

Chorus' individual capex proposal for customer incentives 2023 – Draft decision – Reasons paper

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Commerce Commission

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Chapter 1 Introduction

Purpose and structure of this paper

- 1.1 This chapter sets out our draft decision on Chorus Limited's (**Chorus**) individual capital expenditure (**capex**) proposal for customer incentives for 2023.
- 1.2 The paper is structured as follows:
 - 1.2.1 Chapter 1 is an introduction;
 - 1.2.2 Chapter 2 covers the legal framework for our decisions; and
 - 1.2.3 Chapter 3 discusses our draft decisions and the reasons for those decisions, including:
 - 1.2.3.1 our draft decision;
 - 1.2.3.2 key reasons for our draft decision; and
 - 1.2.3.3 summary of Chorus' proposal and the process we have undertaken to reach our decision.
- 1.3 Please note that all dollar amounts quoted in this paper are in nominal terms unless otherwise stated.

Our draft decision

- 1.4 Our draft decision is to determine an individual capex allowance for customer incentives in regulatory year 2023 of **\$12.5m**.¹
- 1.5 In addition to determining an individual capex allowance, we intend to request Chorus to provide a connection forecasting methodology report by 30 March 2023 and quarterly updates on incentive quantities and expenditure and connections.
- 1.6 This is our draft decision. The Commission is inviting submissions from interested stakeholders. We will have regard to any submissions received, including any relevant further information received, when making our final decision.

¹ *Fibre Input Methodologies Determination 2020, as amended on 29 November 2021*, clause 1.1.4(2) - a regulatory year is defined in the IMs as a 12-month period ending on 31 December, where if the term "regulatory year" is combined with a year, the 12-month period ending on 31 December of that year.

Background

- 1.7 As part of our final decisions for Chorus' first price-quality (**PQ**) path, which commenced on 1 January 2022, we decided to include \$18.6 million of incentive payment expenditure in the base capex allowance for regulatory year 2022 only.² Our decision was that Chorus would have to submit Individual Capex proposals to us if it wanted to seek approval for incentive payment expenditure for regulatory year 2023 and regulatory year 2024.³
- 1.8 Incentive payments are payments Chorus makes to Retail Service Providers (**RSPs**) to incentivise acquisition of new customers on its fibre network or to incentivise existing customers to upgrade to new services.
- 1.9 Any capex approved under an individual capex allowance will be used in calculating the "actual allowable revenue" component of the "wash-up account balance" for the corresponding regulatory year of Chorus' first price-quality path, which runs from 1 January 2022 until 31 December 2024 (**PQP1**).⁴ This will then be available to be drawn down in future regulatory periods.⁵ In effect, the value of the wash-up attributable to the individual capex allowance will be the return on and depreciation for that capex for the relevant regulatory years.
- 1.10 These incentive payments (also called customer retention costs) are capitalised as customer retention assets by Chorus in accordance with Generally Accepted Accounting Practice (**GAAP**).

² Commerce Commission "Chorus' price-quality path from 1 January 2022 – Final decision: Reasons paper" (16 December 2021), paragraph C3.

³ Commerce Commission "Chorus' price-quality path from 1 January 2022 – Final decision: Reasons paper" (16 December 2021), paragraph C4.

⁴ *Fibre Input Methodologies Determination 2020, as amended on 29 November 2021*, clauses 3.1.1(7)-(9) and 3.1.1(11)(d).

⁵ *Fibre Input Methodologies Determination 2020, as amended on 29 November 2021*, clause 3.1.1(2)(c) and 3.1.1(5).

- 1.11 As part of our final decisions for PQP1, we articulated an economic test that we would apply when carrying out our assessment of incentive expenditure.⁶ The economic test we apply is whether the expected incremental revenue exclusively from the incremental end-users/upgrades that the incentive payments drive outweigh the incremental costs, including the incentive expenditure itself.⁷ Our economic analysis of Chorus' proposed incentive payments for PQP1 (regulatory year 2022) concluded that the expenditure sought fell within the estimated range meaning that the amount of incentives approved was likely to support competition, efficiency and was unlikely to be overstated.⁸
- 1.12 Chorus has applied for \$16.8 million (nominal) of expenditure for incentive payments for regulatory year 2023 through its individual capex proposal. The proposed expenditure can be broken down into:
- 1.12.1 \$12.8 million for connection incentives;
 - 1.12.2 \$6.1 million for upgrade incentives; and
 - 1.12.3 offset by \$2.2 million for claw-backs.
- 1.13 For more information on what Chorus is seeking, please refer to Chorus' proposal. We have published Chorus' proposal alongside this draft decision on our website.⁹

Design proposal and individual capex proposal

- 1.14 The fibre IMs splits the individual capex application process into two stages:¹⁰
- 1.14.1 the **notification stage** where Chorus must notify us of its intention to submit an individual capex proposal and submit a **design proposal**; and
 - 1.14.2 if we approve Chorus' design proposal, the **final proposal stage** where Chorus must submit an **individual capex proposal** that is consistent with the design proposal.

⁶ Commerce Commission "Chorus' price-quality path from 1 January 2022 – Final decision: Reasons paper" (16 December 2021), paragraph C57.

⁷ Commerce Commission "Chorus' price-quality path from 1 January 2022 – Final decision: Reasons paper" (16 December 2021), paragraph C63.

⁸ Commerce Commission "Chorus' price-quality path from 1 January 2022 – Final decision: Reasons paper" (16 December 2021), paragraph C124.1.

⁹ Chorus "Chorus' individual capex proposal for customer incentives" (30 June 2022).

