



Chorus additional information relating to incentive payments

Submission | Commerce Commission

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## Executive Summary

Thank you for the opportunity to comment on the information provided to the Commission by Chorus relating to its incentive payment scheme (**incentive payments**) and the Chorus spreadsheet accidentally omitted from its earlier disclosure.

Since considering incentive payments in the May 2021 draft PQ decision, the Commission received further submissions and information relating to Chorus' incentive payments (**additional material**) and finalised its section 201 guidance (**guidance**).

We support the Commission's s201 guidance. The guidance confirms that regulated providers must charge the same price for materially the same FFLAS service wherever it is supplied, and that "price" includes any adjustments, incentives, rebates, or discounts associated with the service. It is the effect the pricing structure has on end-user prices – i.e., whether it results in different prices for the same service - rather than how prices are labelled or structured that matters.

### Chorus additional information

We believe that the guidance reinforces s201 concerns with Chorus' current practices which have the effect of differentiating prices for the same service. Chorus has further signalled future incentives based on non-location eligibility criteria that, concerningly, is expected to have the effect of differentiating prices, i.e., by defining eligibility in a way that results in lower prices for end-users in retirement villages.

Chorus argues that the Commission is not required to consider compliance with s201 or other requirements of the Act to accept the expenditure path. It is unclear how Chorus' proposed approach would be consistent with the IMs that already require the Commission, in considering a capex proposal, to have regard to compliance and competition effects<sup>1</sup>.

And more generally, the implication of Chorus' approach is that the Commission should be comfortable providing an allowance for a category of expenditure at a general envelope level, regardless of whether Chorus is legally allowed to spend the specific contents of that envelope. We think the opposite is true. The Commission must reach a view, based on reasonable evidence, on whether each element of the envelope of expenditure it provides an ex-ante capex allowance for will comply with the Act on an ex-post basis. The distinction Chorus seeks to make between the two tasks does not exist under the Act. It would be irrational under the Act for the Commission to set a price path (which is a price-quality requirement) that provides for Chorus to recover expenditure that contravenes a price-quality requirement.

The Commission cannot approve expenditure unless satisfied that the expenditure is compliant with the regulatory obligations of the Act and best promotes the Part 6 purposes.

### Completing the PQ determination process

At this stage, the Commission does not have a compliant proposal that it could approve for the first regulatory period, and Chorus has further signalled future alternative approaches that are equally non-compliant.

The Commission has already set out its concerns relating to uncertain and likely non-compliant expenditure proposals<sup>2</sup> and - to partially mitigate the risks for end-users and permit a greater degree of scrutiny to ensure the payments are not excessive, over-stated or anti-competitive - proposed to consider any connection incentive proposals through an individual capex proposal. We believe this

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<sup>1</sup> IMs at 3.8.6

<sup>2</sup> Commission Draft PQ decision at 4.150-4.151

is the only approach available to the Commission. The additional material raises no new issues, and the Commission should have comfort that it can apply its draft approach to omit the proposed expenditure.

Nonetheless, the additional material and s201 guidance reinforces the underlying problems with the proposal and the Commission should also consider:

- Whether further compliance action is required outside the PQ determination process, including whether the connection incentives and programme to pro-actively deploy fibre lead-ins comply with non-discrimination and competition requirements.
- Omitting connection incentive and pro-active lead-in expenditure, to date, from the FLA calculation and interim initial RAB. Non-compliant expenditure should not form any part of the BBM model.
- Whether the pro-active lead-in programme is properly reflected in forecast volumes and unit costs, i.e., the programme could incorrectly inflate connection forecasts or be built into actual demand unit costs.

### Release of additional information

The Commission has also released additional information relating to incentive payment volumes and a Chorus spreadsheet inadvertently omitted from earlier PQ path consultation releases:

- We recommend that the Commission clarify the criteria Chorus used to identify premises with a lead-in and no connection. There are a number of different scenarios and the estimate risks under-reporting the incentives impact.
- The Chorus spreadsheet relating to earlier expenditure path submissions is a useful summary that highlights our concerns that Chorus mischaracterises the Commission's proposed adjustments as efficiency adjustments when they relate to the omission of unsupported expenditure and application of the most up to date view of unit costs and volume forecasts. The Commission cannot engage in the price path negotiation Chorus is proposing, nor accept Chorus' equally unsupported countervailing expenditure proposals.

