Chorus' proposed expenditure for PQP2

2degrees' Response to Commerce Commission consultation

December 2023

PUBLIC

Executive summary

2degrees has significant concerns about the extent to which Chorus has demonstrated its PQP2 expenditure proposal is justified and efficient.

There appear to be a large number of examples – in both absolute terms and relative to Part 4 electricity precedent – where the independent verifier was not able to verify Chorus' expenditure in certain areas (e.g. customer operations, marketing, and network maintenance) and/or that the proposal would meet the evaluation criteria and other concerns. This raises questions about the adequacy of Chorus' proposals/justifications for the expenditure.

These concerns are exacerbated by the apparent absence or only limited feedback loop whereby Chorus has adjusted its proposals in light of the independent verifier feedback, a process we understand has worked effectively under Part 4 of the Commerce Act.

Process issues

The timeframe for submissions (4 weeks plus 2 weeks for cross-submissions) is not sufficient to allow stakeholders to fully engage or scrutinise Chorus' expenditure proposals.

One of the implications of the limited timeframe for submissions is that it puts substantially more onus on the Commerce Commission to ensure that Chorus' expenditure proposal is well justified and to the long-term benefit of end-users.

Cost allocation

Chorus is proposing a very large number of changes in allocators that uniformly increase the amount of costs that would be allocated to fibre services.

We consider that review of allocators should include a range of different possible options, including quantified impact, rather than simply Chorus' preferred allocator options. If all the changes Chorus was proposing to the allocators were "objectively justifiable and demonstrably reasonable" we would not generally expect them all to change the allocation in Chorus' financial favour.

Extra care is needed in considering changes to allocators as, given the regulated price of copper services is fixed, the Commission will not see the normal 'see-saw' effect of a change that increases allocation to one service resulting in a reduction in allocation to (and reduction in regulated price for) another service. The Commission should be particularly careful to ensure the impact of the proposed changes is not simply to increase FFLAS prices and loosen the limitations on excessive profits (contrary to the section 162(d) purpose).

Marketing

2degrees has concerns about the use of regulated revenue from provision of monopoly services in order to 'compete' with RSPs using alternative technologies. This undermines competition and the purpose of Chorus' separation under the Act.

We note the independent verifier wasn't able to verify "Product, sales, and marketing" expenditure of $115 million against all assessment factors. We expect the Commission to question the proposed usage of these funds, including the specific spend and justification for its sizeable marketing costs under the regulatory framework.

We do not consider Chorus' argument that "large RSPs have an incentive to promote alternatives to fibre" is an argument for its own marketing.[1]

We also do not see it as Chorus' role to act as a de facto regulator and use its own marketing to compare what it says is "a sometimes-confusing range of technology and product alternatives available to end-users."[2]

Unlike RSPs, Chorus is not a signatory to the TCF Broadband Marketing Code - a Code put in place to give effect to the Commission Marketing for Alternative Services Guidelines and to ensure alternative broadband services are marketed appropriately.

Regulated revenue effectively gives Chorus a 'free' option for use of marketing targeted at end-users and targeted at minimising the extent to which end-users consider alternative and competing technologies. This goes well beyond "raising awareness of fibre as a category" and blurs the line between Chorus' role as a provider of a wholesale platform into actively engaging in retail activity.

In our view, if the Commission supports Chorus engaging in this marketing activity (by allowing it to recover this in its regulated revenue) then it should also support Chorus complying with the same marketing rules as RSPs, and becoming a signatory to the TCF Broadband Marketing Code.

Network resilience expenditure

The storms and cyclones the North Island experienced this year highlight the importance of robust and resilient network infrastructure.

2degrees is supportive of expenditure where: (i) the extent to which it will increase network resilience can be measured; and (ii) the benefits to end-users from the improvement outweigh the costs i.e. the investment better ensures FFLAS services are of a quality that reflects end-user demands (section 162(c) purpose).

[1] Chorus, Our Fibre Assets 2023.
[2] Chorus, Our Fibre Assets 2023.

We agree with Spark that “any substantive new investment programme [should] be considered through individual capex proposals”.[3] It may be useful for the Commission to clarify when expenditure should and should not be proposed through an individual capex proposal versus base capex.

Network extension

2degrees shares Spark’s view that Chorus’ expenditure proposal for network extension is not ‘business as usual’ and should be dealt with through an individual capex proposal rather than as part of the expenditure proposal for the price-quality path determination[4] or otherwise through the established Crown Infrastructure Partners (CIP) process for funding fibre coverage.[5]

The proposal to spend $201 million to supply a further 40,506 customers (at nearly $5,000 per premise) is considerable additional expenditure well in excess of the $5 million threshold for individual capex proposals. This is one of the most significant expenditure items in Chorus’ proposal.

We consider that the Commission’s incremental cost versus incremental revenue (subsidy-free) test may provide a bright-line for where network extension would be justified under Telecommunications Act testing. The range of different tests Chorus has canvassed highlights the lack of prescription and certainty provided by the Capex IM.[6]

2degrees also agrees with Spark that “To the extent there are wider benefits that justify policy intervention, these should be considered by Government rather than through the Commission and Telecommunications Act.”[7]

Chorus relies on arguments about “the inequality faced by the 650,000 New Zealanders caught on the wrong side of an ever-growing digital divide”, “rural programmes … are likely to require ongoing subsidies for capacity upgrades”, “Improving rural connectivity is in line with [the previous] government policy”, and “The Fibre Frontier investment was deemed by [survey] participants to “directly address fairness & equity and regional economic growth”.