¹⁰ *Fibre Input Methodologies Determination 2020, as amended on 29 November 2021*, clause 3.7.22(6).

1.15 Chorus submitted its individual capex design proposal for incentive expenditure for regulatory year 2023 (**design proposal**) on 6 April 2022. We approved Chorus' individual capex design proposal on 5 May 2022 with conditions.¹¹ Specifically:

- 1.15.1 we considered the key parameters of Chorus' design proposal were sufficient;
- 1.15.2 we considered the breadth of information provided in Chorus' design proposal was appropriate but considered that greater specificity was required in some areas;¹²
- 1.15.3 we waived the requirement for independent verification;
- 1.15.4 we considered Chorus' proposed timeline was appropriate; and
- 1.15.5 we decided to undertake a two-week consultation on our draft decision in Q3 2022.

1.16 Chorus submitted its individual capex proposal on 30 June 2022.¹³

How you can provide your views

Scope of submissions

- 1.17 We are interested in your views on our draft decision, including:
- 1.17.1 the amount of expenditure we have determined;
 - 1.17.2 whether we ought to request information from Chorus, as described in paragraph 1.5; and
 - 1.17.3 whether the information we intend to request from Chorus, as described in paragraphs 3.60 to 3.61, is appropriate.
- 1.18 We are not seeking views on the appropriateness of incentive payments within the PQ path.

¹¹ Commerce Commission "Approval of Chorus' individual capex design proposal for incentive payment capex 2023" (5 May 2022).

¹² Commerce Commission "Approval of Chorus' individual capex design proposal for incentive payment capex 2023" (5 May 2022), Attachment A.

¹³ [Chorus "Chorus' individual capex proposal for customer incentives"](#) (30 June 2022).

Process and timeline for making submissions

- 1.19 Submissions can be made to the Infrastructure Regulation mailbox (infrastructure.regulation@comcom.govt.nz) by 5pm on **1 November 2022**. Please include “Chorus individual capex draft decision” in the subject line.
- 1.20 We will invite cross-submissions by **5pm on 9 November 2022**.

Confidentiality

- 1.21 The protection of confidential information is something the Commission takes seriously. The process requires you to provide (if necessary) both a confidential and non-confidential/public version of your submission and to clearly identify the confidential and non-confidential/public versions.
- 1.22 When including commercially sensitive or confidential information in your submission, we offer the following guidance:
- 1.22.1 Please provide a clearly labelled confidential version and public version. We intend to publish all public versions on our website.
 - 1.22.2 The responsibility for ensuring that confidential information is not included in a public version of a submission rests entirely with the party making the submission.
 - 1.22.3 Please note that all submissions we receive, including any parts that we do not publish, can be requested under the Official Information Act 1982. This means we would be required to release material that we do not publish unless good reason existed under the Official Information Act 1982 to withhold it. We would normally consult with the party that provided the information before any disclosure is made.

Chapter 2 Legal framework

Purpose and structure of this chapter

- 2.1 This chapter describes the legal requirements for determining an individual capex allowance. This chapter is structured as follows:
- 2.1.1 considerations under the Telecommunications Act 2001 (**the Act**);
 - 2.1.2 considerations under the capex IM; and
 - 2.1.3 considerations under s 201 of the Act and Chorus' non-discrimination obligations.

Considerations under the Act

- 2.2 Under s 166(2) of the Act, we must make determinations that we consider best give (or are likely to best give), effect:
- 2.2.1 to the purpose in s 162; and
 - 2.2.2 to the extent that we consider it relevant to the promotion of workable competition in telecommunications markets for the long-term benefit of end-users of telecommunications services.
- 2.3 As explained in our *Fibre input methodologies: Main final decisions - reasons paper* (IM reasons paper),¹⁴ we consider that by applying the evaluation criteria set out in the capex IM, our draft decision would best give effect to s 166(2) of the Act. We explain in paragraphs 2.9 to 2.11 below how we consider that an application of the relevant capex IM provisions would ensure that we have fulfilled our obligation under s 166(2). We note that this is consistent with our explanation of the requirements of the Act and application of the capex IM in *Chorus' price-quality path from 1 January 2022 – Final decision: Reasons paper*.¹⁵

¹⁴ Commerce Commission "Fibre input methodologies: Main final decisions – reasons paper" (13 October 2020), paras 7.135-7.139.

¹⁵ Commerce Commission "Chorus' price-quality path from 1 January 2022 – Final decision: Reasons paper" (16 December 2021), paragraphs 4.10-4.25.

Considerations under the capex IM

- 2.4 The capex IM specifies that we will determine a capex allowance after Chorus submits an individual capex proposal.¹⁶ After receiving an individual capex proposal, we will determine a capex allowance for each regulatory year of a regulatory period in accordance with the general evaluation requirements in Subpart 8 of the IMs and the specific requirements set out in section 4 of Subpart 7 of the IMs.¹⁷
- 2.5 When we determine an individual capex allowance after a regulatory period commences, it will be used to calculate a wash-up amount.¹⁸
- 2.6 We must evaluate Chorus' individual capex proposal by considering whether the proposed capex meets the capital expenditure objective and reflects good telecommunications industry practice.¹⁹ The proposed capex would meet the capital expenditure objective if that expenditure reflects the efficient costs that a prudent fibre network operator would incur to deliver PQ fibre fixed line access services (**FFLAS**) of appropriate quality, during the relevant regulatory period and over the longer term.²⁰
- 2.7 Good telecommunications industry practice means:²¹
- 2.7.1 the exercise of a degree of skill, diligence, prudence, foresight and economic management, that would reasonably be expected from a skilled and experienced asset owner engaged in the management of a fibre network under comparable conditions. A decision on good telecommunications industry practice should take into account domestic and international best practice, including international standards and factors such as the relative size, age and technology of the relevant fibre network and domestic regulatory and market conditions, including applicable law.

