5 August 2021

To: Sasha Daniels, Spark
From: Craig Shrive and Petra Carey

Subject: Opinion on legal risks of including incentive payments as capex for Chorus' price-quality path

Introduction

1. In its reasons paper for its draft Chorus price-quality path decision (**"draft decision"**), the Commerce Commission ("**Commission"**) has proposed that it will assess Chorus' "**Incentive Payments"** (defined below) as part of an individual capex proposal. It has also set out its proposed approach to any such assessment. The result is that the Incentive Payments have been excluded from Chorus' base and connection capex expenditure allowances.

2. You have asked us to advise on the appropriateness of the Commission's approach, and to identify whether there are legal risks for the Commission if it were to decide to change its position and include Incentive Payments within the relevant capex allowances for the purpose of determining Chorus' allowable revenue under the price-quality path.

Executive summary

3. We consider that the Commission is entitled to adopt its draft decision on Incentive Payments. Both the Act and input methodologies provide it with discretion to exclude the Incentive Payments in the way it proposes. If the Commission was to change its draft decision, the less risky approach from a legal perspective would be to remove the ability for Incentive Payments to be assessed under an individual capex proposal (such that there would be no capex allowance).

4. We consider that, if the Commission was to instead change its approach to include the Incentive Payments in the relevant capex allowances, it would be at risk of legal challenge on the basis that it does not have an evidential foundation to reasonably demonstrate that such a decision complies with section 166(2) of the Telecommunications Act ("**the Act**"), which requires the Commission to make a determination or decision that it considers best gives, or is likely to best give, effect to the promotion of workable competition in telecommunications markets for the long-term benefit of end-users of telecommunications services ("**Purpose Statement**").

5. In particular, we do not think the Commission can legally decide to include Incentive Payments as capex that is recoverable before following a proper process to reach evidenced conclusions on the following:

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(a) Whether the Incentive Payments comply with the geographically consistent pricing requirement under section 201 of the Act; and

(b) Whether the Incentive Payments comply with the non-discrimination requirements under the Deed of Access - Undertakings for Fibre Services ("**Fibre Deed**") and Deed of Access - Undertakings for Copper Services ("**Copper Deed**") ("**non-discrimination obligations**").

6. We think that there is a material risk that the Incentive Payments do not comply with either section 201 or the non-discrimination obligations. The Commission would need to investigate this before making a decision, because Chorus must not receive an allowance for payments that breach the Act.

7. It might be argued that section 201 and non-discrimination obligations are technically separate to determining the price-quality path under the Act, and therefore do not affect the Commission's assessment of an appropriate capex allowance. We note that:

(a) A breach of section 201 amounts to "contravening a price-quality requirement". It would be an illogical outcome if a pricing practice that amounts to such a breach could nevertheless be included in the price-quality path determination itself. Put another way, section 201 and determination of the price path are inextricably linked under the Act; and

(b) More broadly, section 201 and non-discrimination obligations are key components of a regulatory scheme that has been designed to prevent harm to competition. It logically follows that if there is a risk that the Incentive Payments breach those provisions, then including an allowance for recovery of those payments would also risk breaching the Purpose Statement. This is recognised by the assessment criteria proposed by the Commission.

8. Furthermore, we agree with the Commission's concern that permitting Chorus to include the Incentive Payments in capex allowances takes risk away from Chorus, and guarantees its ability to recoup the costs from all end-users. While it is true that incentive payments can be pro-competitive, it appears to us that Chorus would have a strong ability (and motivation) to set anti-competitive Incentive Payments if it knew that costs of those payments are always recoverable. Using an analogy with predatory pricing under section 36 of the Commerce Act, firms with substantial market power would ordinarily be scrutinised if they were able to reduce price with the knowledge or intent that they could recoup this type of expenditure because they did not (or will not) face the risk exposure that competition brings. The Commission is therefore right to be cautious and should refrain from including Incentive Payments if there is a risk that such an approach would be directly contradictory to the Purpose Statement that must guide its decisions.

