PQ RAB draft decision

Cross-submission | Commerce Commission

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Executive Summary

Thank you for the opportunity to provide feedback on submissions on the draft Price-Quality (**PQ**) RAB draft decision (**the draft**) and proposed IM amendments (**proposed amendments**).

We don't support Chorus proposals to further amend the attribution and cost allocation methodology. For example, Chorus argues that:

- Chorus should be considered a standalone, fibre first business for the purposes of setting a $6B RAB. We agree with the Commission and Vocus' observation that the approach is not consistent with the IMs nor will it best give effect to the Part 6 purposes, and is inconsistent with Chorus' position throughout the IMs process that it be considered a multi-service broadband provider for BBM purposes.

- Marketing spend should be allocated on the basis of 12 years relative revenue. While we agree there are long term brand recognition benefits, the proposed approach is inconsistent with wider considerations that went into determining the permitted IM allocators – i.e., that they reflect current use to achieve proportionality - and long-term benefits would only apply to a portion of marketing spend. In a competitive market most benefits are taken over a shorter period and, without adjusting for this, the proposed approach over-emphasises long term benefits.

- More duct routes should be attributed to fibre. However, a cross check against Chorus reported data suggests that the proposed approach will over-state the employment of ducts for UFB services. On the face of it, around 17% of existing ducts are able to be shared and around 40% of Chorus duct kms overall can be used for UFB services (significantly less than the current RAB allocations suggest).

Chorus' submission further highlights our earlier concerns that the PQ process – whereby by the Commission and interested parties are being asked to consider an ongoing series of discrete Chorus proposals - is becoming increasingly disconnected from the process anticipated by the September 2020 process and approach paper (updated) and the expected IM outcomes.

In recent submissions Chorus has proposed significant changes to settled IM positions, submitted new and updated network data and identified material errors in its earlier proposals. These proposals are material – implying significant increased costs for consumers – and cut across IM principles such as Chorus being considered a multi-service broadband provider for the purposes of the BBM.

Accordingly, to best mitigate this risk, we believe the Commission was right to signal that it would finalise the RAB through 2022. The Commission should also ensure that new proposals are considered in light of; the principles that sit behind the IMs, the submissions made on the issue through the IMs process, and the significant costs being loaded onto consumers by these amendments.

Introduction

1. Thank you for the opportunity to provide feedback on submissions on the draft Price-Quality (**PQ**) RAB draft decision (**the draft**) and proposed IM amendments (**proposed amendments**).

2. The Commission received submissions from Chorus, New Street, Vocus and Spark.

3. A number of the issues raised in submissions were addressed in our earlier submission. In this submission we provide feedback on Chorus' proposed attribution and cost allocation framework, and the implications of having to consider a series of amendments for the current process.

4. The amendments have substantial implications for end-users – i.e., proposed amendments to apply a non-standard allocator to marketing costs and fund the holding costs of notional tax loss credits likely implies a transfer from consumers to Chorus of over $200M alone[1] – yet are being considered late in the process and with little regard to the context that underpins the original IMs approach.

Attribution and cost allocation

5. Chorus recommends that the Commission:

    a. Apply its non-compliant approach whereby costs are attributed on the basis that Chorus was established to provide fibre services.

    b. Use 12 years of copper and FFLAS revenue instead of the proposed 8 for the purposes of allocating marketing costs.

    c. Consider further its approach to allocating ducts on the basis of newly provided network data.

Chorus as a standalone, fibre first business

6. Chorus proposes that the Commission should determine a $6B RAB on the basis that it is a standalone, fibre first business[2]. It suggests that Chorus was established to build and operate a fibre to the home network[3], and so Chorus' overall costs should be considered incremental to the fibre business with only the residual incremental costs allocated to its other copper and competitive businesses. This would increase the RAB cost to end-users by around $500M.

7. We agree with the Commission and Vocus'[4] observation that this Chorus proposal is not objectively justifiable or demonstrably reasonable, and does not comply with the IMs or give best give effect to the purpose of Part 6.