¹⁶ *Fibre Input Methodologies Determination 2020*, as amended on 29 November 2021, clause 3.7.1(1). The specific requirements for an individual capex proposal are set out in section 4 of Subpart 7 of the capex IM.

¹⁷ *Fibre Input Methodologies Determination 2020*, as amended on 29 November 2021, clause 3.7.1(3).

¹⁸ *Fibre Input Methodologies Determination 2020*, as amended on 29 November 2021, clause 3.7.1(4)(b).

¹⁹ *Fibre Input Methodologies Determination 2020*, as amended on 29 November 2021, clause 3.8.5(1)(b).

²⁰ *Fibre Input Methodologies Determination 2020*, as amended on 29 November 2021, clause 3.8.5(2).

²¹ *Fibre Input Methodologies Determination 2020*, as amended on 29 November 2021, clause 1.1.4(2), definition of "good telecommunications industry practice".

- 2.8 We must evaluate Chorus' individual capex proposal by having regard to relevant assessment factors when considering whether the individual capex proposal has met the capital expenditure objective.²² The assessment factors help us identify the different aspects of prudence and efficiency. We must have regard to as many of the assessment factors as are relevant when evaluating the individual capex proposal.²³ The assessment factors are specified in clause 3.8.6(1)(a)-(t) of the IMs.
- 2.9 As we stated in our IM reasons paper, through our evaluation of a capex proposal we aim to limit Chorus' ability to over-forecast its investment needs for a given regulatory period. This limits Chorus' ability to extract excessive profits while preserving incentives to improve efficiency (s 162(b) and (d)).²⁴ Through the use of our economic test, we are able to ensure Chorus' incentive spend is efficient (consistent with s 162(b)), while promoting workable competition in telecommunications markets for the long-term benefit of end-users of telecommunications services (consistent with s 166(2)(b)) by not allowing Chorus to engage in predatory pricing. Predatory pricing may not promote s 166(2)(b) as it may undermine workable competition, in telecommunications markets for the long-term benefit of end-users of telecommunications services.
- 2.10 The evaluation criteria, including the assessment factors that support the evaluation of the proposed capex against the capital expenditure objective, allow us to identify and evaluate where good asset management has been applied. We consider that good asset management is important for Chorus to ensure capex meets the expenditure objective.²⁵
- 2.11 Having scrutinised and evaluated Chorus' individual capex proposal in accordance with the capex IM, and in light of the s 166(2) purposes, we consider that the proposal provides sufficient information for us to consider whether the proposed capex meets the capital expenditure objective and reflects good telecommunications industry practice under clause 3.8.5(1) of the IMs. This is discussed further below at paragraphs 3.57 to 3.59.

²² *Fibre Input Methodologies Determination 2020*, as amended on 29 November 2021, clause 3.8.5(1)(b) and 3.8.6.

²³ *Fibre Input Methodologies Determination 2020*, as amended on 29 November 2021, clause 3.8.6.

²⁴ Commerce Commission "Fibre input methodologies: Main final decisions – reasons paper" (13 October 2020), paras 7.135.

²⁵ Commerce Commission "Fibre input methodologies: Main final decisions – reasons paper" (13 October 2020), paragraph 7.137.

Considerations under s 201 and Chorus' non-discriminations obligations

Section 201

- 2.12 Section 201 of the Act requires Chorus to set prices that are geographically consistent:

Section 201 Geographically consistent pricing

A regulated fibre service provider who is subject to price-quality regulation 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.

- 2.13 A failure to comply with s 201 is a contravention of a price-quality requirement and could lead to penalties under Subpart 8 of Part 6 of the Act.²⁶
- 2.14 We issued guidance on our intended approach to s 201 last year.²⁷ As we stated in our guidance note, Chorus bears the responsibility for ensuring its pricing decisions comply with the requirements of s 201 and we have the responsibility for maintaining oversight of Chorus' decisions and, if necessary, bringing enforcement action.²⁸
- 2.15 We elaborated on this further in our final decisions for PQP1, where we outlined our approach to ex-ante and ex-post scrutiny of incentive payments in relation to s 201 and Chorus' non-discrimination obligations:²⁹
- “We perform ex ante scrutiny before approving expenditure by assessing whether there are reasons to believe that the proposed expenditure would breach Chorus' legal obligations (ex ante scrutiny), and ex post scrutiny by subsequently monitoring and enforcing Chorus' compliance with legal obligations during the regulatory period (ex post scrutiny)”.
- 2.16 As stated in our guidance note, incentive payments made by Chorus to access seekers can form part of the price, and therefore come within the scope of s 201.³⁰

²⁶ Telecommunications Act 2001, s 215(2)(b)(iii) and sections 215-218 generally.

²⁷ Commerce Commission “Guidance on our intended approach to s 201 of the Telecommunications Act 2001” (30 September 2021).

²⁸ Commerce Commission “Guidance on our intended approach to s 201 of the Telecommunications Act 2001” (30 September 2021), paragraphs 30-31.

²⁹ Commerce Commission “Chorus' price-quality path from 1 January 2022 – Final decision – Reasons paper” (16 December 2021), para C77.

³⁰ Commerce Commission “Guidance on our intended approach to s 201 of the Telecommunications Act 2001” (30 September 2021), paragraphs 46-48.