## Introduction

1. Thank you for the opportunity to comment on the information provided to the Commission by Chorus relating to its incentive payment scheme (**incentive payments**) and Chorus spreadsheet accidentally omitted from earlier disclosures.
2. In the Commission's May 2021 draft PQ decision, it proposed to exclude incentive payments from the Chorus' capex allowances, suggesting that Chorus has the option to make an individual capex application through the first regulatory period.
3. Following the consultation process on this matter, the Commission has received (collectively **additional material**)
  - a. A context paper from Chorus on 10 September 2021 (**context paper**).
  - b. Four RSP letters supporting Chorus incentive payments, and
  - c. Additional information from Chorus relating to its intended incentive payments - including design principles, structure, and forecast initiatives – and proposed steps to ensure any incentive payments comply with Chorus' regulatory obligations under s201 and its non-discrimination obligations.
4. The Commission has now requested stakeholder views on Chorus' response and subsequent letters received, specifically:
  - a. Whether the information provided by Chorus on incentive payments raises any compliance issues with respect to the geographically consistent pricing requirement under s201.
  - b. Whether any costs Chorus may incur in making incentive payments to obtain contracts with RSPs meet the definition of "capex" as defined in the fibre input methodologies, and
  - c. Any general views on the consultation material published this time and how the Commission should incorporate the additional material in its final PQ decisions on Chorus' expenditure allowances.
5. These questions are discussed below.

## Incentive payments and compliance with s201

6. The Commission was right to signal concerns in its draft PQ decision that Chorus' incentive payments are inconsistent with the requirements of the Act and to decline to accept it as it was proposed.
7. The Commission has also now finalised its s201 guidance and these provide clear guidance that:
  - a. Section 201 requires price quality regulated providers to charge the same price for materially the same service wherever it is supplied.
  - b. The relevant difference in price can, for example, relate to differences between neighbours' or regions, and price includes any adjustment, incentives, rebates, or discounts associated with the service.

- c. It is the effect of the practice on end-user prices that matters rather than how prices or services are presented, i.e., that all elements that go to the value of the service provided are important as is pricing structures that lead to differences.
- 8. Chorus' current pricing initiatives that formed the basis for its expenditure proposal are – in themselves – clearly inconsistent with s201 requirements, for example:
  - a. Chorus mix it up prices are differentiated based on whether the end-user customer is currently connected to specific fibre plans, and
  - b. "Bonus" credit prices are only available to defined customers (previously "fibre ready" and currently "intact ONT" addresses).
- 9. In our earlier submission, we also set out our concerns that Chorus' connection incentives are<sup>3</sup>:
  - a. Inconsistent with s201 obligations to offer the same price for materially the same service.
  - b. Inconsistent with the non-discrimination requirements of the Deeds as the incentives have the effect of discriminating against RSPs that invest in competing telecommunications infrastructure or seek to offer entry level broadband services. For example, through pocket pricing, incentive thresholds that advantage RSPs who focus on higher speed services or offer bundles that do not include other communications services, and a requirement to only promote the fibre technology.
  - c. Potentially inertia pricing (or a loyalty penalty) that is not in end-user interests. Chorus' connection incentive construct has many of the features that the UK Financial Markets Authority identified as potentially working against end-user interests and warranting further investigation<sup>4</sup>.
- 10. Therefore, the Commission does not have a compliant expenditure proposal to consider, and the only viable option is to consider proposed expenditure through the first regulatory period through, for example, an individual capex proposal as proposed.

### **Chorus' argument that the Commission is not required to consider s201 compliance**

- 11. Chorus states in its context paper that it is "concerned about a blurring of the Commission's role in its ex-ante assessment of an envelope of expenditure with its ex-post enforcement role" and submits that "it is both unnecessary and unworkable for the Commission to reach an ex-ante compliance view of current or future incentive offers when evaluating incentive expenditure".
- 12. Chorus argues that the Commission's task when evaluating Chorus' incentive expenditure proposal is to apply the evaluation criteria in the Capex IM. In Chorus' view, the sole consideration for meeting the criteria is whether the expenditure reflects the efficient costs a prudent fibre network operator would incur to deliver PQ FFLAS of appropriate quality<sup>5</sup>.
- 13. However, rather than the bounded analysis Chorus suggests, the IMs anticipate a comprehensive assessment of expenditure that extends to compliance with legal and regulatory obligations. Clause 3.8.6 requires that the Commission must have regard to<sup>6</sup>:

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<sup>3</sup> Spark submission on Fibre PQ and ID draft decision (8 July 2021)

<sup>4</sup> Spark submission PQ draft decision from 63

<sup>5</sup> Chorus submission at 6

<sup>6</sup> IMs at 3.8.6

(a) whether the **proposed capex** complies with all applicable legal and regulatory obligations associated with the provision of **PQ FFLAS**;

[...]

