CHORUS

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Anna Rawlings and Tristan Gilbertson
Chair and Telecommunications Commissioner
Commerce Commission
BY EMAIL

Dear Anna and Tristan

PART 6 IMPLEMENTATION: RISK OF REGULATORY FAILURE

I am writing on behalf of Chorus' Board on progress in implementing Part 6 of the Telecommunication Act, particularly the Commission's 27 May 2021 Draft Price Quality Determination (draft decisions).

There is a risk of significant regulatory failure in the implementation of Part 6. The current approach risks undermining the success of the UFB Public Private Partnership and weakening retail competition. We believe the draft decisions simply do not understand Chorus and its market context. They appear targeted at a hypothetical monopoly, more akin to other industries Commission staff have experience in regulating.

Chorus' circumstances are entirely different, and failure to appreciate this will have serious impact for New Zealand and consumers.

We are at real risk of repeating the mistakes that were made in the copper pricing decisions which failed to take into account the broader environmental factors affecting Chorus' ability to operate and left Chorus and investors under-compensated by several hundred million dollars. This set of decisions and the huge reduction in revenue placed Chorus under severe operating and balance sheet pressure.

My request to you, as the Commission leadership, is to provide the broader context and commercial understanding to your staff to avoid a decision that has no regard for Chorus' commercial and operating circumstances. I set out further detail below.

CURRENT PROCESSES

1. Starting RAB

As you are aware, we are very concerned by the Commission's changing the process for determining the starting RAB. Chorus currently has no certainty on the value of its business. We need clarity on when the elements of the starting RAB will be determined.

I will leave substantive matters on the value of the RAB to Chorus' submissions. I do note, however, that the fibre build has been New Zealand's largest ever PPP investment in infrastructure and our investment will have spanned more than a decade once work is completed in December 2022. The fact the rollout has been delivered on time and in line with our fixed price contracts, through a period of very high construction inflation, is exceptional. I know of no other New Zealand infrastructure programme over that period which can come near that. The severe cost and schedule overruns in other infrastructure such as transport are well known.

Had that not been achieved, Chorus and its private investors, who invested $3 for every dollar of Crown funding, risked bearing the loss and penalties associated with any performance failure, therefore they should be accorded a return that reflects the risk they took. They should also have the opportunity to recover the costs incurred building the UFB network including the costs incurred to set up and operate Chorus as a stand-alone business.

If the Commission underestimates the starting RAB, Chorus will never have the opportunity to make a normal return. The regime will have failed at the first hurdle. In establishing the starting RAB, the Commission must also remember the protections consumers already have under the anchor services mechanism.

2. Draft Price Quality Determination

Chorus now faces a competitive situation not anticipated when the UFB programme was initiated. Fixed wireless (FWA) can deliver a broadband service which, while not of the same quality or speed as fibre, still provides a credible alternative for customers.

FWA is being pushed very aggressively by the mobile network operators (MNOs), who are also the dominant retail providers of Chorus's fixed line services and fibre to consumers. MNOs have stated that they aspire to have 25%-40% percent of their customers on FWA.

The Commission knows that:

- MNOs are using their advantages as vertically integrated firms to migrate an increasing portion of their customers onto FWA, including targeting areas where fibre is just about to be rolled out but is not yet available.
- Unlike fibre, FWA is not subject to the price or quality regulation. Whereas Chorus cannot market directly to consumers and must offer all the same pricing. The FWA providers have no such constraints. This is a huge competitive advantage
- While Chorus has invested in a strong public information campaign to provide consumers sufficient information to make an informed choice and offers incentive to all RSP's to promote fibre uptake. We are still operating on a severely tilted field - and cannot do anything about poor sales practices that have been employed at times to achieve FWA uptake.

Despite this, the draft Commission decisions state that FWA is not a substitute for fibre and decline capex we use for incentive payments to RSPs (including the

MNOs) to drive fibre uptake. Further, they make arbitrary cuts to our operating expenses.

This ignores the deep deliberation Chorus directors and management made in approving that outlay. Currently, we are outside our debt to EBITDA credit rating thresholds with both Moody's and S&P and risk a credit rating downgrade, which would have serious consequences. As a result we manage our cash outlays extraordinarily tightly and any decision to spend cash on marketing or incentives is carefully considered by an experienced board and scrutinised by our investors.

The Commission's proposal that we reapply for a pool of incentive capex under an individual CAPEX process is not workable. Its final CAPEX decision will not be known until November 2021, leaving no time to reapply given the 1 January 2022 deadline. This leaves Chorus in a position where its ability to use incentives to drive demand for fibre is at real risk. The Commission is overseeing a potential market failure in retail markets as it is removing Chorus' ability to respond to FWA or compete on anything even approaching an even footing. We fail to see how this will improve outcomes for consumers.

Chorus' incentives to tightly control spending apply more broadly across the business. That the Commission should apply further savings is, at best, arbitrary. Our approach to the expenditure proposal from the outset has not been to adopt a negotiating stance by submitting higher than required expenditure in the expectation of Commission cuts. There is a significant chance that these cuts will limit Chorus' ability to continue to deliver for consumers.

NEXT STEPS

Despite the success of the UFB roll-out, we believe New Zealanders will not realise the full benefits of fibre services if the Commission maintains its current course on the implementation of Part 6. Chorus cannot afford to maintain and keep ahead of consumer demand for its fibre network if the draft decisions do not reflect the commercial realities of operating a network in a competitive environment.

Since February this year Chorus has seen a reduction of more than $670 million in market capitalisation as potential RAB and MAR outcomes have been indicated to the market. The recent draft MAR decision has compounded investors' concerns about the regulatory process and the prospect of a fair return for the UFB investment. Attached for the Commission's information is a summary of a report undertaken by New Street Research. This report reflects the tenor of the feedback we are receiving from the investment community.

We have already responded to investor feedback in part by stating that we will not invest in further expansion of the fibre footprint given the current settings for WACC and treatment of Crown funding. Investors are now suggesting that we constrain further discretionary investment in fibre until regulatory outcomes are clear.

While the incremental decisions to date have, in our view, been negative for investment in fibre networks and, ultimately, for consumers, there is still time to achieve final price-quality decisions that will deliver the full potential of fibre for New Zealand. Our submissions on the Commission consultations will set out our positions.

Thank you for your consideration of these issues.

Yours sincerely

Patrick Strange
Chairman