Chorus' expenditure allowances for the second regulatory period (2025 – 2028)

2degrees' Submission in response to Commerce Commission consultation

May 2024

PUBLIC

Executive summary

Thank you for the opportunity to submit on the Commerce Commission's draft decision in relation to *Chorus' expenditure allowances for the second regulatory period (2025 – 2028)*, dated 18 April 2024.

Chorus' expenditure allowance is an important contributor to industry (and consumer) cost, and we welcome the Commission's recognition that any expenditure it approves is ultimately borne by Kiwi consumers in the prices they pay for fibre services, as well as recognition that Chorus needs to demonstrate that proposed expenditure is prudent and efficient.

The draft decision confirms 2degrees' concern that Chorus has not adequately demonstrated its Second Price Quality Path (PQP2) expenditure proposal is justified, prudent and efficient, despite having had opportunity to learn from experience with the first PQP determination (PQP1) as well as Part 4 Commerce Act precedent.

The draft decision reflects that there are a large number of examples – in absolute terms and relative to Part 4 precedent – where the Independent Verifier was not able to verify Chorus' expenditure in certain areas and/or the Commission was not satisfied the proposed expenditure was justified. A recurring theme of the draft decision appears to be that Chorus has not provided sufficient supporting evidence to support their expenditure proposal.

Cost allocation

2degrees welcomes the Commission's recognition Chorus has proposed a large number of changes to cost allocators which uniformly increase the amount of costs that would be allocated to fibre fixed line access service (FFLAS). We also welcome the Commission draft decision not to adopt many of Chorus' proposed changes.

We agree Chorus' proposed changes to allocators "reflect behaviour from a regulated supplier seeking to increase profits" and "It is the risk to harm to end-users of FFLAS that the cost allocation IM is designed to, and should, mitigate".

Network expansion

We welcome that Chorus has withdrawn, at least for the time-being, most of its network expansion proposal and is now seeking approval for a more limited investment e.g. infill housing. We also welcome that Chorus "now consider[s] the most appropriate regulatory mechanism for seeking approval for any further fibre frontier investment would be via the individual capex proposal mechanism …"

We agree with Chorus "there is no clear precedent for how the Commission should evaluate the merits of our fibre extension proposal" and "This contrasts with the regulation of Transpower's grid enhancement and development investments, for which there is a well-established and relatively prescriptive economic test specified in an input methodology". Chorus' observations highlight the issues 2degrees raised about the level of prescription in the Chorus fibre Capex Input Methodology (IM) versus the Transpower Capex IM. This is an aspect of the IMs the Commission could revisit to provide greater clarity about what is needed to determine whether an investment would be approved / would be to the long-term benefit of end-users.

Implications of reduced network expansion

We agree with the Commission that the reduction in connections – based on Chorus' revised network expansion proposal – will have a flow on impact (reduction) on expenditure, including base capex – augmentations, connection capex and opex.

Customer incentives

2degrees' concerns about incentive payments have not changed. This includes for the full period 2025 to 2028, however we welcome that the Commission's draft decision at least limits incentive payment expenditure to 2025 and excludes the remainder of Chorus' proposed PQP2 incentive payment expenditure.

We agree with the Commission that "the level of capex required for the later years of PQP2 is highly uncertain", "Chorus' proposal insufficiently justifies the extent of the amount of the proposed capex" and "the role that incentive payments will play within the overall context of Chorus' marketing and promotional activities throughout the PQP2 period has not been sufficiently demonstrated."

The proposed expenditure allowance versus Chorus' actual expenditure

2degrees considers that particular caution is needed in approving Chorus' proposed expenditure where either Chorus spent less than the approved expenditure in PQP1, or Chorus is now proposing to spend more in PQP2 than (a) it spent in PQP1 and/or (b) it was approved to spend in PQP1.

In these types of examples there is a substantial risk and likelihood of windfall gains/excess returns (being granted revenue Chorus' doesn't spend) and the Commission effectively approving the same expenditure twice. These concerns arise, for example, in relation to network resilience base capex (underspend of $12m in PQP1) and opex (underspend of $32.2m).

Marketing

2degrees continues to have concerns about the use of regulated revenue from provision of natural monopoly services in order to 'compete' with Retail Service Providers (RSPs) using alternative technologies.

