to submissions made by Chorus, we appreciate that the Commission may be concerned with the issue of asymmetric

---

[25] See Chorus Submission on the Telecommunications (New Regulatory Framework) Amendment Bill 2017 (2 February 2018), paragraph 77: "*The decision on how the categories of common costs are allocated to should be left to the Commission, as the expert regulator.*"

[26] L1 Capital, 8 July 2021, *Submission on Chorus Price-quality path from 1 January 2022 - Draft Decision*, p2.

[27] Chorus, 8 July 2021, *Submission on price-quality path draft decision*, paragraph 95.

[28] Chorus, 8 July 2021, *Submission on price-quality path draft decision*, p9.

[29] This will in turn sustain demand for Chorus' fibre network.

risk in its decision making process, i.e. the relative risks that may arise in a scenario where Chorus is undercompensated vs. a scenario in which higher costs are imposed on end users of fibre services due to Chorus being overcompensated. For the following reasons, we do not support any adjustment for asymmetric risk in the current circumstances:

a. This would only be justified if there was **clear evidence** of asymmetric risk both:
   - distorting outcomes such that they are inconsistent with those produced in workably competitive market; and
   - causing detriment to end users of fibre.

   Available evidence does not support either proposition resulting from the Commission's existing decisions or approach.
b. It would be necessary to establish the direction and magnitude of an asymmetric risk "effect" to determine an appropriate adjustment. We have no evidence of either the direction or magnitude of this effect.
c. In these circumstances, any adjustment purporting to address an asymmetric cost effect would be arbitrary and open to challenge.

35. Finally, our strong view is that any change to any previously settled Commission decision or approach would require further consultation in order to comply with administrative law requirements.

Contact

36. Please contact the following regarding any aspect of this submission:

Tom Thursby
Lead Counsel & Head of Public Policy
t: 029 7733 654
e: tom.thursby@vodafone.com

Kamile Stankute
Senior Public Policy Advisor
t: 021 439 311
e: kamile.stankute@vodafone.com