9. Accordingly, it is in our view no answer to argue that, even if included in capex allowance, the Incentive Payments could still be prevented in practice by section 201 and/or non-discrimination obligations (such that any harm to competition would be avoided in practice). We agree with the Commission that, to ensure consistency with the Purpose Statement, Incentive Payments must only be included in capex allowances if they comply with section 201 and/or non-discrimination obligations.

Description of Chorus' Incentive Payments

10. Under Chorus' "Mix it up" Fibre Offer, Chorus is offering "credits" for customers which meet certain thresholds:

    (a) Under the "Connect to 100M or above" incentive, customers receive credits for migrating offnet customers and customers on existing copper and lower speed fibre connections to selected fibre speed connections. At least 85% of the customers' orders on 100M or above is required to be eligible for this incentive; and

    (b) Under the "Get to the Gig" incentive and the "Hype it Up" incentive, customers receive credits for migrating offnet customers and customers on existing copper and lower speed fibre connections to selected fibre speed connections, and for upgrading existing fibre connections to Chorus most popular fibre plan and Chorus' fastest Hyper fibre plan available, respectively.

    (c) Under the “Bonus Credit” incentive (from 1 July to 30 December 2021 amended to be “Intact ONT Addresses” credits), customers receive credits for migrating copper and offnet end-users at selected addresses to fibre.

11. In other words, Chorus pays incentives to its customers for switching end-users to Chorus' fibre network and for upgrading existing fibre connections. We are advised that, in practice, these incentives provide a more limited incentive to upgrade existing copper and fibre customers, and are heavily weighted towards converting customers from other networks to Chorus’ fibre.

Risk arising under Section 201

Incentives Payments are a "price"

12. Section 201 requires that Chorus:

> must, regardless of the geographic location of the access seeker or end-user, charge the same price for providing fibre fixed line access services that are, in all material respects, the same.

13. Accordingly, if the Incentive Payments are a "price" or part of a price for FFLS, then Chorus has an obligation to ensure the payments comply with this requirement.

14. The Commission's position is that as the definition of price in section 164(1) includes "any related terms of payment", the term "price" includes incentive payments and therefore Chorus' proposed incentive payments must comply with this requirement for geographically consistent pricing.[1]

15. We agree with the Commission's conclusion, albeit our reasoning is slightly different. Essentially, the relevant definitions of price are intended to be broad, and are designed to capture payment or incentive structures that effect the value of the good or service provided.

[1] Commission's draft decision, G7.

That is because ultimately it is the broader value paid or received by the customer that can affect competition for the good or service – and not just the direct price paid.

16. The section 164(1) definition of price applies to Part 6 only. Much of Part 6 focuses on input methodologies and price-quality and information disclosure regulation. That is why, in our view, the section 164(1) definition of price replicates the definition under Part 4 of the Commerce Act (as Part 6 is based on Part 4).

17. In that context, it is apparent that the definition of price in section 164(1) includes "any related terms of payment" because the intention was for this definition to be deliberately broad. Adopting a broad definition of price makes sense in the context of Part 6 (and Part 4 of the Commerce Act), which is designed to ensure that the Commission has broad powers to ensure regulated fibre services providers are suitably incentivised and constrained to act efficiently in all aspects of their regulated service provision, given their substantial market power.

18. We agree with Chorus' submission that the section 164(1) definition of "price" must be read in conjunction with the section 5 definition of "price".

19. The purpose of the definition of price in section 164(1) was to ensure an appropriate definition of price in the context of the price-quality regulation under Part 6. This definition itself refers to price. In addition to including 'any related terms of payment', the definition means "1 or more of individual prices, aggregate prices, or revenues (whether in the form of specific numbers, or in the form of formulas by which specific numbers are derived)." It is therefore necessary to refer to the section 5 definition of price to understand what "price" means under section 164(1).

