DEVILISHLY CLEVER AUTOMATION

devoli

Commerce Commission
PO Box 2351
Wellington 6140
New Zealand

Attention: Wendy MacLucas

15 September 2021

Consultation on the treatment of Chorus incentives as part of Chorus' fibre price quality determination

Dear Wendy

We are writing to you on behalf of **Devoli** - NZ's leading, truly independent, wholesale broadband service provider representing our >500 wholesale partners and >60,000 end users. Our success has occurred because of the industry structure and market participant behaviour. As one of the fastest growing suppliers of fixed broadband services to residential end users, we have delivered significant benefits to those end users with end user prices significantly lower[1] than pre-UFB and structural separation environments, and prices offered by the incumbent fixed line broadband retailers.

As a small organisation "being the David to the Goliaths" we have not historically engaged in debate on regulatory matters, instead we prefer to focus on delivering great service to our customers and their end users, playing by the rules, but always focussing on the value that end users can achieve from being connected to the best broadband service that they can afford. It has been a long and hard struggle for Devoli to get to where it is at and we are concerned that regulatory decisions may be made that move the industry backwards and return market power to Spark, Vodafone and 2 Degrees.

Our submission relates to the pivotal moment soon to be upon the industry as inter-modal competition arrives in the form of 5G mobile services being able to introduce competition for entry level and potential mass market fixed line broadband services. Specifically we are concerned that the Chorus may alter their current business practices to satisfy a regulatory determination to the disadvantage of end users and solely to the benefit of the vertically integrated mobile operators.

The information contained in our submission is provided in confidence given the commercially sensitive topics discussed.

[1] Our largest retail partner has a focus on "every day low prices" to broadband customers with prices $40-$50 lower each month on fibre-based plans relative to copper based plans and $5-10 cheaper than competitor fibre plans

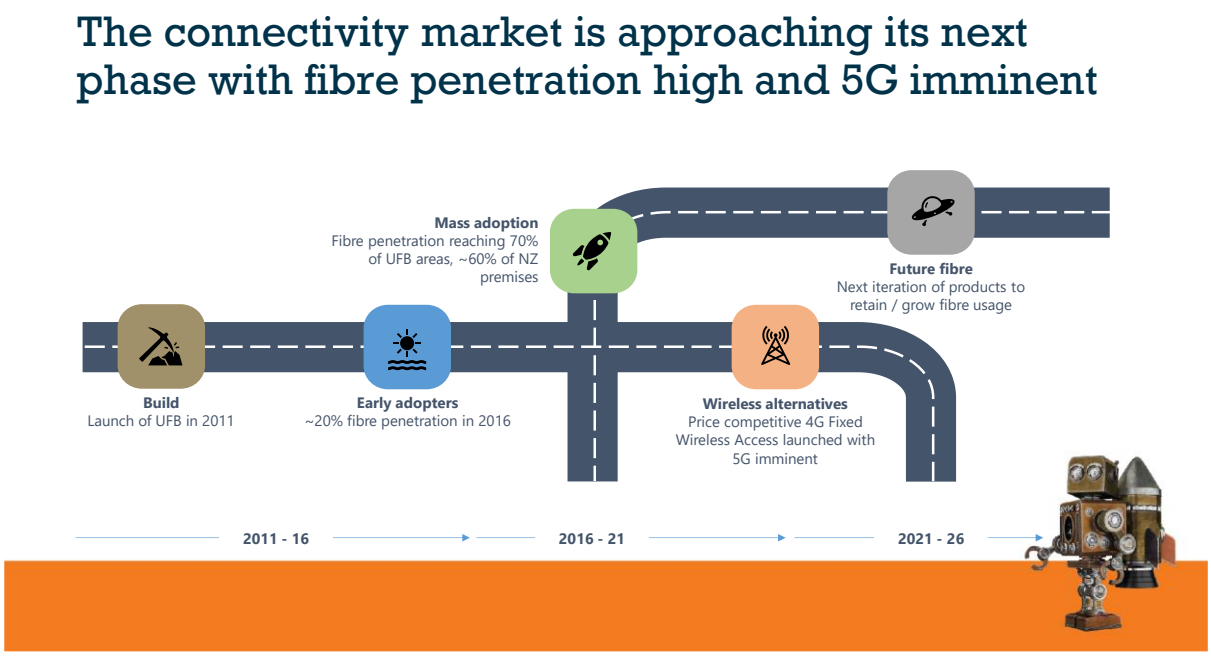
Our understanding of the fibre based broadband market

We are very supportive of Chorus' effort to engage with the industry and evolve the range of fibre products available to the market. To date, the way that Chorus has operated and the commercial terms in place has allowed companies such as Devoli to thrive.