Non-discrimination obligations

- 2.17 Subject to any modifications under ss 206 and 230 of the Act,³¹ Chorus' supply of PQ FFLAS must comply with the undertakings it has given under s 156AD (**fibre deeds**). Under Chorus' fibre deeds, it is required to meet equivalence and non-discrimination obligations in relation to the supply of certain PQ FFLAS.³²
- 2.18 Non-discrimination obligations mean that Chorus must not treat access seekers differently to one another, or differently to itself. Equivalence obligations mean that Chorus must supply relevant PQ FFLAS to access seekers on the same basis that it supplies itself.³³

³¹ Under s 206, on or after the implementation date, Chorus will not be required to achieve price equivalence in relation to the supply of an unbundled layer 1 service to the extent that the service is an input to a service that is subject to a prescribed maximum price under Part 6 that is not a cost-based price. In addition, under s 230, if services are declared under ss 228 and/or 229, then the Governor-General may make regulations discharging a regulated provider from its obligations to supply a service under a s 156AD undertaking.

³² Commerce Commission "Chorus' price-quality path from 1 January 2022 – Final decision – Reasons paper" (16 December 2021), paragraph 7.47.

³³ Commerce Commission "Chorus' price-quality path from 1 January 2022 – Final decision – Reasons paper" (16 December 2021), paragraph 7.47.

Chapter 3 Our Draft Decision

Purpose and structure of this chapter

- 3.1 This chapter outlines our draft decision on Chorus' individual capex proposal for customer incentives for regulatory year 2023. This chapter is structured as follows:
 - 3.1.1 summary of our draft decision;
 - 3.1.2 key reasons for our draft decision;
 - 3.1.3 our assessment to reach our draft decision:
 - 3.1.3.1 need for the expenditure;
 - 3.1.3.2 economic analysis of proposed incentives;
 - 3.1.3.3 our assessment of the level of expenditure sought;
 - 3.1.3.4 classification of proposed expenditure as capex;
 - 3.1.3.5 compliance with s 201 and non-discrimination obligations;
 - 3.1.3.6 compliance with the capex IM; and
 - 3.1.3.7 compliance with additional information with approval of design proposal.

Summary of our draft decision

- 3.2 Our draft decision is to determine an individual capex allowance for customer incentives for regulatory year 2023 of \$12.5m. We consider our draft decision meets the expenditure objective and reflects good telecommunications industry practice. The reduction of \$4.3m from Chorus' individual capex proposal, is based on:
 - 3.2.1 a reduction of \$0.7m to reflect a change to calculating the forecast clawback to align with actual clawback amounts observed in 2020, 2021, and 2022;³⁴
 - 3.2.2 removing \$0.58m in contingency expenditure; and

³⁴ Clawbacks are payments made back to Chorus by RSPs for any incentive payments where the end-user did not stay connected.

- 3.2.3 a reduction of \$3.0m to reflect the incorporation of 12 months of actual incentive payments made from July 2021 to June 2022. We note this is equivalent to a reduction in the forecast number of incentive payments to be made in 2023 and reflects a change in the behaviour of the market in respect to the uptake of incentive payments.

Table 3.1 Impact of our draft decisions on the proposed individual capex allowance

Component of the proposal	Chorus Proposal	Draft decision	Change
Forecast Clawback	-\$2.2m	-\$2.9m	-\$0.7m
Unspecified expenditure	\$0.6m	\$0m	-\$0.6m
Forecast payments	\$18.5m	\$15.4m	-\$3.0m
Total change (ex allocation)			-\$4.3m

- 3.3 In addition, following the final decision on the individual capex allowance, we intend to request information from Chorus to provide:
- 3.3.1 a Connection Forecasting Methodology Report, which would set out how the connection forecast is calculated, the assumptions used along with how they are derived and the evidence that supports the assumptions; and
 - 3.3.2 quarterly updates during the regulatory years 2023 and 2024 on:
 - 3.3.2.1 incentive quantities and expenditure; and
 - 3.3.2.2 connections.
- 3.4 We are seeking submissions on our draft decision, including:
- 3.4.1 the amount of expenditure we have determined;
 - 3.4.2 whether we ought to request information from Chorus, as described in paragraph 1.5; and
 - 3.4.3 whether the information we intend to request, as described in paragraphs 3.60 to 3.61, is appropriate.

Key reasons for our draft decision

- 3.5 These draft decisions recognise that:
- 3.5.1 the need for the expenditure is justified. We consider that our draft decision applies the capex IM (including the evaluation criteria) and therefore best gives effect to s 166(2) of the Act;
 - 3.5.2 the incentive expenditure we are approving for 2023 can qualify as capex;
 - 3.5.3 the incentive expenditure we are approving for 2023 meets our economic test since the expected incremental revenues from incremental end-users outweighs the incremental costs of the incentive expenditure. The expenditure allowance set out in our draft decision, in aggregate and on balance, is therefore likely to improve efficiency and be pro-competitive;
 - 3.5.4 in our view Chorus' proposed individual capex allowance overstates the likely expenditure required for 2023, and does not reflect the efficient costs that a prudent fibre network operator would incur to deliver PQ FFLAS of appropriate quality.³⁵ Therefore, our draft decision is to reduce the allowance relative to the allowance Chorus has sought and to request further information from Chorus requiring it to provide further information in relation to its connection forecasting methodologies, models and assumptions;
 - 3.5.5 from our assessment of the available information, we do not consider that there are significant concerns that the proposed incentive payments for 2023 would contravene s 201 or Chorus' non-discrimination obligations; and
 - 3.5.6 we will continue to monitor Chorus' compliance with s 201 during the regulatory period and take steps to address compliance concerns relating to incentive payments ex post should issues arise.
- 3.6 This is our draft decision. The Commission is inviting submissions from interested stakeholders. We will have regard to any submissions received, including any relevant further information received, when making our final decision.