(g) competition effects, including specific information for sub-categories of **capital expenditure** that have potential impacts on competition in **PQ FFLAS** and other telecommunications markets;

14. More generally, the implication of Chorus' approach is that the Commission should be comfortable providing an allowance for a category of expenditure at a general envelope level, regardless of whether Chorus is legally allowed to spend the specific contents of that envelope.
15. We think the opposite is true. The Commission must reach a view, based on reasonable evidence, on whether each element of the envelope of expenditure it provides an ex-ante capex allowance for will comply with the Act on an ex-post basis.
16. As explained in Russell McVeagh's opinion provided with our cross submission on the draft decision, under the Act a breach of s201 is contravention of a price-quality requirement<sup>7</sup>. That is, a breach of s201 is subject to the same enforcement regime as the price path determined by the Commission. The distinction Chorus seeks to make between the two tasks does not exist under the Act. It would be irrational under the Act for the Commission to set a price path (which is a price-quality requirement) that provides for Chorus to recover expenditure that contravenes a price-quality requirement. There must be a consistent approach across all components of the price-quality requirements.
17. If Chorus was correct that the Commission must distinguish between two different tasks, then the impact could be that the Commission allows the incentive payment expenditure to be recovered by Chorus at no risk under its revenue path, even if the anticipated incentives were in breach of the Act. The Commission noted in the May 2021 Draft PQ Decision that end users risked paying for forecast incentive payments that are not made in practice (e.g., Chorus simply pays the money as dividends)<sup>8</sup>. In other words, Chorus could receive a revenue allowance for costs it may not be legally allowed to incur.
18. Further, the practical effect of the Commission's obligation under section 166(2) (to make decisions that it considers best gives or is likely to best give effect to the promotion of workable competition) is that the Commission cannot make a decision to include incentive payments as recoverable before it is comfortable that these incentive payments would not breach section 201 and/or Chorus' non-discrimination obligations (**obligations**). The very purpose of the obligations is to prevent harm to competition.
19. It would therefore be contrary to s166(2) to allow for recovery of payments that are deemed to harm competition under the Act.
20. The Commission cannot at the time of making a decision meet the relevant threshold in s166(2) where it has publicly raised concerns about whether the incentives comply with the obligations. Put another way, the Commission cannot reasonably conclude that a decision to include these incentives as capex is a decision which it considers best gives or likely to best give effect to the promotion of workable competition.
21. The Commission will also need to consider its administrative law obligations in this respect. A question arises as to whether it could reasonably conclude that s166(2) is complied with when it

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<sup>7</sup> Russell McVeagh Opinion on legal risks of including incentive payments as capex for Chorus' price-quality path (5 August 2021)

<sup>8</sup> Commission *Chorus' price-quality path from 1 January 2022 –Draft decision* (27 May 2021) at 4.150

has raised valid concerns about a lack of evidence demonstrating that the obligations will in fact be complied with.

22. From Spark's perspective, if Chorus continues making incentive payments once s201 enters into force, then the Commission should expect to receive a formal complaint that the obligations are being breached. It is difficult to see how the Commission could satisfy itself that the incentive payments comply with section 201 in advance of a thorough compliance investigation, and court proceedings if necessary.
23. Finally, it appears that Chorus is encouraging the Commission to apply the capex IM as the primary legal consideration when setting its capex allowance, and to disregard the Act. Clearly the Act, under which the IMs are made, takes primacy over the IM. The IM cannot be interpreted or applied in a manner that is inconsistent with the Act's requirements.

### **Chorus argument that unspecified future incentives will comply with s201**

24. It is telling that Chorus has not provided a convincing explanation for how its incentive payments will comply with the obligations - it merely states that it has a robust assessment process to ensure that, in its view, they will.
25. To the extent that Chorus seeks to justify its payments as complying with s201, we think it misunderstands what s201 requires. It states its understanding to be that "the primary focus of GCP is to ensure that rural residential end-users pay the same price for access services as their urban counterparts". Since the incentives do not differentiate based on geographic location, and for the most part are nationally available, Chorus believes they comply.
26. There are two problems with this position.

#### ***Section 201 has broad application***

27. Section 201 is clearly expressed to require Chorus to charge the same price for providing services to any access seeker or end-user where those services are in all material respects the same. Section 201 says that this requirement applies regardless of the geographic location of the access seeker or end-user. In other words, it makes clear that geographic location, which might otherwise be a valid reason to consider a service to be different and/or to price differentially, is not.
28. We agree with the Commission's s201 guidance that under the Act the incentives form part of the price of a service. The result of the incentives offered by Chorus is that some access seekers will be paying different prices for the same service, which is prohibited by s201.
29. We think the Commission's approach to s201 is consistent with the scheme of the Act:
  - a. PQ regulation only applies in areas where Chorus is not subject to competition from other LFCs. In those areas, Chorus is not subject to the section 201 restrictions, and it can differentially price to compete with LFCs. The same does not apply to areas where Chorus is competing, for example, with FWA. Parliament has not seen it fit to allow Chorus to compete on price in those areas.
  - b. Chorus will not be able to price differentially for anchor services, consistent with section 201.
  - c. The equivalence and non-discrimination obligations also restrict Chorus' ability to price discriminate for services subject to those obligations.