As recent entrants into the broadband market, and collectively as one of the fastest growing retail service providers of fibre products, our growth has been achieved by:

- **Simple and clear messaging** - Broadband is complex technology service that many end users do not understand.
- **Market leading pricing** – we position ourselves as market leaders on price across most segments
- **Removal of contracts** –many of Devoli's customers have avoided placing time based contractual terms on end users. This provides flexibility and appeal but does increase the commercial risk borne by Devoli given the nature of the Chorus commercial terms and incentives
- Seeking to **remove other impediments** for end user adoption – to date this has focussed on subsidising the cost of any in home devices and not on-charging any ancillary Chorus fees.

However, as the fibre market reaches penetration, and realistic alternative networks are deployed (such as 5G based wireless broadband), we believe that the future fibre connectivity products need to reflect the changing market.



Change 1 - There is an increasing digital divide growing in NZ on two fronts:

- Geographically – there is a significant difference in access to broadband depending on where the Government and LFC's are electing to deploy fibre. Despite rising prices for copper-based broadband, there has been little to no improvement in speeds or performance. While the RBI programme seeks to improve access to broadband, the service is generally not a reasonable substitute for fixed line based solutions and is limited in its coverage and availability.
- Economically – Fibre based broadband adoption in low socio-economic suburbs is below the adoption rates of wealthier suburbs driven by the low levels of discretionary income and relatively cheaper wireless-based services that offer additional features such as mobility.

Change 2 – Inter-modal competition is finally becoming a reality

- Investment in 4G and 5G networks has continued to improve the performance of terrestrial wireless broadband and the emergence of global satellite-based services, such as Starlink, has started to create realistic network competition for fixed line broadband
- Overseas experiences indicate that 5G services are being offered as alternatives to fibre-based broadband with headline speeds of up to 750mbs and prices akin or below current 100mb and 1gb. And we are aware of many NZ'ers who live outside the UFB footprint are interested in Starlink given the poor performance of copper, RBI, and other wireless broadband solutions.

Change 3 – Fibre penetration appears to be reaching levels of market saturation

- Growth rates in fibre connections appear to be slowing with most of the growth correlating directly with expansion of the UFB footprint
- As a market matures, it becomes more difficult to convince laggards to migrate albeit removing copper may re-energise fibre migrations
- Margins being earnt by many of the growing broadband providers is close to zero on key plans. This has been achievable to date as most retail providers have other profit pools, derived from a wide range of mobile, energy and entertainment services, that they are using to subsidise fibre broadband market entry and growth. As growth slows, so will the retailer desire to price at zero margin.

Below is our understanding of where retailers are earning margins. As can be seen, fibre end users are benefiting from the current market structure and behaviour as there is limited margin being made by the retailers. From a network provider perspective, we note that reasonable margins are being earnt (on both fixed and wireless networks) and that vertically integrated operators such as Spark, 2 Degrees and Vodafone are able to capture margins at both retailer and network level on wireless products.

[redacted]

Example gross margin earnt derived from price leading residential retail plans. Excludes costs of CPE, benefits of customer incentives and customer communication and servicing costs.

As can be seen, any adverse change to the Chorus incentive framework will mean that retailers are most likely to **pass on the change by way of higher prices** to end users.