20. The section 5 definition of price includes:

    (a) "valuable consideration in any form, whether direct or indirect"; and

    (b) "any consideration that in effect relates to the acquisition of goods or services or the acquisition or disposition of any interest in land, even though it ostensibly relates to any other substance or thing".[2]

21. Chorus states that this definition "makes it clear that 'price' means consideration provided by RSPs for the provision of FFLAS".[3] For this reason "this excludes incentive payments from the definition of 'price', as incentives are not part of the consideration provided by RSPs for FFLAS, but are a separate payment to RSPs under separate arrangements made to secure certain behaviours or activities".[4]

22. We disagree for the following reasons:

    (a) There is nothing in the words used in the definition to suggest that the consideration must be provided by the customer. To the contrary, the words used cover consideration "in any form", "direct or indirect", and any consideration "that in effect

[2] We note that this is equivalent to the definition of price under section 2 of the Commerce Act, which informs our view that the definitions are intended to be broad to cover any type of consideration that can impact on competition.

[3] Chorus submission on Draft Section 201 Guidance, para 15.

[4] Chorus submission on Draft Section 201 Guidance, para 15.

relates to the acquisition of goods or services". Such language clearly suggests that the entirety of the consideration arrangements between Chorus and the customer that in any way relate to the provision of the service is relevant.

(b) It is therefore wrong to consider a price simply as consideration flowing from the customer to Chorus. If this were correct, this would necessarily mean that any rebate or similar would not fall within the definition of price. This cannot be right, as it would circumvent the ability to regulate all aspects of pricing under Part 6 (and the Commerce Act). It is therefore important to look at impact on value. The effect of the Incentive Payments is that the value of consideration flowing from customers to Chorus is reduced. This is evidenced by how the Incentive Payments are described in the Mix-it-up Offer documentation:

(i) The Incentive Payments are repeatedly described as "credits". The use of the term "credit" infers that it is an amount which decreases the amount owing on an account, or in this context, decreases the net price for the FFLAS services that are ultimately payable by the customer; and

(ii) Chorus is allowed to conduct a wash-up of credits paid or payable under the Offer and "set off" any amount that the customer owes to Chorus (whether under the terms of the Offer or otherwise) "against any amount payable" by Chorus to the customer including any overpayments of credits. This means that the customer may owe Chorus an amount other than under the Offer, for example, for LLAS services, and Chorus can set this off against what Chorus owes the customer under the Offer. This demonstrates that how the incentive payments work in practice is that they are effectively reducing the price paid for LLAS services.

(c) The Incentive Payments are inextricably linked to the provision of FFLAS. They are not available to customers unless customers purchase FFLAS from Chorus. In that respect, we do not think it is accurate to describe the Incentive Payments as separate payments and a separate arrangement, given eligibility to receive them is dependent on the FFLAS service being purchased.

(d) Put simply, the Incentive Payments are consideration that "in effect" relate to the acquisition of FFLAS by the customer.

23. When viewed in light of the purpose of Part 6, "price" should also be viewed in the context of promoting competition, or at least, preventing harm to competition. In this regard, the competition law rules contained in the Commerce Act, which are aimed at promoting competition, do not adopt a narrow definition of "price". As discussed above, the definition of price under the Commerce Act is the same as the definition of 'price' in section 5 of the Act. For example, the concept of price-fixing under the Commerce Act is not limited to fixing, controlling or maintaining the end price; it captures any discount, allowance, rebate or credit. Commission decisions and Court judgments have previously concluded that a broad range of

practices which have an effect on the price ultimately paid by the consumer or customer is conduct that is subject to the price-fixing prohibition.[5]

24. Finally, Chorus suggests that treatment of the Incentive Payments as capex and not part of "price" is consistent with GAAP, and cautions the Commission from departing from GAAP on the basis it "will create confusion and complexity".[6] We do not think GAAP is relevant to whether the Incentive Payments are a 'price' for the purpose of section 201. For example, if GAAP requires the Incentive Payments to be treated as capex for accounting purposes, this does not mean that it must be treated as capex for regulatory purposes and/or cannot be something else, e.g. a "price", for the purpose of the Part 6 regulatory framework. There is no reference to GAAP in the definition of "price" and GAAP serves an entirely different purpose to the economic regulatory framework provided for in Part 6. The Commission should only seek to apply GAAP if doing so is consistent with the relevant provisions of Part 6.