- d. Section 201 therefore does not say anything out of step with other provisions - it makes clear that even if the specific restrictions above do not apply to a particular service, Chorus must still ensure that the same price is charged to each customer.
30. We therefore think it is important for the Commission to clarify that the intention of s201 is to prevent differentiated pricing for the same service, rather than the narrow interpretation Chorus seeks to adopt, which would only prevent differentiated pricing that is based on or linked to the geographic location of the end user.

***The effect of the pricing differential on customers is what counts***

31. Even if Chorus was correct that s201 only prevents pricing that differs on a geographic basis (which it does not), Chorus could not circumvent s201 by expressing differential prices to be payable based on, for example, the length of fibre required to service an end user. This would inevitably result in geographic differences in pricing - and it is the effect that counts.
32. As previously explained, Chorus' incentive offers do have a geographic impact by targeting those customers where a competing service is available. Customers in different locations will be paying a different price for the same service.
33. So, even if Chorus' incentive payments are not expressly linked to geographic location of the end-user, this does not mean the incentives comply with s201.
34. The purpose of section 201 is to discourage differential pricing to geographic or customer segments by regulated fibre providers like Chorus in response to potential entry or expansion by a competitor, known as 'pocket pricing'. In particular, section 201 was designed<sup>9</sup>:

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

35. In other words, and like the title of section 201 suggests, the purpose of this section is to ensure pricing behaviour achieves "geographically consistent pricing", and conversely to prevent pricing behaviour which would have the effect of resulting in geographically inconsistent pricing. The section would be easily circumvented if it permitted pricing practices which were not necessarily linked to or based on location, but had the effect of different prices in different locations for the same service.
36. At paragraph 43 of the guidance, the Commission provides a relatively clear cut example of pricing practices which would breach section 201 of the Act:

we consider that it would likely raise s 201 issues if Chorus offers any adjustments, incentives, rebates or discounts to access seekers linked to the geographic location of the end-user, whether at the regional, city, suburb or street level.

37. We do not understand the Commission to be saying that adjustments, incentives and discounts must always be "linked to" geographic location of the end-user for the incentive to breach section 201. Rather, we understand the Commission to agree that section 201 will be breached by incentive payments that result in differential pricing for the same service, whether or not they are linked or based on geographic criteria. In this regard, we support the Commission's view at paragraph 52 of the guidance that:

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<sup>9</sup> Telecommunications (New Regulatory Framework) Amendment Bill, Departmental Report to the Economic Development, Science and Innovation Committee, 10 April 2018 at [71].

Section 201 operates in a broader way by setting a general requirement that where Chorus supplies services that are in all material respects the same, it must charge the same price regardless of the location of the access seeker or end-user. We would accordingly be concerned if there was reason to think that Chorus was using differentiation of terms as a justification for differentiating prices in some geographic areas, and thus defeating Parliament's overall intention.

38. This statement is consistent with our view of how section 201 applies. It requires Chorus to charge the same price for the same service, regardless of where the customers are located. Chorus' incentive payments will breach that requirement, as different customers will pay different prices for the same service.

### Completing the PQ determination process

39. Accordingly, at this stage, the Commission does not have a proposal that it could approve for the first regulatory period:
- a. Chorus has submitted a non-compliant approach that cannot be accepted by the Commission.
  - b. Chorus's signalled alternatives are, concerningly, equally inconsistent with s201 and the requirements of the Act<sup>10</sup>. For example, Chorus has indicated it is considering "non-location" eligibility criteria that result in different prices, i.e., targeting a demographic in order to reduce prices at retirement villages<sup>11</sup>, and
  - c. We are not aware of any RSP consultation on potential alternatives to the current approach, and the Commission does not have a compliant initiative to consider..
40. The Commission further set out the end-user risks associated with accepting an uncertain and non-compliant proposal in its Draft PQ Decision<sup>12</sup>. The Commission concluded that an individual capex proposal would partially mitigate the end-user risks that:
- a. Prices end-users pay may be higher or lower depending on the level of the incentive payments, and on whether the incentive payments are successful in attracting and/or upselling end-users,, and
  - b. Chorus over-states the level of incentive payments and/or that end-users pay for forecast incentive payments that are not made (e.g., Chorus simply pays the money as dividends).
41. The Commission further notes that "treating the proposed incentive payments as individual capex allows a greater degree of scrutiny to ensure the payments are not excessive, over-stated or anti- competitive, and requires Chorus to ring-fence and report on them separately"<sup>13</sup>.
42. There is nothing new in the additional material that would suggest the Commission should change this approach. If anything, the additional material adds to earlier concerns in that the Chorus alternatives raise the same compliance issues. The Commission cannot accept non-compliant expenditure, and the only viable way forward is to invite Chorus to submit a compliant individual capex proposal.

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<sup>10</sup> Chorus submission at 12a

<sup>11</sup> Chorus response to question 2, last para

<sup>12</sup> Commission Draft PQ decision at 4.150-4.151

<sup>13</sup> May Draft PQ decision at 4.151

43. We would be happy to engage with Chorus and other interested to develop a compliant approach that may be submitted as an individual capex proposal. This could include, for example, wholesale price reductions across the board or variants of Devoli's recommended initiatives<sup>14</sup>.