8. Chorus' proposed approach is further inconsistent with Chorus' business, in practice, and the underlying IM principle that Chorus is a multi-service broadband provider. Chorus has consistently submitted that it is a multi-service broadband provider for the purposes of the BBM[5]:

> Chorus has consistently stated that it operates one network that includes two technologies, copper and fibre, across different areas in New Zealand. This has led to extensive sharing of assets between the

[1] For example, the time value of deferred tax loss credits for consumers is ~$80M (doubled as the RAB is increased to fund theoretical Chorus holding costs) and future benefit cost allocator increases the RAB by $27M for the outer period alone.
[2] Chorus Submission on initial PQ RAB and additional IM amendments draft decisions (16 September 2021) at 7
[3] Chorus at 81
[4] Vocus at 1 reporting the Commission tentative view
[5] As reported by the Commission in IM Reasons Paper at 3.413

> two services. We expect that Chorus is unlikely to have highly granular data that will allow all instances in which assets are shared to be identified with a high degree of accuracy. This "one network" view is also likely to mean that significant cost allocation is necessary.

9. Further, the principle that Chorus should be viewed as a multi-service provider for the purposes of the BBM underpins a number of IM decisions, particularly the approach to estimating financial losses and cost allocation model[6]. For example, in discussing the Commission's approach to cost allocation:

> The definition of "fibre asset" in s 177(6)(b) of the Act provides that it is "employed in the provision of FFLAS". To ensure consistency with this definition, we consider that causality should be applied with consideration of how an asset is employed at each stage of its life. This is particularly relevant to Chorus, whose multiservice network is transitioning from copper to fibre access technology. As such, our definition of a "causal relationship" in the determination includes how an asset is employed (ie, how a factor "influences the employment" of an asset) to provide regulated FFLAS.

10. We believe that Chorus' proposed approach is inconsistent with the IMs, and with the underlying principle that informed a number of key Commission decisions.

11. The approach to financial losses was considered at length through the IMs process - including canvasing options to consider the fibre network on an incremental basis – and we don't support revisiting the IM decisions. However, if the Commission does decide to consider Chorus' proposal further, a better approach proposed by submitters at the time that fibre services be considered incremental to Chorus' copper-based business should be considered.

A future benefit allocator should be used for marketing spend

12. The Commission proposes to accept Chorus proposals that marketing spend be allocated on the basis of relative future revenues over 12 years (unadjusted for risk associated with later years or the time value of money).

13. Chorus supports the draft approach but recommends that revenues over 8 years[7] be applied on the basis this is consistent with network churn. This would increase RAB costs to end-users by $27M[8].

14. We agree with the Commission that marketing support to promote brand recognition has long term benefits. In which case, marketing activity to build a brand is not dissimilar to investing in an asset from which a firm derives long term revenues. It is unclear why the Commission would apply a different approach to allocating marketing investment with long term benefits to that applying to other long-term assets. We are not aware of any other asset class for which a similar allocator applies.

15. Further, its less clear that Chorus has demonstrated a clear link between past marketing activity and future benefits:

    a. On the face of it, the marketing activity cost categories include a mix of promotional activities with short, medium and longer-term brand building benefits. While we do not have access to the breakdown, it would be very surprising if Chorus marketing activities related solely to long-term future benefits.

    b. Ongoing support is required to maintain the brand recognition that brings long-term benefits, i.e., sustaining customer recognition requires ongoing spend, it's not a one

[6] For example, the Commission rejected submissions that the FLA should be assessed on an incremental basis due to concerns that Chorus, as a multi-service broadband provider, would not recover its costs overall.
[7] Chorus at 63
[8] Commission estimate

of investment. This means that the fibre network benefited from the prior investment Telecom made in promoting broadband as a service, while future - yet to be defined - services will benefit from brand investment made today.

c. Further, brand benefits are unlikely to be uniform across products and across time periods. For example, investing in a brand will see benefits most directly in current promotions and acquisitions, and less over time, and there are likely less benefits for monopoly fibre services than for copper broadband services facing competition from alternative network services.

16. Accordingly, there is no reliable link between the proposed marketing categories and proposed long term brand benefits, and this leaves the Commission in the position of making complex and potentially arbitrary allocations that it has sought to avoid.