Because of the changes noted above, there are flow on effects to the future competitiveness of broadband markets. We expect the market to evolve in the next 12-18 months towards:

- A shift of focus from acquisition to optimisation. Current customer acquisition led offers will become rarer as retailers seek to earn a reasonable return across their portfolio of products.
- Marketing and offers to move away from the speed / price trade off with subtle differences:
    - For price sensitive customers and the pending mass marketing of 5G wireless services, we expect there to be a robust fight for customers who can only afford broadband below current pricing levels (i.e. sub $60 per month)
    - For mass customers (i.e. those on 100mb plans), a value conversation needs to be held to ensure that they do not "spin down" to a lower priced offer
    - For premium customers, the focus will shift to the benefits and value created from current and future premium offerings. This will mean a focus shift to what the end user is doing with the connectivity rather than the connectivity itself.

How Chorus incentives have enabled competition and benefits for end users

Chorus' current process and quantum of incentives appear to be benefiting competition and end user. From our perspective, the incentives play a critical role in the development of our go to market activities and wholesale pricing which, almost always, the benefits of the incentives are passed onto the end user by way of reduction of up-front transition costs[2]. As a small, nimble organisation we are **satisfied with the quarterly processes that Chorus operate** to consult and set our marketing and broadband pricing plans.

[2] Such as installation charges, end user cost of transition or for reducing the cost of newly required CPE

We also note that switching customers will become more complex in the future as fibre penetration increases (meaning that the late adopters and laggards will require greater effort to switch) and competition increases (such as 4G and 5G mobile network alternatives). We note that the Commerce Commission has already raised concerns around the way alternative network products are being communicated and there is material risk that end users remain confused and will base their supplier choices purely on price.

From a process perspective, it is **unclear what benefit introducing regulatory review would add**. Chorus already engages widely with its customers, has a good understanding of the needs of end users and what other network competitors are offering that it uses to design their incentive schemes. Slowing down this process or introducing views of well-intentioned, but ultimately not impacted, parties such as the Commerce Commission would adversely impact our business and the flow on benefits to end users. It's unclear what new information or benefit that the Commerce Commission can add to the current processes other than the potential for gaming of the system by Chorus' vertically integrated mobile network competitors.

To date, the **quantum of incentives has appeared reasonable** to cover a portion of the incremental costs that an end user, retailer or wholesaler incurs to switch residential end users to a fibre service. While this has been effective, it would not appear that Chorus have considered, or are willing to forego, the future margin that they will earn from the end user being connected to their network. This approach means that arguments that the incentives should be considered as part of the price are weak. It does however highlight a concern that we have, that the cost of the incentive is being recovered very quickly by way of price and that a fairer approach would be to recover the cost of the incentive over the life of the asset that should give rise to lower long-term prices charged by Chorus.

Looking ahead, we believe that the **quantum of incentives needs to increase** to further encourage late adopters and laggards to switch networks and, for those already connected, move away from the transition costs to potentially subsidising the cost of the services that drive higher bandwidth services (such as Hyperfibre).

Hampering Chorus, and therefore our, ability to compete on price by reducing the timeliness and effectiveness of Chorus incentives at the same time as the vertically integrated mobile operators are misleading customers, would appear to be a backward step, from our experience, in a reasonable and fair competitive market and may have adverse impact on end users.

How vertically integrated mobile operators may be gaming the system to their own benefit

It should not be lost on the Commerce Commission that the regular and vocal respondents to fixed line regulatory matters also happen to be the owners of vertically integrated mobile businesses. Currently, the three mobile network operators account for 2/3rds of the retail broadband market and have the most to lose from continued competition in the retail broadband market and a clear opportunity to gain both retail and network-based returns in the mobile market. While the industry structural changes have been effective at creating an environment where non-telco retailers, and emerging telcos such as Devoli, have been able to gain market share, these players are only gaining

~1% market share per annum. The **retail broadband market remains concentrated in the hands of the legacy integrated telco's** and will continue to do so for some time.

To make matters worse, **those same players dominate the mobile market with 99% share of the retail mobile market**. These same operators will not be bound by the restrictions placed on Chorus and are free to offer incentives[3], such as free devices and free trial periods, to encourage end users to switch to their networks. They are also able to bundle fixed, wireless broadband with mobile services by offering bundle discounts of ~$10 per month if fixed line services are coupled with mobile services. These operators are clearly willing to restrict Chorus through regulatory means while ignoring their own arguments when it comes to their own mobile network-based services. Coupled with their unwillingness to offer competitive wholesale access terms, it would appear that the mobile operators are gaming the system for their own benefit at the expense of end users.