#### Further compliance actions

44. The compliance and competition concerns with Chorus' connection incentive construct goes beyond PQ expenditure path approval. The incentives are inconsistent with s201 and non-discrimination obligations and, accordingly, the Commission should consider:

- a. Whether further compliance action is required outside the PQ determination process. Chorus' past and current connection incentives raise non-discrimination and competition concerns in their own right – i.e., outside the issue of whether they should be included in the expenditure path – and should be considered further by the Commission.

For example, Chorus' pricing structures reflects its aversion to a particular class of access seeker – i.e., those investing in telecommunications infrastructure or a business model that promotes low speed entry level services – and has the effect of discriminating against these access seekers. The Commission non-discrimination guidance are clear that such behaviour is likely inconsistent with the Fibre Deeds. The Commission should investigate Chorus' behaviour further.

- b. The implications of non-compliant expenditure contributing to the FLA. Chorus connection incentive expenditure contributes to the FLA, yet non-compliant expenditure should not form part of that calculation.
- c. Whether Chorus expenditure to pro-actively deploying fibre lead-ins should be included in the RAB (discussed below). This programme raises competition concerns – being uneconomic from a BBM perspective and weighted towards premises served by alternative networks – and relates to assets which are not employed to meet actual FFLAS demand.

Accordingly, the asset should not be included in the initial RAB. Rather, it should be included in the RAB at the time the asset is employed to provide an FFLAS service.

#### Chorus pro-active deployment programme

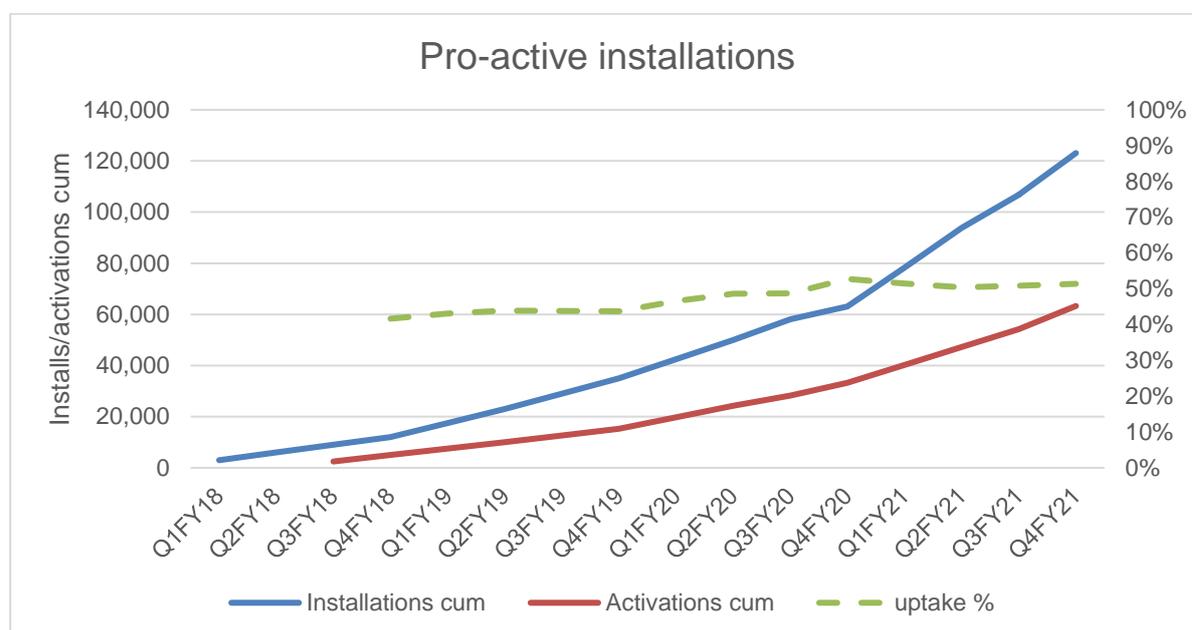
45. Chorus connection incentives included “bonus credits” for connecting premises from a defined list of “fibre ready” premises. That list was heavily weighted 70% towards premises that did not have an ONT deployed (suggesting the fibre lead-in had been pro-actively deployed) and 70% towards premises that were not connected to the Chorus network (suggesting they were customers of other networks).
46. The bonus credit initiative based on the defined list of fibre ready premises raises compliance, discrimination, and competition concerns in its own right, but the pro-active deployment approach on its own raises similar concerns.
47. Since 2018 Chorus has undertaken a programme whereby it deploys fibre lead-ins to premises for which there was no end user customer service order, i.e., making the premises “fibre ready”.