The level of marketing expenditure by a supplier in a competitive market does not provide justification or an appropriate benchmark for marketing expenditure by a regulated natural monopoly. 2degrees consequently does not support the Commission's draft decision to adopt the base year amount Chorus proposed, though we welcome that the Commission has not applied any trend increase in the advertising component of the expenditure.

Introduction

2degrees welcomes the opportunity to submit on the Commerce Commission's draft decision in relation to *Chorus' expenditure allowances for the second regulatory period (2025 – 2028)*, dated 18 April 2024.

Chorus' expenditure allowance is an important contributor to industry (and consumer) cost, and we welcome the Commission's recognition that "any expenditure we approve is ultimately borne by Kiwi consumers in the prices they pay for fibre services" as well as that "Chorus [needs] to demonstrate that proposed expenditure is prudent and efficient."[1]

As identified by the Commission in the draft decision, it is clear that "Chorus has not satisfied this expenditure test in a number of areas". This reinforces our concerns Chorus is falling well short of Part 4 Commerce Act precedent in terms of the robustness, legitimacy and transparency of its expenditure proposals. The extent to which the Commission has agreed to Chorus' expenditure proposals appears to be lower than Part 4 precedent.

Chorus has had opportunity to learn from experience with the first determination as well as Part 4 Commerce Act precedent (including the Individual Price-Quality Path (IPP) regime Transpower operates under).

In the draft decision there are a large number of material areas where Chorus failed to satisfy the Independent Verifier the expenditure was justified, prudent and efficient e.g. "Chorus has not provided an explanation for its proposed changes", Chorus "has not demonstrated why the amount of expenditure proposed is required" and/or Chorus' "proposal did not provide sufficient evidence that the expenditure reflects the efficient costs that a prudent fibre network operator would incur to deliver the service at appropriate quality."

It is our hope the approach Chorus' adopts will mature and follow more closely the approach in the energy sector, but this requires that Chorus is not rewarded and does not benefit financially from the comparatively aggressive approach to economic regulation it is currently taking.

Process issues

We note Retail Service Providers (RSPs) have ongoing concerns about the timeframes provided for consultations on substantial further PQP matters. We reiterate consultation periods of 4 weeks plus 2 weeks for cross-submissions is not sufficient to allow stakeholders to fully engage and respond to consultations, and less than provided for equivalent Part 4 Commerce Act PQP consultations. As noted previously, this puts particular onus on the Commerce Commission to ensure all aspects of Chorus' expenditure proposal are well-justified and are to the long-term

---

[1] https://comcom.govt.nz/news-and-media/media-releases/2024/commission-focused-on-ensuring-chorus-expenditure-benefits-consumers

benefit of end-users (and do not simply result in higher Chorus expenditure and profits, and ultimately support higher prices for end-users).

We are also concerned about the extent to which confidentiality has limited the information available for consultation e.g. all information in Table 5.5 on proposed expenditure on ONTs has been excluded. This prevents us from commenting on Chorus' assumptions about ONT unit costs, its proposed expenditure or whether the Commission's draft decision to reduce Chorus' proposed expenditure (the size of the reduction or what it is reduced from is not specified) is adequate.

Likewise, it is difficult to comment on the efficacy of approving $71.4m in access capex without knowing what it consists of (paragraph 5.141).

In another example the Commission has treated confidential what it is that the Commission doesn't consider to be sufficiently evidenced: "We do not consider the explanation for the [ ] would need to be made within the context of providing an explanation for the efficiency in the base year and the demonstration of the appropriateness of using EDB elasticities as a method for forecasting network related opex costs (opex assessment factors (a), (b), (d) and (j))."

The issues of limited consultation timeframes, and restrictions on the information that is made publicly available to stakeholders, is reflected in the Commission's observation that for a wide range of matters "We did not receive any submissions from stakeholders".

We support the Commission obtaining independent advice

2degrees supports and endorses the Commission engaging Network Strategies to provide independent advice on issues identified in the Commission's review of the Independent Verifier report and Chorus' expenditure proposal.

Cost allocation and double-recovery risk

2degrees welcomes the Commission's draft decision to reject a number of Chorus' proposed changes to cost allocators and to retain allocators approved in the first price-quality path (PQP1).

