Vodafone Aotearoa' submission on the draft price-quality path to be applied to Chorus

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Introduction and summary

1. Nei rā te mihi ki ngā kaimahi o Te Komihana Tauhokohoko, mō te kōwhiringa, a ka taea, kia uruparetia ki te uiuinga e pā ana ki tēnei kaupapa hirahira. Thank you for the opportunity to respond to the consultation on Chorus' first price-quality path.
2. In this submission we make five points for the Commission's consideration:
    a. The draft decision may allow for competition to be harmed.
    b. The quality regime must better address incentives that Chorus may have to reduce costs by delivering a poor customer experience.
    c. Chorus' demand forecasts are overly optimistic, which has affected the revenue smoothing path and some of the expenditure forecasts.
    d. While we agree with the Commission in a number of areas regarding expenditure forecasts, there are further issues to consider.
    e. There is an overreliance on confidentiality and commercial sensitivity to withhold information in this consultation process.

Confidentiality

3. Confidentiality is sought in respect of the information in this submission that is contained within square brackets (**Confidential Information**). Confidentiality is sought for the purposes of section 9(2)(b) of the Official Information Act 1982 on the following grounds:
    a. the Confidential Information is commercially sensitive and valuable information which is confidential to Vodafone; and
    b. disclosure of the Confidential Information would be likely to prejudice unreasonably the commercial position of Vodafone.

4. We ask that the Commission notify us if it receives any request under the Official Information Act 1982 for the release of any part of the Confidential Information, and that the Commission seek and consider its views as to whether the Confidential Information remains confidential and commercially sensitive before it responds to such requests.

The draft decision may harm competition

5. The fixed telecommunications market is entering one of the most dynamic and competitive phases in its history. The success that we are seeing with uptake of fixed wireless access (**FWA**) is down to the differentiated experience that it delivers, the prices at which it's offered, and our customers' desire for choice. For many of our customers who are currently on copper, 4G FWA will provide everything they need to reliably browse, stream and video call together with a much simpler install and setup experience. 5G FWA offers even higher levels of performance and attractiveness to consumers in those areas where it is available.

6. Vodafone's cheapest home internet plan is a $40 FWA service with a 60GB cap. We also recently introduced an unlimited FWA plan for only $65 per month. These are prices that cannot be matched by fibre services given the wholesale costs that retailers face. The growth of FWA services is an outcome that the Commerce Commission as the competition watchdog should be celebrating. Instead, however, there are a number of proposals in the draft decision that provide an opportunity for Chorus to use its market power to unwind the competitive gains made. This is clearly not in the long-term interests of end-users.

7. Chorus has strong incentives to undermine FWA and its uptake by consumers. Chorus itself notes that its revenues have declined due to FWA competition and copper line loss in areas where it not building fibre.[1] Analysts have also recognised that FWA uptake and Chorus' continuing decline in share of fixed connections[2] will impede its revenue performance. In order to arrest its continuing decline in total connections, Chorus is actively seeking to discourage this uptake through in public statements[3] and by encouraging the Commission and consumers to view competing access services through the single lens of peak speed.

8. Vodafone understands that no operator with substantial market power has ever welcomed competition, and we expect Chorus to continue to do whatever it can to arrest the decline in total connections. However, choices made by the Commission in implementing fibre regulation should not assist in this.

9. There are two parts of the regime that may contribute to Chorus being able to utilise its market power to undermine competition, and they must be considered together:

    a. the ability to use the wash-up account to price below cost in the short term; and

[1] Chorus presentation to UBS Australasia Virtual Conference (17 November 2020), page 36, https://company.chorus.co.nz/file-download/download/public/2205.
[2] See Table 1 below.
[3] See, for example, https://www.chorus.co.nz/blog/lifting-hood-broadband-performance

b. the use of incentive payments to price below cost for the most price sensitive customers.