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<sup>14</sup> Devoli 15 September 2021 letter to the Commission at page 7

To date, Chorus has pro-actively deployed lead-ins to over 120,000 premises, of which only around 50% have subsequently been connected to the fibre network (Figure 1)<sup>15</sup>.

Figure 1: Chorus pro-active lead-in deployment programme



48. Further, Chorus appears to have also pro-actively installed ONTs in some customer premises, again without an end-user service order. For example, Chorus reported in August 2020<sup>16</sup> that its managed migration teams were pro-actively installing around 1,000 ONTs per week to “create easy to convert fibre leads”.
49. This is a significant \$100M+ investment that targets customers either served by alternative providers or likely to be actively considering their broadband their provider options. It is hard to envisage an efficient operator funding such capital costs without a contracted revenue stream and this calls in to questions Chorus’ purpose.
50. Further, Chorus’ June 2021 list of premises eligible for “bonus credits” suggests a heavy weighting towards end-users of alternative networks. As summarised in Figure 2,
  - a. Around 70% of the 269,000 eligible addresses were off-net, and therefore likely served by other providers<sup>17</sup>, and
  - b. Of the 191,000 single dwelling premises for which the June 2021 bonus credits were available, 2/3rd of these premises (130,000) were flagged as “off net” and almost half (89,000) did not have an ONT installed suggesting the lead-in was pro-actively installed<sup>18</sup>.

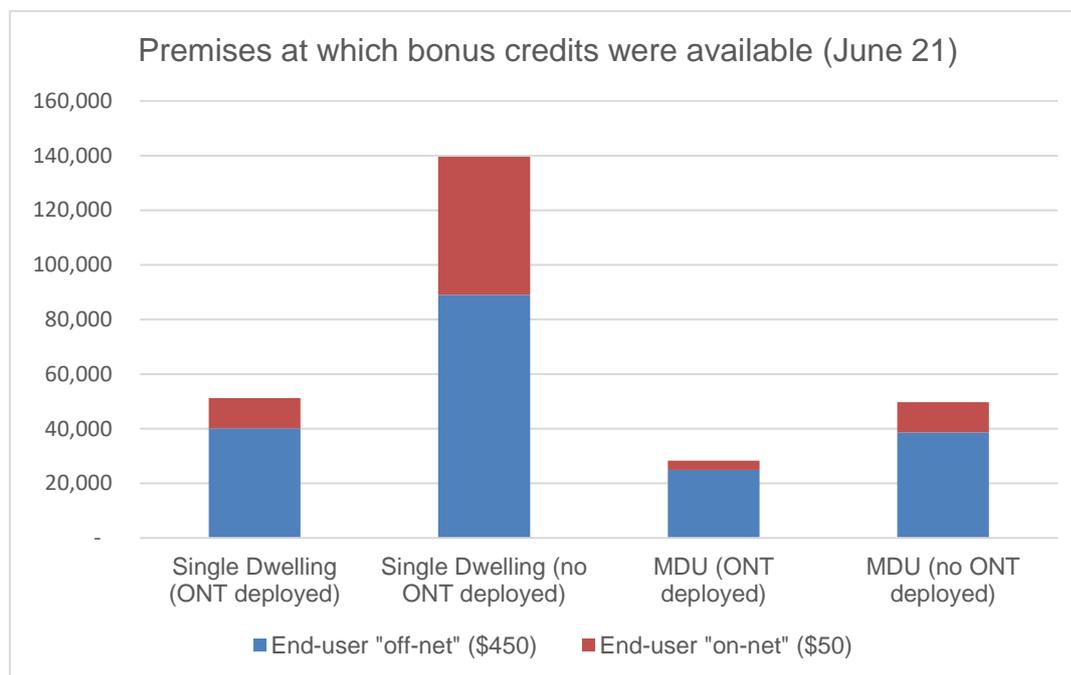
<sup>15</sup> Data from Chorus financial and quarterly connection reporting.

<sup>16</sup> <https://sp.chorus.co.nz/stories/72000-hot-fibre-leads-ready-you-connect> accessed 11 October 21

<sup>17</sup> From Chorus *Fibre Bonus Credit Eligible List (Cleaned Data) June 2021\_0* downloaded 12072021. Chorus replaced the “Fibre Ready” list from July 21 with an “Intact ONT” list which runs to 31 October 2021. Chorus has not yet announced future initiatives.

<sup>18</sup> From Chorus *Fibre Bonus Credit Eligible List (Cleaned Data) June 2021\_0* downloaded 12072021. Applying the MDU class, Offnet flag and ONT available filter. An ONT is generally installed when RSPs place a service order, although we note that Chorus also reports a pro-active ONT installation programme.