17. Nonetheless, if the Commission decides to apply a future benefit approach to marketing spend, it should consider:

    a. Chorus marketing cost categories in more detail to identify specific brand building spend for which the future benefits approach could be applied, or alternatively weight the benefits between current year and long term (8-year) revenues.

       If the information is not available, the Commission could look to external estimates of the optimal balance between brand building and performance (short term, sales driven) marketing. For example, while only a loose proxy, commentators have suggested an effective starting point is around 60% brand building and 40% current initiatives[9]. This would suggest that the future benefits approach should only apply to 60% of expenditure, being an estimate of brand building spend[10].

    b. How the benefits decay over time. While we expect brand marketing benefits to mainly be taken in the short and to decay over time, the proposed approach ignores this decay by valuing benefits as revenue irrespectively of when they are taken. The decay rates have been modelled and – given the significant cost for end-users – should be applied to this estimate[11].

Allocation of duct investment from 2011

18. The Commission has proposed to limit the direct attribution of ducts constructed since 2011 to 95% - and attribution of existing 2011 ducts to a maximum of 30% - to FFLAS.

19. Chorus questions the proposed limits on ducts attributed to FFLAS. Chorus network data suggests that:

    a. 760km of “Micronet” has been deployed on inter-exchange routes (being the duct type and routes where sharing is expected to be possible) relative to the 20,311km of overall UFB ducts deployed. This suggests that around 3.7% of new ducts can be shared.

    b. Conversely 7,043km of the 14,229km of existing 2011 ducts in UFB candidate areas are reported as having UFB fibre deployed, suggesting that 50% of ducts are capable of being shared.

[9] https://brandfinance.com/insights/setting-marketing-budgets#identifier_4_4262
[10] For example, 40% taken immediately and 60% with a life of 8 years.
[11] Again, the brandfinance commentator references journals that estimate this decay over time

20. Chorus' estimate of transport fibre sharing is not dissimilar – given earlier reported uncertainty with the underlying asset register and actual sharing limits implied by the ducting systems – to Network Strategies 5% estimate of potential sharing. Chorus suggests that only 20% of Micronet capacity would be available to share, but this allocation cap is unlikely to apply across the impacted routes as, for example, capacity is available across existing and new ducts and the non-FFLAS services are characterised by Network Strategies as being high revenue but requiring few fibres.

21. There's nothing to suggest that the Commission should change its approach. However, if the Commission does apply a different approach, we agree with Chorus that this should be applied consistently across existing and new assets and between different services.

22. More concerningly, the analysis highlights our concerns that the proposed methodology over-allocates to the fibre network. Chorus reports that it has around 65,000km of ducts of which – based on the information provided in Chorus' submission - it's likely that only ~40% of these ducts can be employed in the provision of FFLAS services. Setting aside new "UFB" ducts, this suggests that around 17% of existing duct kms are capable of being shared[12].

23. As a sanity check, this suggests if anything that the proposed allocation cap exceeds the actual ducts able to be shared with UFB fibre. A more IM consistent approach would be to allocate a maximum of 40% of total existing and "UFB" ducts to the fibre network[13].

km		**Duct route**
15,981	25%	core, mesh and regional connectivity (outside UFB areas, not FFLAS)
21,665	33%	existing duct (residual from reported volumes, not FFLAS)
7,803	12%	shared duct routes (micronet and shared existing, allocated FFLAS)
19,551	30%	new "UFB" duct (attributed directly to UFB, FFLAS)
65,000		reported duct network (FY21 report)

24. Further, none of the analysis is consistent with the draft that suggests $5.1B of assets are employed in the provision of FFLAS services[14] relative to reported total assets of only $5.3B[15], which leaves few Chorus assets outside Part 6 regulation.

[12] Assuming that Chorus has shared an existing duct wherever possible.
[13] Data from Chorus submission at 44 and 58 and FY21 reporting. FY21 reports a Chorus ~65000km duct network. Chorus submitted data: duct supporting core, mesh and regional connectivity duct route less same category in UFB areas (19221-3240); shared duct routes is micronet plus pre-2012 duct shared (760+7043); total new "UFB" duct is total UFB duct built less micronet (20311-760); existing duct is the residual. We note that Chorus reported 40k duct route kms in its November 2020 UBS Australasia Virtual Conference presentation.
[14] Unallocated initial RAB value. These are assets used fully or in part to provide FFLAS services. The Commission's proposed methodology means that these assets will ultimately be fully incorporated into fibre prices as Chorus transitions to a fibre first business. The FLA is an additional $1.45B.
[15] Reported assets excluding WIP and there are differences in reporting and reporting dates. Nonetheless, it highlights that few assets fall outcome Part 6 regulatory decisions.