We also welcome that the Commission has provided quantified information on the impact of Chorus' proposed changes in cost allocators. We reiterate Chorus should both: (i) provide a range of possible options for allocators it is proposing to change; as well as (ii) the quantified impacts of those options. We would welcome Chorus taking this approach in the future if it wants to change cost allocators.

We agree Chorus' "proposed allocator type changes all appear to increase the allocation of expenses to FFLAS and reduce the allocation to non-FFLAS." The draft decision demonstrates Chorus has not met the Commission's requirement that "The choice of allocators must also be objectively justifiable and demonstrably reasonable".

The information provided in the draft decision highlights that Chorus' cost allocation proposals would result in substantial and arbitrary increases in its regulated FFLAS expenditure allowances which would result in windfall gains to Chorus and a weakening of the limit to excessive profits, which would not offer any benefits to consumers (only detriments through higher prices).

2degrees agrees with the Commission that:

- Chorus' proposed changes to allocators "… may … reflect behaviour from a regulated supplier seeking to increase profits" and that "It is the risk to harm to end-users of FFLAS that the cost allocation IM is designed to, and should, mitigate".
- "An over-allocation of shared costs where those costs are driven by non-FFLAS services to Chorus FFLAS, will inflate Chorus' allowable revenue for FFLAS services, even if the full allowable revenue is not recovered in PQP2, but is washed up for a future period. We consider this will have negative implications for workable competition given Chorus holds a significant portion of the wholesale market for FFLAS and its pricing will influence the general market price."
- "The Chorus proposal will accelerate the transfer of cost recovery from copper to FFLAS while Chorus' corporate and CTO functions continue to manage material copper totex costs as it proceeds with the withdrawal of the copper network. We are not persuaded that less than 11% of Chorus shared corporate costs (under a revenue-allocation approach) are incremental costs driven by ongoing management of the copper network." This reinforces our concerns about copper-fibre double cost-recovery.

These observations are all far removed from the Commission's "key outcome" that "regulated fibre service providers allow end-users to share the benefits of efficiency gains in the supply of FFLAS, including through lower prices: s 162(c)" or that "Cost allocation must also minimise the risk that regulated providers could over-recover shared costs enabling them to extract excessive profits: s 162(d)." Instead, they highlight the risk, in terms of promotion of workable competition under s 166(2)(b), that "a disproportionate allocation of expenses to regulated FFLAS may distort competition, including in the supply of services that are not regulated FFLAS."

Network expansion

2degrees welcomes that Chorus has, for the time being at least, withdrawn most of its proposal for substantial network expansion (it is now proposing $13m expenditure rather than $201m during PQP2). Spending $13m to build to 10,000 premises offers a lot better value than the additional $188m to build to an additional 30,000 premises.

We welcome that Chorus "now consider[s] the most appropriate regulatory mechanism for seeking approval for any further fibre frontier investment would be via the individual capex proposal mechanism …" 2degrees previously commented that we share Spark's view Chorus' expenditure proposal for network expansion is not ‘business as usual’ and should be dealt with through an individual capex proposal (ICP) rather than as part of the expenditure proposal for the price-quality path determination[2,3] or otherwise through the established Crown Infrastructure Partners (CIP) process for funding fibre coverage.[4]

Based on the updated commentary (in particular, the content that remains largely unchanged) we continue to have concerns about the nature of the tests and justifications Chorus considers to be appropriate in attempting to justify that its expenditure proposals are prudent and efficient.

In this respect, we note the Commission’s commentary that “In areas where fibre frontier is rolled out, any alternative providers should only face competition from a Chorus service that is provided on a commercially prudent basis”, the importance of “clearly (and with certainty) set[ting] out the geographic areas to be served and the associated costs”, and the “risk of requiring ongoing higher charges for existing customers”. We agree with the Commission these are all relevant considerations in determining whether to approve Chorus’ network expansion proposals.

The Fibre Capex IM

Chorus blames uncertainty about “future regulatory and policy frameworks and market evolution” for its decision to reduce its network expansion proposals rather than the evident issues with its proposals.[5] The updated “15.0 Fibre Frontier” suffers from much of the issues raised by RSPs in the previous consultation round. We do not agree with Chorus that it has demonstrated “the network expansion capex included in our original proposal is strongly in the interests of consumers and New Zealand generally, meets the capital expenditure objective and reflects good telecommunications industry practice.”