Incentive Payments do not appear to be geographically consistent

25. Based on the above, our view is that the Incentive Payments must comply with the geographically consistent pricing requirement because they are a 'price' for the purpose of section 201.

26. We do not have full visibility over how the Incentive Payments are applied, although we understand that the majority of Incentive Payments are being offered in areas where there are alternative connections (such as fixed wireless) available. The requirement is clear that Chorus' charges for FFLAS must be the same wherever the access seeker or end user is located. To only apply those Incentive Payments to areas where alternative networks to copper and fibre, such as wireless, are available, would seemingly fail to meet this requirement.

27. We therefore agree with the Commission that each Incentive Payment will require careful assessment for compliance with section 201, as failing to comply amounts to contravention of a price-quality requirement (such that all the penalties, compensation and offence provisions under sections 215 to 218 apply).

28. Our view is that if it is found that the Incentive Payments do not comply with section 201, then legally they cannot be included in a capex allowance for the price quality path. That is because section 215(2)(b)(iii) makes clear that failing to comply with section 201 amounts to "contravening a price-quality requirement". It would be an illogical outcome if a pricing practice that amounts to such a breach could nevertheless be included in the price-quality path itself.

29. More broadly, the purpose of section 201 is to discourage differential pricing to geographic or customer segments by regulated fibre providers like Chorus in response to potential entry or expansion by a competitor, known as 'pocket pricing'. In particular, section 201 was designed:[7]

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[5] E.g. in *Caltex New Zealand Ltd v Commerce Commission* CA 69/98, the High Court and Court of Appeal found that the free car wash promotion was an integral part of the price for petrol (or car washes), and in *Commerce Commission v Lodge Real Estate Ltd* [2018] NZCA 523, the Commission found that move to vendor-funding could be seen as the removal of a "discount or allowance" (in the form of the provision of free advertising on Trade Me).

[6] Chorus submission on Draft Section 201 Guidance, para 19.

[7] Telecommunications (New Regulatory Framework) Amendment Bill, Departmental Report to the Economic Development, Science and Innovation Committee, 10 April 2018 at [71].

> To ensure comparable pricing for all customers, and to discourage 'pocket pricing', where a regulated fibre provider could strategically drop prices in a geographic area to undermine competition.

30. The assumption underpinning this restriction is that this type of pricing behaviour by a firm with substantial market power is harmful to competition, as it can deter entry and expansion. The requirement to offer geographically consistent pricing only applies to services that are subject to PQ regulation, and PQ regulation is only imposed to the extent that Chorus is considered to face insufficient competitive constraint on its services.[8]

31. The Commission recognised this potential harm in its draft decision:[9]

> there is a risk of over-recovery if these payments are included in baseline connection capex. This is because if the proposed new connection incentive payments are applied through the connection capex variable adjustment mechanism, they will become a fixed unit cost that Chorus recovers for every new connection. However, we understand that these payments would not necessarily be paid out for every new connection, but rather are subject to eligibility criteria that Retail Service Providers must meet. In other words, Chorus would recover an amount for every new connection and may not incur an actual cost for every new connection.

32. If the Commission were to include the Incentive Payments in the capex allowance such that Chorus could achieve guaranteed recoupment of this expenditure, this risks being inconsistent with the Commission's obligation to give effect to the Purpose Statement, as this would not appear to promote workable competition in telecommunications markets for the long-term benefit of end-users of telecommunications services.

33. In our view, it is therefore necessary for the Commission to be certain that the Incentive Payments do not breach section 201 before making a decision which would guarantee Chorus' ability to recoup the cost of these payments going forward.

Risk arising under non-discrimination obligations

34. The non-discrimination obligations are set out in Clause 5 of the Fibre Deed**.** Clause 5 of the Fibre Deed is largely replicated in the Copper Deed.[1] Sub-clauses 5.1 and 5.2 of the Fibre Deed state:

> 5.1 When doing or omitting to do anything in respect of a Service Chorus will not Discriminate:
>
> (a) between Access Seekers;
>
> (b) in favour of any Chorus Related Party; or

[8] Commission Fibre IMs – Final Decision Reasons Paper 2.57.
[9] Draft decision, para 4.186.