The process to finalise the PQ decisions

25. In our earlier submission we set out our concerns that the Commission's draft approach appeared to depart from the expected IM outcomes in key areas and undermines expected protections against the double recovery risk.

26. Chorus' submission further highlights concerns that the PQ process – whereby by the Commission and interested parties are being asked to consider an ongoing series of Chorus proposals relating to different components of the BBM - is becoming increasingly disconnected from the process anticipated by the September 2020 process and approach paper (updated) and the expected IM outcomes. For example, while we are rapidly approaching the December 2021 deadline, the Commission is being asked to consider new proposals and updated data. In recent submissions Chorus:

    a. Has proposed that the Chorus apply: a non-compliant methodology to determine a $6B RAB, multiple new allocators and existing allocators solely on the basis of technicality causality.

       These are significant changes that challenge the underlying IM principles such as: Chorus being a multi-service broadband provider, the proportionate allocation of costs and determining allocators by reference to proportionality, reasonableness, and the purposes of the Act.

    b. Continues to submit additional network data and analysis such as the duct route distances to support these positions. This data and analysis that should have been made available to the Commission earlier in the process and hasn't been subject to a formal assurance process[16].

       Further, the process sees data that was previously withheld as confidential being made available at a late stage in the process. For example, Chorus provides data relating to duct coverage in its submission, yet similar information which would have assisted interested parties to understand proposed cost allocations was previously withheld as confidential[17], and

    c. Has identified errors in the analysis and data provided to the Commission earlier, including the double counting of duct routes[18] para 60].

       The number of changes and inconsistent proposals further undermines the value of any assurance Chorus secured on the original proposal.

27. Submitters are showing frustration with the approach. The number of industry submissions has fallen away significantly in latter consultations and Vocus observes in its submission that

> 18. The use of confidentiality seems to have reached a nadir where Chorus advocates that a particular allocator be used but argues it should be treated as confidential on the basis *"Chorus itself has expressed some concerns over the reliability of allocator values"*. It should be axiomatic that if there are *"concerns over the reliability of allocator values"* then they cannot be *"objectively justifiable and demonstrably reasonable"* and should not be used.

[16] Chorus submission at para 58
[17] For example, BBM IAV model responses to Commission s221 Notice (26 March 2021) at Figure 7.21 onwards
[18] Chorus submission at 60

28. These concerns can only undermine the reliance placed on the process and determined outcomes.

29. More generally, Chorus' approach highlights the risks of the Commission considering a series of incremental proposals that – overall – risk becoming disconnected from earlier BBM decisions and expected IM outcomes. We agree with Chorus that the Commission should aim to make consistent decisions across the PQ components and to the original IMs, but also acknowledge it is difficult to do this when elements of the approach are being challenged in isolation.

30. Accordingly, to best mitigate this risk, we support the Commission signalling that it would finalise the RAB through 2022. As it stands, we believe that the Commission should focus on resolving key principles and issues – i.e., whether Chorus will continue to be consistently viewed as a multi-service provider - by the December deadline. This would narrow the range of potential final RAB values significantly.

31. Further, the Commission should:

    a. Ensure that the additional proposals are considered in light of the principles that sit behind IMs and expected outcomes, submissions made on the issue through the IM process, and the significant increased costs for consumers. For example, end users would likely prefer the Commission allocate tax loss benefits where the alternative is to simply add $80M to the RAB, and

    b. Apply the high-level modelling anticipated by the process paper to validate the results. While we submitted that the draft would likely result in a double recovery of cost, Chorus has now submitted that the draft approach will not permit it to achieve a normal return on existing assets[19]. The Commission should resolve concerns that there has been a misstatement of costs.

[End]

[19] For example, Chorus sets out that it won't achieve FCM on existing duct assets with the allocation cap at 53b