Figure 2: breakdown of June 21 bonus credits for “fibre ready” premises



51. The list of addresses eligible for bonus credits is heavily weighted towards “off-net” premises - the premises most likely served by alternative networks - and these addresses receive the highest discount (\$450 relative to \$50 for on-net addresses).
52. Further, a simplified high-level cost benefit analysis of the pro-active deployment of lead-ins suggests a loss of around \$340 per annum on every customer acquired through this programme<sup>19</sup>. While we do not agree that proposed net benefit test on its own is sufficient to demonstrate an initiative is consistent with the Part 6 purposes, a loss of this nature should be a concern. Pro-active deployment of this nature is only viable where benefits are taken elsewhere, i.e., by suppressing wider competition or retaining non-FFLAS revenues – and costs are guaranteed through the BBM.
53. We believe that Chorus’ pro-active deployment programme consciously targets customers of other networks, reflecting prohibited discriminatory and pocket pricing behaviours. The Commission should consider:
  - a. A compliance review of the pro-active installation programme.
  - b. Omit the pro-active fibre investment from the interim initial RAB and, subject to a compliance review, bring permitted values in to the RAB at the time it is finalised through 2022.

<sup>19</sup> Based on \$1224 pro-active connection capex, 50% uptake, \$600 connection incentive, average other BBM growth capex per new connection, average BBM opex per customer, 4 year acquired customer life and 12 year life of connection (from Chorus future benefits submission) and IMs draft WACC. Using Chorus updated expenditure path estimates. This estimate is slightly lower than our earlier estimate as Chorus has indicated an acquired customer life of 4 years and connection of life of 12 years for planning purposes.

At most, the fibre assets should only be included in the RAB at the time the premises are connected through a RSP service order (which is the case with all other demand driven expenditure), and

- c. Check the fibre connection forecast volumes and unit costs to ensure they net out any prohibited pro-active deployment programme. The pro-active programme could incorrectly inflate connection forecasts or, if forecast unit costs include an uplift to fund pro-active programmes, over-state permitted unit costs.

## Whether incentive payments are capex for the purposes of the BBM

54. The Commission has asked whether the incentives are capex as anticipated by the IMs. We agree that the Commission is right to question whether the incentives are capex for the purposes of the IMs and potentially the Act.
55. In the draft decision, the Commission says that whether an incentive payment is capex will require a fact-specific enquiry on a case-by-case basis. The key questions in each case, given the definitions of "capex" and "core fibre asset", would be whether:
  - a. The costs of incentive payments have been, or are intended to be, incurred in the acquisition of a "core fibre asset"; and
  - b. whether the contracts that Chorus obtains through incentive payments constitute "core fibre assets", i.e., whether they are employed (meaning "available for use") in the provision of regulated FFLAS.
56. In its open letter, the Commission invites views on whether the costs Chorus will incur in making incentive payments meet the definition of "capex" under the IM.
57. We have reviewed the information provided by Chorus and reflected on the Commission's views in the draft decision. We agree that the Commission is right to question whether the incentive payments can be capex under the IM, for a number of reasons.
58. To start with, we do not think GAAP is relevant to whether the Incentive Payments are capex. As Russell McVeagh cautions in its advice<sup>20</sup>, consistency with GAAP is not relevant to whether practices are consistent with the Act. GAAP serves an entirely different purpose to the economic regulatory framework provided for in Part 6 and the Commission should only seek to apply GAAP if doing so is consistent with the relevant provisions of Part 6. For example, if GAAP requires the Incentive Payments to be treated as capex for accounting purposes, this does not mean that it must be treated as capex for regulatory purposes and/or cannot be something else. GAAP can assist the Commission to develop rules for the value of assets entering the RAB for implementation convenience, but it is the Act and the IM that determines what should be included in the RAB and/or whether values under GAAP need to be adjusted to achieve the purposes of Part 6.
59. We note that Chorus says the purpose of its incentives is to drive demand. Broadly, they either seek a transfer of customers to fibre, or to encourage existing fibre customers to upgrade their fibre product. The incentives are not expressed to cover any capital costs involved in connecting the customer to a fibre service.
60. In fact, Devoli states in its submission that: "to date, the quantum of incentives has appeared reasonable to cover a portion of the incremental costs that an end user, retailer or wholesaler

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<sup>20</sup> Russell McVeagh at 24. While Russell McVeagh were discussing "price", the same general principles apply.

incurs to switch residential end users to a fibre service." This shows that the incentives are seen as compensation for costs incurred by parties other than Chorus.