10. It is particularly important that these settings are favourable to competition from the start of the first regulatory period. Mobile operators like Vodafone are currently rolling out their 5G networks. The expectation of growing FWA market share is a significant element of the business case for this ongoing investment. But if Chorus can use its market power to shut down competition it may mean a scaling back of 5G investment and a reduction in competition. Neither outcome is consistent with the dynamic efficiencies and competitive outcomes that the Commission should be promoting through this process.

Limits must be placed on how wash-up can be used to account for pricing below cost

11. The Commission has considered (but dismissed) the inclusion of any cap on how much voluntary under-charging can be included in the wash-up account. We agree with Spark and Vocus that this will create a risk that Chorus may price below costs to reduce or distort competition.

12. We are extremely surprised that the Commission has comforted itself that this risk will not eventuate simply because Chorus *has said* that it plans to keep prices stable.[4] This ignores the obvious incentive that Chorus has to remove competition provided by other access technologies and to attract end users to consuming a very different product mix than is the case today, as we have explained previously. If simply trusting assurances that Chorus will not take advantage of its incentives were sufficient, then it is unlikely that Government would have established the Part 6 regime in the first place and the Commission should not be accepting assurances at face value.

13. The Commission also suggests that Chorus' investment needs would operate to diminish this risk.[5] This is a very simplistic view which ignores the reality that Chorus can fund investment in a number of ways. If Chorus and its investors believe that they can achieve higher long term returns by pricing lower in the short term, then there is no financing reason to stop them taking this approach. The only constraint on Chorus will be the regulatory rules that the Commission sets and how it enforces them in practice.

14. It is not acceptable for the Commission simply to dismiss the risk of pricing below cost as it has. It must reconsider its approach to how this very real risk is recognised and addressed. We propose that a similar approach is taken as that used for electricity distribution companies regulated under Part 4 of the Commerce Act. This would limit both how much voluntary under-charging can be placed in the wash-up account, but also how long these costs can remain in the wash-up account.

[4] Para 3.66
[5] ibid

Incentive payments must be carefully assessed

15. Incentive payments are a particular challenge for the regime as it is currently designed. As noted by the Commission, their mere existence suggests that Chorus would be better suited to a price cap, as it shows they have some control over fibre uptake.[6] The Commission also highlights that incentive payments may be over-forecast and under-delivered,[7] and they may result in average prices increasing.[8]

16. As a pragmatic decision, the Commission is proposing to only allow incentive payments if they are applied for as individual capex. This will allow a greater level of scrutiny and oversight of the funding requested. The Commission has also indicated that they will assess individual applications for incentive payments against the following test:

> *"is there evidence to show that the expected incremental revenues exclusively from the incremental end-users outweigh the incremental costs?"*[9]

17. This is a sensible compromise given the constraints faced by the Commission.[10] However, we make the following comments:

    a. The incremental costs considered must be both the costs of the incentive payments, and the incremental costs of servicing the connection. Chorus has indicated as part of the initial setting of the RAB that several costs categories are related to the number of connections. These costs and others like them will need to be accounted for.

    b. The incremental revenues must exceed incremental costs during the period of the incentive payment, not over a full average customer lifetime. As shown in the 2019 Electricity Price Review,[11] often the customers that seek incentive payments can be transient, shifting from one service to another as soon as an incentive ends. The Commission must not assume they will continue using fibre after any contractual period associated with the incentive payment concludes.

    c. We disagree with the Commission that the non-discrimination rules mitigate any of the risks associated with incentive payments.[12] The non-discrimination rules require that Chorus offer the same terms (including discounts) to all access seekers. It has no bearing on inter-product competition.

    d. Moreover, recent experience shows us that despite the operation of non-discrimination rules Chorus is prepared to use incentive payment mechanisms in a manner that: i) requires RSPs that sell access types other than fibre to suppress

[6] Para G20.
[7] Para G23
[8] Para 4.150.1.
[9] Para G3.1.
[10] Para G20
[11] https://www.mbie.govt.nz/assets/electricity-price-review-final-report.pdf, p2
[12] Para G37.

information to consumers about the choices available to them; and ii) unfairly disadvantages these retailers relevant to those retailer that sell fibre only.[13]

e. We find it highly unlikely that many of the recent incentive payments offered by Chorus would meet the test proposed by the Commission (at §16 above). We therefore ask that the Commission exclude these costs from the calculation of the financial losses asset.

f. Finally, the Commission must commit to moving Chorus to a price-cap for the second regulatory period to expose Chorus to demand risk so that it is better placed to determine whether an incentive payment is in end-users' long-term interests.