(c) where Chorus supplies a Service to itself, in favour of Chorus itself.

5.2 In these Undertakings, "to Discriminate" means to treat differently, except to the extent a particular difference in treatment is objectively justifiable and does not harm, and is unlikely to harm, competition in any telecommunications market.

35. The wording of the Deed non-discrimination clause is similar to clause 56 in the Telecom Separation Undertakings ("**Undertakings**").[2] The intent was to implement the test that the Commission was already applying in this context, so the Commission's guidance on the Undertakings non-discrimination clause is therefore directly relevant to how it will interpret and apply the Deed non-discrimination clause.

36. The Commission has previously determined that any discrimination between access providers does not require different terms and conditions to apply to access providers and can instead occur through the effect of the terms and conditions. The Commission stated:[10]

> Differences may be found where different sets of terms and conditions (for the same service) are made available to different Service Providers, or because the same set of terms might have a different impact on one class of Service Provider. For example, terms and conditions may have the effect of discriminating against a class of Service Providers, **even when the same terms and conditions apply to all Service Providers, because they have the effect of putting one of more Service Providers in a materially disadvantageous position with respect to other Service Providers** (or a Telecom business unit).
>
> **[Emphasis added]**

37. Consequently, the Commission found under the Undertakings non-discrimination clause that any terms and conditions that have the effect of limiting the parties to whom the offer is acceptable can be discriminatory.[11]

38. The Commission's guidance on equivalence and non-discrimination is also illustrative:[12]

> Assessing difference in treatment requires consideration of both the terms on which the offer is made and the effect of those terms on access seekers. Where a network operator makes the same offer to access seekers but this has a different effect on certain access seekers, for example because of their commercial structure or the services they offer, then in principle this could constitute a difference in treatment.

39. Further, the guidance makes the following observations about assessing difference in treatment with regards to price:

[10] Commission Overview of Non-Discrimination, 24 March 2011 at [12].
[11] Commission, Consultation on the non-discrimination and EOI obligations under the Telecom Separation Undertaking Requirements with respect t the complaints concerning the Telecom Wholesale loyalty offers, 19 October 2009.
[12] Commission's Equivalence and Non-discrimination Guidance, 20 September 2020, para 4.17

> The prices must be meaningful. In other words, the prices have to be those actually paid by access seekers once any adjustments, rebates or discounts have been accounted for.

40. We understand that the Incentive Payments do have a prejudicial effect on Spark compared to other RSPs as:

    (a) Some of the incentives encourage and better enable RSPs to target Spark's fixed wireless customers and/or would be unattractive to Spark where it wants customers to remain on or move to its fixed wireless network. Essentially, the incentives are prejudicial to RSPs that have invested in alternative networks.

    (b) The relevant incentives thresholds advantage RSPs whose business strategy is to focus on higher speed services, or who offer bundles that do not include other communications services.

    (c) The requirement is to promote fibre broadband, as opposed to broadband in general, which is what Spark would like to offer.

41. Under the non-discrimination obligations, there is a material risk that the Incentive Payments place Spark in a "materially disadvantageous position" compared to its competitors such that the Commission must investigate further before reaching a view on the appropriate treatment of Incentive Payments for price-quality path purposes.

Commission's discretion

42. Under the fibre input methodologies, the Commission may exclude capex from the base capex allowance after having regard to various matters. Uncertainty regarding the need for the capex and the economic case justifying it are two factors that the Commission must have regard to, among others. There is clear uncertainty about need for the capex (it is arguably illegal) and the economic justification (it may be anti-competitive in the context of the Part 6 objectives).

43. Accordingly, we are of the view that the Commission has the discretion to adopt its proposed approach of excluding the Incentive Payments from Chorus' base and connection capex expenditure allowances, and would similarly have the discretion to change its draft decision and remove the ability for Incentive Payments to be assessed under an individual capex proposal such that there would be no capex allowance and which would, in our view, be the less risky approach from a legal perspective.