Hampering Chorus' ability to create an even playing field for market participants such as Devoli by way of incentives seems to go against the goals of increased competition and increased benefits for end users.

How we think Chorus incentives should be treated

Without appropriate incentives designed to reduce the impediment of switching networks, then demand for fibre-based services will decline. A simple and clear process where Chorus can engage with market participants to design appropriate incentives should be retained such that marker participants can plan and arrange their business for the ultimate end user of benefits. We do not see any reason for the current process that Chorus follows to be interrupted by way of a complex regulatory approval process. The process has allowed Devoli to be successful, to optimise its own development and investment programme and, through our partners, deliver attractive offers to end users. Changing the process will create uncertainty and slow down businesses such as ours to the lowest common denominator – often to the advantage of the incumbents such as Spark, Vodafone and 2 Degrees.

Currently Chorus capitalises the incentives in accordance with generally accepted accounting practice and amortises the incentives over the life of the customer. We believe that the accounting standards are too prescriptive in their nature and do not reflect the length of the economic benefit obtained by Chorus. History would show that, more often than not, the customer remains connected to the fibre network well beyond the contracted period that the incentives are amortised against. We propose that the capitalised incentives should be **spread over the life of the asset (i.e. 25+ years)** which would, as Sparks submission stated, remove the concern that the incentives become "risk free" investments given that the incentives can be recovered through the regulatory pricing framework. By amortising over the life of the asset, Chorus retains an element of risk should the end user opt to switch to an alternative service.

[3] Most mobile operators have offered subsidised devices as part of mobile only plans for many years and are currently offering significant incentives for their Fixed Wireless Broadband services of up to $150 (credits), free devices (modems and Wi-Fi CPE) and ~$10 per month discount off mobile services

We have commenced discussions with Chorus on how the incentive framework needs to evolve as fibre penetration approaches saturation. We believe that the incentives need to:

- Increase in the case of business services to reflect the significant switching costs that are borne by businesses in their own internal network elements to leverage the advantages of higher fibre specification services
- Increase and widen in the case of residential services – the current incentive framework covers the cost of installation and the cost of initial CEP costs (i.e. modems, routers, Wi-Fi mesh networks). For Chorus, the challenge is to justify their premium services (such as the 1gb plan and Hyperfibre services) which requires a shift of incentives from the physical equipment to one focussed on the services that require higher speeds such as low latency, high bandwidth services.

Alternative methods for the Commission to consider to enable effective competition and ultimately the benefit of end users

We note that the Commerce Commission has undertaken several studies into the effectiveness of competition in the mobile industry. Devoli is currently exploring the opportunity to take our success in the fixed line broadband market into the mobile market. Our early interactions, other than with one operator, have been largely fruitless as the behaviour of two of the three major mobile operators is focussed on protecting their excessive returns on capital, reducing competition, offering unrealistic wholesale access terms and prices, and restricting the benefits of competition and innovation for end users.

Should the Commission retain its proposed regulatory decision on Chorus, then we ask that the Commission consider:

- Discounting the views of the vertically integrated mobile operators, who are also dominant retail fixed line broadband providers, and focussing on the views of unconflicted broadband providers such as Devoli; and /or
- Prevention of similar constructs on other network providers to ensure that Chorus can compete effectively; and /or
- Establishment of a robust wholesale access to the mobile infrastructure by way of regulated resale or wholesale services; and /or
- Operational or structural separation of the mobile broadband market in a manner successfully established in NZ on the fixed broadband networks over a decade ago

Conclusion

We see no reason to add complexity to an environment that is working for the benefit of end users, albeit we seek some tweaks to the way that Chorus incentives are measured for the purposes of determining the effective regulatory price for fixed line broadband services.

We hope you take our views into consideration and are happy to discuss the matters raised in this letter with you at your convenience.

Kind regards

Karl Rosnell

CEO,
Devoli