The one aspect of Chorus’ concerns about regulatory uncertainty which we agree with is in relation to the non-prescriptive nature of the fibre Capex IM. We agree with Chorus “there is no clear precedent for how the Commission should evaluate the merits of our fibre extension proposal”, “the input methodologies do not make the appropriate economic test clear” and “This contrasts with the regulation of Transpower’s grid enhancement and development investments, for which there is a well-established and relatively prescriptive economic test specified in an input

---

[2] Spark, Fibre price-quality regulation: process and approach for the 2025-2028 regulatory period, 28 September 2023, at https://comcom.govt.nz/__data/assets/pdf_file/0026/330893/Spark-submission-on-the-Process-and-approach-paper-for-the-2025-2028-regulatory-period.pdf.
[3] Spark make a sensible distinction between expenditure on network extensions and “”BAU” expenditure for extending fibre to, for example, new sub-divisions”.
[4] Spark, Fibre ID and PQ draft decisions, cross-submission, 5 August 2021, at: https://comcom.govt.nz/__data/assets/pdf_file/0024/262239/Spark-Cross-submission-on-Fibre-PQ-draft-decisions-5-August-2021.pdf.
[5] It appears the actual reason is that Chorus is now seeking agreement for the expenditure (and more) directly with the Government: https://www.nzherald.co.nz/business/rural-broadband-chorus-has-a-25-billion-proposal-for-new-telco-minister-paul-goldsmith/5OTHGH6B5ZGE5ERP3H23DM3UEY/

methodology". We agree the fibre Capex IM lacks "specificity" in relation to "the appropriate economic test" to apply.

We note it was available for Chorus to raise these concerns at the time the Commission was consulting on the IMs but Chorus instead advocated for "less prescriptive rules, relative to the Transpower capex IM".[6]

Chorus' observations highlight the issues and concerns 2degrees raised about the level of prescription in the Chorus fibre IM versus the Transpower Capex IM, and the gaps that exist in the Chorus' Capex IM compared to the Transpower Capex IM. We consider that this is an aspect of the IMs the Commission should revisit to provide greater clarity and certainty about the operation of Part 6 of the Telecommunications Act and what would be needed to determine whether an investment would be approved/would be to the long-term benefit of end-users.

Implications of reduced network expansion

We agree with the Commission that the reduction in connections – based on Chorus' revised network expansion proposals – will have a flow on impact (reduction) on Chorus' expenditure requirements, including base capex – augmentations, connection capex and opex: "We have identified several … areas of expenditure that we expect will be impacted by the new information provided and we have accounted for this in our draft decision on those expenditure categories."

We are concerned though that while the Commission "consider[s] that the reduction in connections included in the new information regarding Chorus' fibre frontier investment may have a flow on impact on standard installations base capex", it has "not reduced expenditure to be included in our draft decision for this sub-category" and the Commission "do[es] not consider we have a sufficient basis for estimating any change in capex associated with the reduction in connections and have accordingly not made any reductions."

The Independent Verifier also commented "Some methods used to calculate these expenditure items were not transparent and it was not provided with some pieces of information it expected to be given to verify the expenditure proposal" and the Commission relied on qualified assessment that Chorus' assumptions about costs "appears reasonable".

We are concerned with the Commission "invit[ing] Chorus to set out its view of the impacts to the wider expenditure proposal of the new information in submissions." We consider that the Commission should formally require Chorus to provide more complete information about the impact of the updated information on the "fibre frontier network extension".

---

[6] Chorus, Submission on Fibre input methodologies: Draft decision – reasons paper dated 19 November 2019 and Draft fibre input methodologies determination 2020 dated 11 December 2019, 28 January 2020.

Customer incentives

2degrees' concerns about incentive payments have not changed.

This includes for the full period 2025 to 2028, however we welcome that the Commission's "draft decision is to include incentive payment expenditure of $13.6m (constant $2022) in the base capex allowance for 2025 only" and, in particular, to exclude the remainder of Chorus' proposed PQP2 incentive payment expenditure.

We agree with the Commission that "the level of capex required for the later years of PQP2 is highly uncertain (assessment factor (o))", "Chorus' proposal insufficiently justifies the extent of the amount of the proposed capex" and "the role that incentive payments will play within the overall context of Chorus' marketing and promotional activities throughout the PQP2 period has not been sufficiently demonstrated."