The quality regime must give an incentive for good customer service

18. We are disappointed with the light touch approach to quality regulation that is proposed. As noted by the Commission, "*[t]he information asymmetry between us and regulated providers is likely to be higher in PQP1 than in subsequent regulatory periods*".[14] We are therefore surprised that the Commission has decided to wind back the quality oversight of Chorus to its lowest point in the company's history. The Commission is giving Chorus the ability to achieve cost savings by choosing to reduce service levels and customer experience.

19. The fibre install experience remains a major source of complaints from our customers. There have been wait times of several months in the past, missed appointments confusion and poor workmanship. As a result, the industry negotiated with Chorus a stronger quality regime that required rebates for missed appointments. Under the proposed regime there is no reason for Chorus to continue to pay these rebates or work collaboratively with the rest of the industry to solve any service issues beyond the very basic metrics proposed. We find this approach particularly surprising given the Commission's broader focus on retail service quality issues. It is strange to us that, in the context of fibre regulation, the Commission would enable a reduction in service levels with real detriment to end users at a time where it is increasingly expecting retailers to further enhance the experience of end users. We ask that the Commission address this inconsistency.

20. A number of other risks were raised in the joint submission from 2degrees, Spark, Vocus and Vodafone on the quality aspects of the draft input methodologies.[15] The Commission appears to have given very little consideration to this submission. We ask that this is revisited and that the Commission properly considers options for intervening against behaviours that are not in end-user's interests.

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[13] [ ]

[14] Para 5.12

[15] https://comcom.govt.nz/ data/assets/pdf file/0027/206847/2degrees,-Spark,-Vocus-and-Vodafone-Submission-on-Fibre-input-methodologies-Draft-decision-28-January-2020.pdf

21. Instead of a detailed consideration of the quality risks during the first regulatory period the Commission relies on a number of other mechanisms that are unlikely to be effective:

    a. There is a heavy reliance on the regulation of the declared services.[16] This includes the 100Mbps service that is currently the most popular consumer-grade service offered by Chorus. However, we expect that this service will become less relevant over the first regulatory period as it is outcompeted on price by FWA plans and other alternatives. In practice, we do not expect this anchor service to have much market influence, and it is unlikely to constrain the terms on which Chorus' offers other services or Chorus' wider activities. Services like Hyperfibre over-cater for the needs of many New Zealanders at considerably higher prices than what can be provided using FWA. We understand that Chorus aggressive upselling to New Zealanders makes obvious commercial sense in a context where anchor services will be subject to price caps from the end-2022 whereas enhanced services will not. Chorus can avoid direct price regulation and offset revenue loss by inducing end users to move to higher priced fibre plans.

    b. There is also a reliance on competition from FWA to constrain Chorus. However, the extent of this competition is undermined by a developing narrative that the only dimension of service quality is peak speed. Alternative services such as FWA offer consumers significant flexibility, convenience and ease of set up. [

    ] However, Chorus continues to oppose FWA on the basis that highest available speed must inevitably determine the "best" choice for any consumer. If the Commission does wish to place reliance on FWA services as a source of competitive constraint, then it's critical that it takes a more sophisticated approach that recognises the range of dimensions on which consumers choose between different services.

Feedback on proposed quality metrics

22. We make the following comments on the few quality metrics that have been proposed:

    a. It may not be possible for Chorus to meet the layer 1 availability standard of only 15 minutes of downtime in any given month without substantial over-investment. When a layer 1 fibre is cut it will typically take about 15-30 minutes to repair *per fibre*. But that is only after the fault has been detected, located, and arrangements are made to fix it. These steps can reasonably take several hours.