61. The incentive payments therefore do not appear capable of meeting the definition of "capex" under the IM. The payments are not to acquire a core fibre asset, because the relevant core fibre assets have already been deployed by Chorus in areas where the incentives are provided (the point is to increase use of the assets that Chorus has already deployed). Similarly, the contracts themselves are not "core fibre assets", because they are not employed in the provision of FFLAS.
62. It would also stretch the meaning of "fibre asset" in section 177 of the Act to interpret it as including the costs of acquiring customer contracts. It is clearly focussed on assets that are used to provide FFLAS. Put simply, a contract is not employed in the provision of FFLAS to the customer - it merely creates the obligation for FFLAS to be provided (using assets that have already been deployed), and for the customer to pay.
63. In summary, the Commission is right to question whether current incentives are consistent with the IMs and the Act. For example, Chorus' current incentives appear to:
  - a. Be unrelated to a specific or identifiable FFLAS asset or cost.
  - b. Apply to an asset that is not available to be employed in the provision of FFLAS, i.e., the asset is specific to the end user and is not an asset that available to subsequent RSP or FFLAS end-users.
  - c. Be based justifications that they are a cost of acquiring an end user contract and/or a contribution to the RSP costs to acquire customers. However, these costs would sit outside the definition of FFLAS because they relate to downstream assets or retail costs.
64. We believe that the underlying difficulty is that in practice Chorus' incentive scheme is a discounted price for some end-users rather than the acquisition of a fibre asset (which is consistent with capex for the purposes of the regulatory model). Therefore, Chorus' current incentives do not sit comfortably with the definitions in the IMs or the Act.

## Further views on the consultation material

### Estimate of connected premises

65. Chorus reports that by June 2021 it had passed 1.28M premises of which 118,000 premises were not connected and had an existing lead in, and this will increase to 1.34M premises passed and 143,000 not connected by December 2022.
66. The Commission may wish to consider the updated premises passed (in UFB areas) data provided by Chorus further as:
  - a. There are a number of "yet to be connected" scenarios - i.e., based on whether there is a lead-in, fibre to an MDU or an intact ONT - and it is unclear to which scenario the Chorus data relates.

For example, as noted in Figure 2 above, Chorus offered bonus credits to 268,000 "fibre ready" premises (this is not limited to UFB areas). Ideally, the Commission would have a reconciled view against which it can assess Part 6 and discrimination concerns.

- b. The data suggests an increasing proportion of fibred premises will not be used to serve customers. While the number of premises passed will increase by 5% (1.28M to 1.43M), the number of premises with an existing lead in but not connected will increase by 20% (118,000 to 143,000).

Depending on the scenario Chorus is reporting, this may suggest an ongoing proactive lead-in deployment programme which shouldn't form part of the expenditure path as it delivers a negative return.

### Chorus expenditure proposal reconciliation

67. The Commission has also published a Chorus spreadsheet inadvertently omitted from earlier releases.
68. We agree that the table is a useful summary that highlights our concerns with Chorus' proposed approach<sup>21</sup>:

- a. That Chorus mischaracterises Commission proposed adjustments as arbitrary or implying unrealistic efficiency gains when, in practice, they primarily relate to the omission of unsupported and highly uncertain expenditure or the Commission applying the most up to date view of unit costs and volume forecasts. Chorus' characterisation of the adjustments has likely, in turn, informed investors submissions that the draft assumes unrealistic efficiency gains<sup>22</sup>.

The spreadsheet suggests that the Commission has made \$88M of efficiency adjustments that could be reversed when these relate predominantly to other concerns with Chorus' expenditure proposal<sup>23</sup>.

- b. That Chorus has, in effect, invited the Commission to calibrate the framework outcomes against valuations implied by the Chorus share price. The Commission can not engage on this basis; Part 6 does not seek a specific revenue outcome, the Commission can't omit unsupported expenditure and replace it with equally unsupported expenditure elsewhere, or boost FFLAS revenues to support Chorus' other commercial concerns.

The spreadsheet summarises Chorus proposals that Commission proposed adjustments be mitigated by making countervailing adjustments in other cost categories.

- c. That Chorus' proposed countervailing expenditure increases are not supported by detailed evidence and assurance processes and puts into question Chorus' original proposal and assurance. What should the Commission make of proposed increased expenditure when these same cost categories were previously certified by Chorus as meeting the expenditure objective?

For example, the spreadsheet highlights Chorus proposals that the \$34.5M of innovation capex that the Commission suggested be subject to an individual capex proposal should, instead, be spread across other cost categories<sup>24</sup>.

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<sup>21</sup> Spark cross-submission on *Fibre ID and PQ draft decisions* (5 August 2021).

<sup>22</sup> For example, L1 capital 30 September submission at page 4

<sup>23</sup> For example, the Spark cross-submission at Figure 1 reconciles Chorus claims against the Commission reasons for making the expenditure adjustment.

<sup>24</sup> From column headed "Reprioritise innovation".

69. The spreadsheet confirms the conclusion of our cross-submission that the Commission:
- a. Cannot engage in a negotiation of the nature suggested as that would inevitably result in an uncertain regulatory framework, undermining certainty for our sector and also Part 4 sectors regulated by the Commission.
  - b. Does not have the evidence and assurance necessary, at this stage, to accept Chorus' claimed additional costs and much of the disputed expenditure to which Chorus was concerned should be considered through individual capex proposals as proposed.

**[End]**