³⁵ By not doing this, the proposed individual capex does not meet the capital expenditure objective as specified under clause 3.8.5(2) of the IMs.

Our assessment to reach our draft decision

- 3.7 Our draft decision is to approve an individual capex allowance of \$12.5m for incentive capex for the 2023 regulatory year. This represents a \$4.3m reduction on the allowance sought by Chorus.
- 3.8 We have applied the evaluation criteria from the capex IM during our assessment. This required us to have regard to the relevant assessment factors when considering whether an individual capex proposal met the expenditure objective.³⁶ We used the assessment factors to assess Chorus' proposal for prudence and efficiency. Following our assessment, we are satisfied Chorus' proposed expenditure meets the capital expenditure objective and reflects good telecommunications industry practice in all but a few areas that we outline below in paragraph 3.18.
- 3.9 Our assessment of Chorus' individual capex proposal included:
- 3.9.1 an assessment of the need for the expenditure;
 - 3.9.2 economic analysis including sensitivity and impact analysis of the proposed incentive expenditure;
 - 3.9.3 an assessment of Chorus' approach and reasonableness of the methodology and assumptions used to forecast the proposed incentive expenditure;
 - 3.9.4 assessment of the classification of proposed expenditure as capex; and
 - 3.9.5 compliance:
 - 3.9.5.1 with s 201 and non-discrimination obligations;
 - 3.9.5.2 of the proposal with the capex IM.
- 3.10 In evaluating Chorus' individual capex proposal we have applied the evaluation criteria in the capex IM (including the assessment factors). We consider that by applying the evaluation criteria set out in the capex IM, our draft decision would best give effect to s 166(2) of the Act.

³⁶ *Fibre Input Methodologies Determination 2020*, as amended on 29 November 2021, clause 3.8.5(1)(b).

Need for the expenditure

- 3.11 Chorus states that its customer incentives accelerate fibre uptake, promote RSP competition (especially helping smaller RSPs to compete with vertically integrated mobile network operators) and drive cost efficiencies that results in lower prices for consumers.³⁷ We agree that incentive payments can promote competition, accelerate uptake and can drive cost efficiencies. We consider that our draft decision to include \$12.5m in an individual capex allowance is procompetitive and ensures that the benefits are passed on to consumers.

Economic analysis of proposed incentives

- 3.12 The expenditure amount of \$16.8m sought by Chorus,³⁸ as well as the lower amount proposed by the Commission, meets the requirements of our economic test. The amount sought remains below the maximum estimated incentive allowance implied by our economic test under a wide range of scenarios, including those assuming lower levels of new connections and upgrades. This suggests that, in aggregate, the amount of incentives sought is unlikely to be anti-competitive or inefficient.
- 3.13 Our economic assessment of the proposed incentive allowance for 2023 involves applying a test that we developed and consulted on previously. The test was first used to help assess incentive payments for 2022 as part of Chorus' PQP1 expenditure proposal. This test is part of our overall assessment of Chorus' expenditure proposal and, combined with our assessment of the methodology and approach used by Chorus to develop its proposal, has been used to reach our draft decision on Chorus' individual capex proposal.
- 3.14 Application of our test gives an estimated incentive allowance that is equal to the net present value (**NPV**) of the stream of incremental cashflow that the incentive payments generate. Incentive payments below this level should mean that the benefits of these payments exceed the costs. We then use that estimated incentive allowance to indicate the maximum incentive that would remain economical, as referred above in paragraph 3.12.
- 3.15 There are several inputs that go into our economic test. These include:
- 3.15.1 estimates of the average revenue per user (**ARPU**) resulting from new connections and upgrades;
 - 3.15.2 the length of time additional revenues should be counted;

³⁷ Chorus "Customer incentives – individual capex design proposal" (6 April 2022), paragraph 7.

³⁸ This is equivalent to \$15.2m in 2021 dollars.

- 3.15.3 the proportion of new connections which require lead-ins;³⁹
 - 3.15.4 costs incurred for connections which require lead-ins;
 - 3.15.5 the average life of lead-ins;
 - 3.15.6 the proportion of new connections and upgrades assumed to be incremental (i.e. resulting from incentive payments and which would not have occurred anyway);
 - 3.15.7 forecast new connection and upgrade numbers; and
 - 3.15.8 the weighted average cost of capital (**WACC**).
- 3.16 The calculation underlying our economic test involves the following steps:
- 3.16.1 first, we estimate the NPV of incremental cashflow for new connections which require lead-ins, intact new connections, and upgrades, respectively;
 - 3.16.2 we then multiply the above NPVs by forecasts for the numbers of new connections which require lead-ins, intact connections, and upgrades, respectively; and
 - 3.16.3 finally, we apply sensitivity analysis to reflect uncertainty with respect to key parameters and variables.

Assessment of the level of expenditure sought

- 3.17 Following our assessment of the expenditure proposed by Chorus, we are satisfied that, except for the aspects listed below in paragraph 3.18, the proposed capex meets the capital expenditure objective and reflects good telecommunications industry practice.
- 3.18 Our draft decision is on the information currently available to us that the following aspects of Chorus' proposal did not meet the capital expenditure objective:
- 3.18.1 the determination of the clawback amount proposed by Chorus;
 - 3.18.2 the inclusion of a contingency amount within the proposal; and
 - 3.18.3 overestimating the relative number of incentives to be paid in 2023.

³⁹ A lead-in refers to the assets and capital expenditure required to connect a property to Chorus' network boundary.