    We recommend retaining the yearly measure from the UFB contracts. We often apply the rule of thumb that a fibre will be cut about once every 18 months. So,

[16] Para 5.67

allowing for a single event occurring once every 12 months and lasting up to two hours is reasonable.

b. The layer 2 availability standard may also be challenging. We recommend that the Commission obtain better information about cost trade-offs before finalising this metric. In cases where there is a back-up, 3 minutes is an extremely long period of time to restore a layer 2 service. However, where there is no back-up then it is unreasonably short. For example, if the reason for a layer 2 failure is a power outage, then if there is a back-up battery or generator, this should start almost instantly. However, this sort of back-up is expensive, and may add unnecessary costs to the network. If there is no back-up, then it will require deploying a mobile unit, or waiting for the power to restore, both of which are likely to take far longer than 3 minutes, especially when measured on a per month basis.

c. We agree with the performance quality standard. Port utilisation above 80% will result in a poor customer experience, however, we agree that the blunt enforcement approach chosen requires some buffer. 90% utilisation represents a good threshold for an unacceptable level of performance.

Chorus' demand forecasts re overly optimistic

23. Chorus estimates of fibre uptake are more than [ ] our own forecasts. The difference is shown in Table 1 below. This has a substantial impact on forecasts that may result in windfall gains for Chorus.

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24. Mobile operators have publicised ambitions to grow the market share of FWA over the first regulatory period so that it captures 30-40% of the fixed internet market. As 5G FWA becomes more commonplace this will create competitive pressure on Chorus and is very likely to slow fibre uptake compared to its ambitions.

25. Much of the regime already accounts for differences between forecast and actual volumes, in particular:

a. Chorus is subject to a revenue cap in the first period. That means that its revenue allowance does not change if connections are less than forecast. While we do not agree with this approach, we accept it is part of the legislative regime the Commission must implement in the first period.

b. Connections capex adjusts based on actual volumes to account for the uncertainty of uptake.

26. However, there are three places where forecast volumes are not adjusted for actuals:

a. *Assessing the smoothing of the allowable revenue*: At the moment it appears prices will remain relatively stable over the entire period. However, if Chorus' uptake forecasts are wrong then customers are vulnerable to much sharper price changes.

b. *Maintenance opex and network related capex*: As noted at paragraph 4.80 of the consultation paper, expenditure forecasts affect maintenance opex and network related capex due to changes in the system peak bandwidth forecast.

c. *Cost allocation between copper and fibre assumed in the forecasts*: This is because connections are used as the allocation method for many cost categories, particularly for opex. We note that changes to asset allocations within the period will be consulted on as part of the draft decision on Chorus initial PQ RAB. However, there is potential for final decisions on the treatment of demand forecasts to tie the Commission's hands in this later consultation.

27. The material over-estimation of uptake by Chorus is likely to generate a substantial windfall gain. We propose two changes to mitigate this risk:

a. require the use of independent forecasts of demand, such as those produced by IDC; and

b. include in the wash-up any changes in costs directly related to changes in demand. In Table A1 the Commission notes that opex and inter-period capex forecasts will not be adjusted for actuals to preserve the incentive to improve efficiency. We agree with this principle but note that in the special case of an over-forecast of connections, the differences between actual and forecast costs are not due to efficiency, so can be safely adjusted. This is also consistent with the requirements in s195 and s196 to ensure that the wash-up accounts for any under or over recover of revenue due to differences between forecast and actual demand.

Other comments on the expenditure allowances

28. Any forecasts that use historic trends from 2018 – 2022 will require extra scrutiny. When the amendments to the Telecommunications Act 2001 were passed in November 2018 it provided an incentive for Chorus to increase expenditure. After the amendment passed, Chorus was obviously aware that any unrecovered costs would be washed up into the losses asset.

29. A number of Chorus' forecasts rely on base years after 2018 – including corporate support and product sales and marketing. To avoid the error of forecasting from inflated costs, the Commission must assess whether costs since 2018 have materially changed before using them in any forecasts.