Even if the Commission "accept[s] in general terms the need for the expenditure", this leaves open the question of what the size and strength of the incentive payments should be. There is no financial disadvantage (only upside) to Chorus from the Commission approving excessive incentive payment allowances.

We agree "Chorus has not … provided reasons and explanation for the assumptions and has not demonstrated why the amount of expenditure proposed is required", "in a number of instances, Chorus has not provided evidence, and has not provided sufficiently detailed information to show that the key assumptions and the approach to forecasting incentive capex are reasonable and appropriate (assessment factors (e) and (t))" and "there are a number of issues with the models provided, including calculation errors, and inconsistent use of formulas within the forecast calculations, and use of hardcoded numbers with no explanation of the assumptions." We are concerned these issues are not unique to incentive payments but apply to Chorus' wider expenditure proposal.

What Chorus is proposing to be allowed to spend versus what it has spent

2degrees considers that particular caution is needed in approving Chorus' proposed expenditure where:

(i) Chorus spent less than the approved expenditure in PQP1; and

(ii) Chorus is now proposing to spend more in PQP2 than:

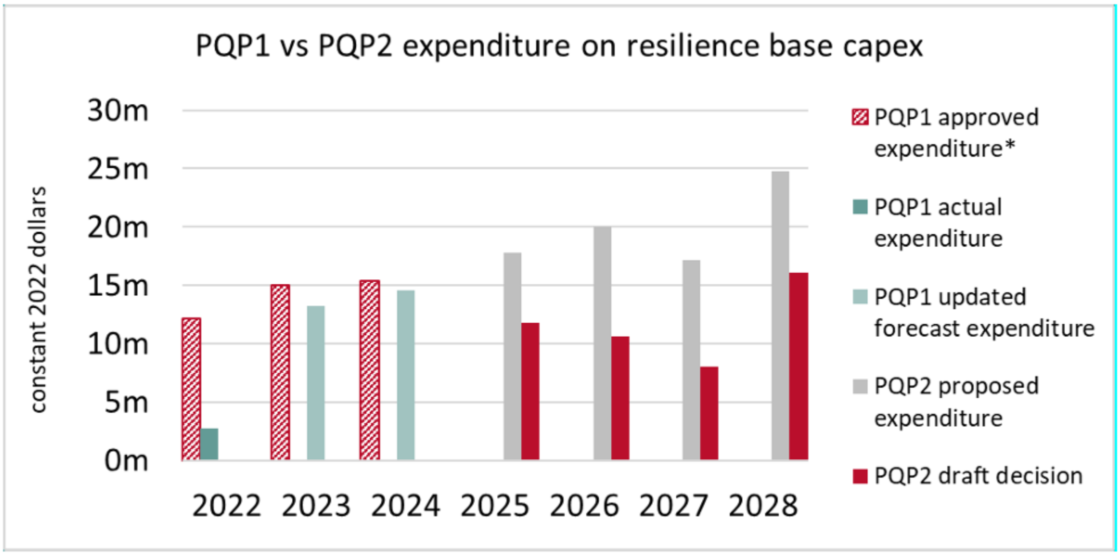
(a) it spent in PQP1; and/or

(b) was approved to spend in PQP1.

In these types of examples there is a substantial risk and likelihood of windfall gains/excess returns (being granted revenue Chorus' doesn't spend) and the Commission approving the same expenditure twice.