3.19 In addition, our draft decision includes acceptance of the escalation factors used by Chorus for the purposes of determining the incentive allowance.

3.20 Each of the items in paragraphs 3.18 is discussed further below.

Clawback amount

3.21 Chorus calculates an expected clawback over regulatory year 2023 of \$2.2m. Our draft decision is to increase the clawback to \$2.9m from the \$2.2m proposed by Chorus. This reduces the total capex allowance by \$0.7m from that proposed by Chorus.

3.22 A clawback is a rebate paid back to Chorus from an RSP in the event that a connection that resulted in an incentive being paid is lost or downgraded within a specified period (typically 12 months). For example, the Mix it Up incentive offer specifies a period of 12 months and applies to all connection downgrades and disconnections that occur within this time.

3.23 Chorus' proposed clawback is calculated based on a percentage of the incentives clawed back for each month over a 12-month period. The total percentage applied over the 12 months is [CCI]⁴⁰% for new connections and [CCI]% for upgrades. Chorus notes in the proposal that clawbacks "are close to [CCI]{}". The same rates are used for consumer and business clawbacks.

3.24 After reviewing Chorus' clawback forecast and having regard to the assessment factors in clause 3.8.6(1)(c), (e), (p), and (t) of the capex IM,⁴¹ we consider that the clawback forecast by Chorus under-estimates the clawback amount. For example, Chorus' calculation relies upon samples from mid-2019 and does not test the methodology against historical actuals.

3.25 Our review of the clawback as compared with actual total clawbacks made shows that the clawback rates are on average approximately [CCI]% of the actual clawbacks over 2020, 2021, and the forecast outcomes for 2023.⁴²

3.26 Accordingly, for this draft decision, we are utilising Chorus' methodology for determining clawback amounts, determining correct calculated weighted average clawback rates from the samples provided, and have aligned the rates with the actual clawbacks.

⁴⁰ Chorus confidential information is marked as "[CCI]".

⁴¹ *Fibre Input Methodologies Determination 2020*, as amended on 29 November 2021, clause 3.8.6.

⁴² Back casting refers to forecasting backwards in time. In this case we have used Chorus' calculation methodology to forecast what the clawback would have been in 2021 and 2022 to determine how well the methodology performed against actual clawback payments made.

Additional incentives for flexibility

3.27 Our draft decision is to remove \$0.58m which Chorus added for “incentives capex that we intend to spend in CY [Calendar Year] 23 but have not yet allocated to specific programmes”.⁴³ Chorus included \$0.8m in its proposal but the calculation methodology used by Chorus only results in a reduction of \$0.58m from the proposed allowance.

3.28 Chorus’ rationale for including the additional incentives within the allowance includes:

“Retaining flexibility to respond to market dynamics in this way is consistent with good telecommunications industry practice.”⁴⁴

“It would not be reasonable for the Commission to expect Chorus to develop business plans for our incentives ahead of when it is commercially rational, just to meet regulatory requirements. There is also precedent for the Commission being comfortable with a regulated firm (Christchurch International Airport) setting aside funds for a type of expenditure where the exact projects have not been confirmed”.⁴⁵

3.29 We do not consider the inclusion of an extra \$0.58m meets the capital expenditure objective as:

3.29.1 no indication has been provided as to the net benefit that an additional \$0.58m would provide in regard to additional connections or upgrades;

3.29.2 Chorus has a high degree of flexibility in regard to incentive design and rates. Subject to the requirements of s 201 and non-discrimination requirements, Chorus has complete flexibility and nothing within the determination of an individual capex allowance restricts its ability to respond to the market; and

⁴³ Chorus “Chorus’ individual capex proposal for customer incentives” (30 June 2022), section 2.3, page 12.

⁴⁴ Chorus “Chorus’ individual capex proposal for customer incentives” (30 June 2022), section 2.3, page 12.

⁴⁵ Chorus “Chorus’ individual capex proposal for customer incentives” (30 June 2022), section 2.3, page 12.

3.29.3 the Christchurch International Airport Limited decision used by Chorus as a reason for including the additional expenditure is not analogous.⁴⁶ The quote Chorus cited came from a summary and analysis of information publicly disclosed under s 53B(2)(b) of the Commerce Act 1986. This is different from a capex proposal for a PQ path which is different to our summary and analysis of information publicly disclosed under information disclosure. It was also made in the context of fixed physical infrastructure development (terminal redevelopment) which, unlike incentive products, has limited inherent flexibility.

3.30 Accordingly, after reviewing Chorus' additional incentive for flexibility and having regard to the assessment factors in clause 3.8.6(1)(b), (c), (e), (j), and (p) of the capex IM,⁴⁷ our draft decision includes the removal of the additional \$0.58m from the incentive allowance.

Inclusion of 12-month actual incentive payments

3.31 Our draft decision is to reduce the individual capex allowance by \$3.0m reflecting a change in market behaviour towards incentives as demonstrated in the 12 months from July 2021 to June 2022.

3.32 Chorus forecasts the incentive payments for 2023 by scaling a derived per connection incentive payment made in the last six months of 2021 (July to December) with the relative change in net connections forecast to occur in 2023.

3.33 In regard to the forecasting approach, Chorus notes that:⁴⁸

“Our programmes pay out based on volumes, so our forecast expenditure is sensitive to forecast connection demand”;

“As this proposal relates to a single calendar year and regulatory settings assume that expenditure is spread evenly across the year, the timing of the customer incentives capex is not uncertain”;

“As the expenditure consists of payments to RSPs for meeting certain requirements, it is not dependent on physical network build or contractor availability uncertainties that may apply to other types of capex”; and

“Our expenditure forecast assumes continued participation by existing RSPs in the incentives programme. If RSPs were to exit one or more of our incentive programmes then our investment could be lower than forecast”.