Capex

30. We support a number of the Commission's proposals on capex.

    a. We agree that corporate and IT innovation expenditure must be treated as individual capex. This will ensure the money is only added to allowable revenues if Chorus actually undertakes the project. It also allows the commission to put more oversight on this risky project.

    b. We agree with updating demand forecasts for installation expenditure, network aggregation and network transport and field sustain expenditure. However, as above more needs to be done to verify the demand forecasts proposed by Chorus.

    c. We agree with adjusting base year figures to account for over-forecasting and uncertainty. However, as noted above the Commission must take special care with base years set between 2018 and 2022 because of the perverse incentives in play at that time.

    d. We agree with removing the unjustified variations in the unit costs for connections.[17] Unit costs have remained steady since the UFB roll-out began, there is no reason to suspect that this will suddenly change over the first regulatory period.

Opex

31. We support a number of the adjustments proposed by the Commission to the opex forecasts.

    a. We agree with adjusting network maintenance to account for changes in forecast demand. However, as above we consider that more needs to be done to verify the demand forecasts proposed by Chorus and to justify price changes that happened after the Amendment Act was introduced in November 2018.

    b. We agree with accounting for the expected efficiency improvements from IT capex investments. It is important that expected efficiency savings are shared with end-users from the start of the regime.

32. Below we provide some further discussion on the corporate support expenditure, and the labour overlay, network operations and asset management.

Corporate support expenditure

33. The Commission proposes to reduce Chorus' forecast of corporate support expenditure, because of unjustified increases in costs in the years leading up to the start of the first regulatory period. We agree with reducing corporate support, but it is likely that the Commission has not gone far enough.

[17] Para 4.180

a. As covered above, there were some unnatural incentives for costs between 2018 and 2022. The Commission must consider their impact on the calculation of the base year of the forecasts.

b. The cost allocation approach used to determine the corporate support base years is likely very material. In the previous consultation it was revealed that this expense category was allocated using a totex approach. We strongly disagree with this approach, as it would result in material double-recovery with copper revenues. If this allocation method is changed then the base year data for the forecasts must also be changed.

Labour overlay, network operations and asset management

34. At paragraphs 4.75-4.76 the Commission notes that it considered reducing the labour overlay, network operations, and asset management opex to '*reflect uncertainty and unjustified expenditure*'. However, the Commission chose not to do this on the basis that it had already made significant reductions elsewhere in the opex forecast. This is not a legitimate reason to not adjust the forecasts. If the expenditure is 'unjustified' then it cannot be included. There is no maximum amount the Commission can reduce forecasts. Instead, it must search for the best estimates, rather they trying to keep to some arbitrary proximity of what Chorus itself has proposed.

Over-use of confidentiality

35. The Commission must release information in a manner that supports and enables effective consultation, subject to the terms of the Official Information Act 1982. We are concerned that a culture of 'assume it is confidential' has set in at the Commission resulting in significant information being withheld from interested persons, to a point where it is difficult to comment meaningfully on proposals.

36. For example, in our last submission we mistakenly used information from Chorus' model believing it represented their actual proposal. Although the arguments made in our submission remain good, we are now aware that these numbers were randomised to maintain (asserted) confidentiality. We have not seen any justification for taking this approach and are doubtful that any real justification exists, given this withholding relates to past information that has already been publicly sliced and diced in a number of ways in Chorus' annual reports and investor presentations.

37. As a regulated utility Chorus and the other LFCs must accept that information is publicly disclosed unless there is a very strong reason to withhold.

38. We are also concerned about the ability for the LFCs to align and provide a united front to the Commission on what information is commercially sensitive. We don't know whether this is being done directly or as a result of a 'follow the leader' approach where all LFCs adopt the same confidentiality approach as the company that discloses information first (Chorus). Regardless of this, the Commission needs to ensure the integrity of its consultation process

and we recommend that information should only be released once supplied by all LFCs so as to avoid the apparently coordinated approach to confidentiality at play.

Contact

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