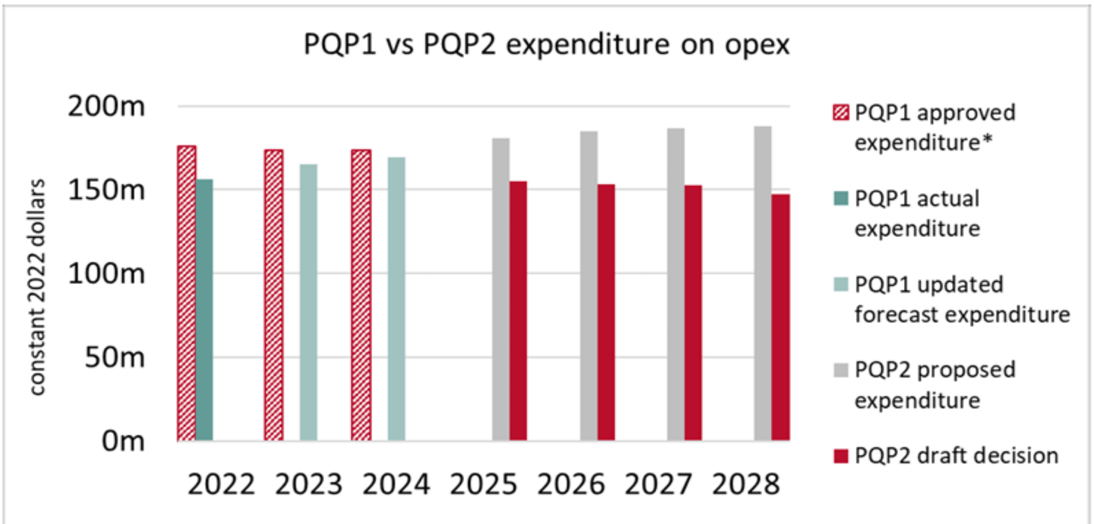
An example of this is provided by Chorus' proposed resilience base capex. Chorus underspent by $12m over the 3 years of PQP1. We note the draft decision is to grant less expenditure in PQP2 than was granted in PQP1 (except for 2028) which should help mitigate this risk.

Figure 5.6 PQP1 vs PQP2 resilience base capex



Another example is Chorus' expenditure on opex.[7] Chorus underspent opex by $32.2m over the 3 years of PQP1.

Figure 7.1 PQP1 vs PQP2 opex



[7] This applies to maintenance opex, network operating costs and corporate opex (as per Figure 7.2).

Network resilience expenditure

It is important Chorus understands the distinction between in principle stakeholder support for investment in resilience versus the level of support for specific expenditure proposals and whether they are justified. Recognition of the importance of resilience expenditure does not mean Chorus' proposals are supported or that it has demonstrated they are prudent and efficient.

We agree with the Commission's concerns that "Chorus did not quantify the benefits from such investments or explain why investments in dual fibre paths should be made to a level that goes beyond its architectural specification standard (assessment factors (d), (e) and (t))", and "greater effort could have been spent on understanding and explaining the benefits and costs of specific investments to stakeholders."

We also share the Commission's concern that the alternatives to investing in dual pathways Chorus provided "only considered alternative levels of investment based on current, increased and decreased investment options" and "No consideration appears to be given to whether opex solutions or additional critical spares may be more effective or whether alternative capex solutions or alternative technologies may offer greater or more cost-effective resilience against high impact, low probability events (assessment factor (i))."

We welcome the Commission's guidance to Chorus: "Going forward we expect Chorus to continue to assess the appropriateness of its architectural standards and to consider alternatives. We expect investments in dual fibre pathways to be invested where they meet a reasonable cost benefit test, relative to alternative options. We also expect Chorus to continue to consult with all of its stakeholders to identify high value targets for investments and to identify whether more cost-effective alternatives exist."

Marketing

2degrees continues to have concerns about the use of regulated revenue from provision of monopoly services in order to 'compete' with RSPs using alternative technologies.

The Commission stated part of our concerns at paragraphs 7.20 and 7.21 of the draft decision but was silent on whether it agreed or disagreed with our concerns and reasonings.

The fact the Commission "expect[s] Chorus to consider developing approaches in the lead up to PQP3 to illustrate the economic benefit from expenditure such as marketing including incorporating aspects such as the expected return on investment" makes it very clear Chorus' marketing expenditure proposal is not well justified.

We do not consider marketing expenditure by a supplier in a competitive market provides justification or an appropriate benchmark for marketing expenditure by a regulated natural monopoly. We are not aware of the Commission adopting equivalent benchmarks under Part 4 of the Commerce Act. The Commission's finding that Chorus' proposed advertising expenditure is less than Spark's on a per connection basis does not mean it is safe or reasonable for the Commission to conclude "Chorus proposal was not obviously excessive (opex assessment factors (b) and (j))".

2degrees consequently does not support the Commission's draft decision to adopt the base year amount Chorus proposed, though we welcome that the Commission has not applied any trend increase in the advertising component of the expenditure.