⁴⁶ Commerce Commission “Review of Christchurch International Airport’s pricing decisions and expected performance (July 2017 – June 2022) – Final report – Summary and analysis under section 53B(2) of the Commerce Act 1986” 1 November 2018), paragraph B16.

⁴⁷ *Fibre Input Methodologies Determination 2020*, as amended on 29 November 2021, clause 3.8.6.

⁴⁸ Chorus “Chorus’ individual capex proposal for customer incentives” (30 June 2022), section 2.5, page 13

- 3.34 We have identified a number of risks associated with Chorus' forecasting methodology. These include:
- 3.34.1 the methodology assumes that the response to the incentives offered by RSPs (and ultimately by end-users) is similar (but scaled) to that which existed during the last six months of 2021;
 - 3.34.2 reliance on six months of expenditure is not sufficient. In effect six months reflects only 2 payment cycles for incentive payments as the majority of payments are made on a 3-month basis;⁴⁹
 - 3.34.3 the forecast is reliant on the forecast net connections in 2023. The forecast provided by Chorus shows a relative growth of 60% greater than the growth in 2023 connections forecast in Chorus' PQP1 proposal. While Chorus is confident of an increased uptake in Hyperfibre, this represents a small proportion of the overall increase in connection numbers and the justification and evidence provided for the remaining increase was limited; and
 - 3.34.4 Chorus has not provided substantial information on the effectiveness of the incentive payments on the uptake for new connections or upgrades.
- 3.35 We also note that the expected total incentives and clawback amounts for the 2022 regulatory year appear to be significantly below what Chorus originally sought in its PQP1 proposal. This illustrates the level of uncertainty involved in the forecasting of the incentive payments and supports the reduction in the capex allowance we have made in reaching our draft decision.
- 3.36 Accordingly, after reviewing the actual incentive payments during the 12 months from July 2021 to June 2022, Chorus' forecast growth in net connections, and having regard to the assessment factors in clause 3.8.6(1)(c), (e), (g), (J), (p), and (t) of the capex IM, we consider there is a high risk that the methodology over forecasts the expected requirement for incentive payments in 2023.^{50, 51}

⁴⁹ Chorus "Chorus' individual capex proposal for customer incentives" (30 June 2022), section 8.2, page 32.

⁵⁰ *Fibre Input Methodologies Determination 2020*, as amended on 29 November 2021, clause 3.8.6.

⁵¹ Commerce Commission "Chorus' price-quality path from 1 January 2022 – Final decision – Reasons paper" (16 December 2021), at paragraph 4.159.2.3. In this paragraph we highlighted the incentive regulated providers have to game expenditure forecasts by over forecasting.

- 3.37 As such, our draft decision is to reduce the proposed individual capex allowance by \$3.0m. The reduction has been determined by applying the 12 months of actual incentive payments to forecast consumer incentives payments for regulatory year 2023. Our approach keeps the number of business connections and incentives as proposed by Chorus.

Draft decision on Chorus' approach to cost escalation

- 3.38 Our draft decision is to accept Chorus' proposed escalation of incentive expenditure for the purpose of establishing the individual capex allowance.
- 3.39 The design and pricing of individual incentives are within Chorus' control, and our approval of an individual capex allowance does not determine the specifics of the pricing or other terms Chorus may set. As set out at paragraphs 3.12 to 3.16 above, the total proposed incentive expenditure meets the requirements of our economic test.
- 3.40 As such, we have accepted the implied escalation of the incentive expenditure proposed by Chorus.

Classification of proposed incentives as capex

- 3.41 Our draft decision is that Chorus' proposed incentive payments for 2023 are capable of being treated as capex as defined under the Act and the IMs for the purposes of our individual capex proposal assessment.
- 3.42 As part of our final decisions for PQP1, we stated that incentive payments should be treated as capex at this stage.⁵² We stated that capex involves costs incurred in acquiring and developing "core fibre assets" or "UFB assets" and that expenditure will qualify as a "core fibre asset" if it is capitalised as an asset under GAAP and the asset is used (or available for use) in the provision of FFLAS.⁵³
- 3.43 Chorus states in its final proposal that the proposed expenditure is capitalised under the NZ IFRS 15 accounting rules.⁵⁴

⁵² Commerce Commission "Chorus' price-quality path from 1 January 2022 – Final decision – Reasons paper" (16 December 2021), paragraph C46.

⁵³ Commerce Commission "Chorus' price-quality path from 1 January 2022 – Final decision – Reasons paper" (16 December 2021), paragraphs C49-C50.

⁵⁴ NZ IFRS 15 is an accounting standard that covers revenue from contracts with customers and incorporates the equivalent IFRS standard as issued by the International Accounting Standards Board.

- 3.44 We remain of the view that Chorus' proposed incentives for 2023 can be treated as capex so long as they can be capitalised under GAAP. We are of the view that any new incentives that are not capitalised under GAAP may not be treated as capex. Our draft decision is that we have no reason to divert from our position set out in our final decisions for PQP1. As Chorus does not finalise its incentive offers for the second half of regulatory year 2023 (July to December) until after we approve this proposal, we are unable to have a view on the capitalisation of incentives offers that we have not seen.

Compliance with s 201 and non-discrimination obligations

- 3.45 Chorus is subject to two legal and regulatory requirements that are relevant to the individual capex proposal for customer incentives, specifically:

3.45.1 section 201 of the Act requiring geographically consistent pricing; and

3.45.2 non-discrimination and equivalence obligations.

Section 201 of the Act - geographically consistent pricing

- 3.46 We have no reason to consider that the incentives included in the individual capex allowance are likely to cause Chorus to fail to comply with s 201 as the incentives appear to be available to all RSPs nationally. Further, the incentives do not appear to discriminate on a geographic location. However, we note that our draft approval of the individual capex allowance does not in any way limit Chorus as to the form of the incentives it offers into the market.
- 3.47 Chorus explains in detail the measures it takes to ensure compliance with s 201 in its final proposal. Chorus has subjected all proposed incentive offers to an internal legal review to ensure compliance with s 201. Specifically, this process involves:
- 3.47.1 assessing whether incentives are available to all RSPs on the same terms;
- 3.47.2 assessing whether any particular RSP or group of RSPs would be advantaged or disadvantaged by the incentive or the way the incentive is structured; and
- 3.47.3 ensuring incentives are not determined by location but are available nationally.
- 3.48 Having subjected the proposed incentives to this legal review, Chorus certifies that the incentives proposed for 2023 comply with s 201.

- 3.49 Nevertheless we have looked at the conditions associated with the proposed incentive payments for 2023. There appears to be nothing in the conditions associated with the proposed incentives, as described by Chorus within the final proposal, to suggest they are not available to all RSPs nationally or discriminate on a geographic location.
- 3.50 In regard to the incentive offers currently in the market, we issued Chorus with a notice under s 193(2) of the Act as part of our final decisions for PQP1. The notice requires Chorus to submit a half-yearly compliance statement signed by a director that includes:⁵⁵
- 3.50.1 a summary of the processes Chorus has taken to ensure its prices charged for FFLAS, including any incentives, comply with s 201; and
 - 3.50.2 a statement about whether Chorus has complied with s 201.
- 3.51 Chorus submitted its compliance statement for the half-year ending 30 June 2022 stating compliance on 29 July 2022. We have not done any further investigation into the validity of Chorus' statement at this time.
- 3.52 We note that Chorus states that it plans its incentives for its financial year (July to June). Therefore, Chorus' incentive planning beyond June 2023 is limited, and further planning for incentives into financial year 2024 (July 2023 to June 2024) will be done closer to the time.

Non-discrimination and equivalence obligation

- 3.53 We have looked at the conditions associated with the proposed incentives payments for 2023. We are satisfied the information provided gives no evidence of access seekers being treated differently to one another with respect to incentive payments. However, as with our ex-ante s 201 assessment, we note that our draft ex-ante approval of the individual capex allowance does not in any way limit Chorus as to the form of the incentives it offers into the market.

⁵⁵ Commerce Commission "Notice to supply information to the Commerce Commission under section 193(2) of the Telecommunications Act 2001 – Compliance statements for the first regulatory period" (16 December 2021), clause A7 of Attachment A.

Compliance with capex IM

- 3.54 The capex IM sets out the key requirements that an individual capex proposal must contain. The final proposal must be in accordance with the approved timeframes specified in the design proposal and consistent with the key parameters, information requirements, assurance processes and any conditions approved by the Commission in relation to the design proposal.⁵⁶
- 3.55 We approved Chorus' design proposal with conditions on 5 May 2022. Attachment A of our letter to Chorus specified the additional information we required as part of our approval.⁵⁷
- 3.56 We assessed the information provided in the proposal against the following requirements:
- 3.56.1 approved timeframes;
 - 3.56.2 key parameters of the proposal;
 - 3.56.3 information requirements of proposal; and
 - 3.56.4 assurance requirements of proposal.
- 3.57 Following an assessment of the final proposal, we consider that the information provided within the final proposal provides sufficient information for us to consider whether the proposed capex meets the capital expenditure objective and reflects good telecommunications industry practice under clause 3.8.5(1) of the IMs.
- 3.58 In a small number of instances, Chorus has not provided information or has not provided sufficiently detailed information. We are of the view that this is not a sufficient reason to decline the proposal as the information provided allows us to consider whether the proposed capex meets the capital expenditure objective and reflects good telecommunications industry practice under clause 3.8.5(1) of the IMs. Some of the areas where information was not provided are less relevant to the nature of the capex incorporated within the proposal (for example, incentive payments do not affect PQ FFLAS quality).
- 3.59 We sought and were provided information via a subsequent request for information (**RFI**) issued to Chorus to clarify one of the requirements during our evaluation of Chorus' final proposal.

⁵⁶ *Fibre Input Methodologies Determination 2020*, as amended on 29 November 2021, clause 3.7.25.

⁵⁷ Commerce Commission "Approval of Chorus' individual capex design proposal for incentive payment capex 2023" (5 May 2022), Attachment A.

Further information to be sought from Chorus

- 3.60 Following our review of the information provided by Chorus as part of the individual capex proposal and the subsequent request for information notices we issued, our intention is to request Chorus provide a connection forecasting methodology report by 30 March 2023 and quarterly updates on incentive quantities and expenditure and connections. This is to explain the detailed methodology, assumptions and evidence for both the approach Chorus uses and the basis upon which its connection forecasts are made.
- 3.61 At this time, we consider that this information would be necessary for us to carry out our functions and exercise our powers under Part 6 to determine any future individual capex allowance and to determine Chorus' price-quality path (**PQ path**) for the regulatory period that starts on 1 January 2025 (**PQP2**). This is necessary as we think that Chorus needs to improve the quality of its reporting on connection numbers to assist with our assessment of any future capex proposal against the capital expenditure objective and good telecommunications industry practice. Assessment of any future capex proposal will involve analysis of Chorus' connection numbers, and we believe requiring further information will ensure future proposals are of a higher quality.