[3] Spark, Fibre price-quality regulation: process and approach for the 2025-2028 regulatory period, 28 September 2023.
[4] Spark, Fibre price-quality regulation: process and approach for the 2025-2028 regulatory period, 28 September 2023.
[5] Spark, Fibre ID and PQ draft decisions, cross-submission, 5 August 2021.
[6] See, for example, Chorus, Our Fibre Assets 2023, Figure 15.5.
[7] Spark make a sensible distinction between expenditure on network extensions and ““BAU” expenditure for extending fibre to, for example, new sub-divisions”.

Introduction

2degrees welcomes the opportunity to submit in response to Chorus' expenditure proposal for PQP2.

We have significant concerns about the extent to which Chorus has demonstrated its expenditure proposal is justified and efficient.

We are also concerned Chorus is relying on wider public policy/social justifications (including social benefits) for network extension, rather than the framework the Commission must apply under Part 6 which is based on efficiency, replicating workably competitive market outcomes and promotion of competition.

Process issues

The timeframe for submissions (4 weeks plus 2 weeks for cross-submissions) is not sufficient to allow stakeholders to fully engage or scrutinise Chorus' expenditure proposals.

There is a very large volume of material released as part of the consultation. The tight timeframe has meant we have had to rely principally on the Commerce Commission's consultation paper and limited elements only of the Chorus documentation.

We share the previous concern expressed by One NZ that "It is critical that stakeholders are provided with sufficient time to engage with and submit on all relevant documents … The regulatory settings that will apply to Chorus in PQP2 will have an impact on the wider telecommunications market and end users of fibre services, particularly as regards the prices paid and quality of service experienced by end users of fibre services, and it is important that the proposals are sufficiently scrutinised before the regulatory settings post 2025 are determined by the Commission."[8]

In response to One NZ, the Commission commented that "The timeframes have been designed to enable us to meet our obligations under the IMs and reflect similar timeframes we have used previously." 2degrees and other stakeholders have previously raised concerns about the timeframes provided for submissions,[9] so we do not consider referencing previous precedent to be a strong argument. Also, while we acknowledge the Commission is working to deadlines that cannot necessarily be shifted, the alternative would have been for Chorus to submit its proposal earlier to give stakeholders more time to review and submit.

[8] One NZ submission on fibre price-quality regulation: proposed process and approach for the 2025-2028 regulatory period, 28 September 2023.
[9] We have raised these types of issues previously e.g. https://comcom.govt.nz/__data/assets/pdf_file/0018/226710/Two-Degrees-Submission-on-PQID-process-and-approach-paper-14-October-2020.pdf.

It would also be helpful that where material could be released prior to the consultation that this happens, rather than ‘omnibus’ release of all material at the same time the Commerce Commission consultation paper is released.

One of the implications of the limited timeframe for submissions is that it puts substantially more onus on the Commerce Commission to ensure the Chorus’ expenditure proposal is well justified and to the long-term benefit of end-users. There is much less scope for the Commerce Commission to rely on stakeholder/access seeker scrutiny and submissions.

Independent verification

2degrees continues to support independent verification. From what we understand, the independent verification process appears to work relatively well in relation to Transpower’s individual price-quality path (IPP)/expenditure proposals and electricity distributor customised price-quality path (CPP) applications under Part 4 of the Commerce Act.

However, in relation to Chorus’ expenditure proposal, we are concerned there appear to be a very large number of examples where the independent verifier was not able to verify Chorus’ expenditure in certain areas (e.g. customer operations, marketing, and network maintenance) and/or that the proposal would meet the evaluation criteria and other concerns. This raises questions about the adequacy of Chorus’ proposals/justifications for the expenditure. This appears to be exacerbated by the absence or limited extent of a feedback loop whereby Chorus adjusts its proposals in light of the independent verifier feedback.

This appears to contrast (unfavourably) with Part 4 (Commerce Act) precedent. Transpower, for example, which is also going through its expenditure proposal/price-quality reset process, updated its plans to incorporate feedback and new information following stakeholder and customer engagement, and use of an independent verifier (GHD Advisory). One element of the proposal GHD rejected was $15.4 million for "other AC substation equipment" due to the lack of supporting information. In response, Transpower removed the transformer expenditure and increased the information around the AC substation equipment.[10]

Cost allocation and double-recovery risk

2degrees and other stakeholders have previously raised concerns about double-recovery (whereby costs that are recovered through copper prices are also recovered through fibre). This issue has not gone away and is heightened with Chorus’ proposals to change allocators in a way that would result in higher allocation of costs to the fibre (FFLAS) business. We agree with One NZ that “the Commission

[10] Transpower, Regulatory control period 4 proposal April 2025 – March 2030, November 2023, available.

must prevent any proposals that enable double recovery of shared costs across FFLAS and services that are outside of the PQ regulatory regime."[11]

The other way to look at this, as Incenta point out, is that "common … costs should be recovered (<u>but only recovered once</u>) across all services." [emphasis added][12] Incenta also make the point that "the amount of cost that Chorus is able to recover from … other regulated services [principally copper] … cannot be changed, given those prices … are a CPI-escalated version of prices originally determined according to a total service long-run incremental cost (TSLRIC) method."[13] This highlights the care that is needed in considering changes to allocators as you will not have the normal 'see-saw' effect of a change that increases allocation to one service resulting in reduction in allocation to (and reduction in regulated price for) another service.

Chorus is proposing a very large number of changes in allocators that uniformly increase the amount of costs that would be allocated to fibre services. It is not apparent to 2degrees that the Commission should accept any of the changes. This contrasts with cost allocation for electricity distribution businesses (EDBs) and airports, which Incenta points out have made very few changes and which include changes in allocations which result in both increases and decreases in allocation to the regulated business, with airport changes resulting in net reductions.

The issue of potential over-allocation appears to be systematic with Chorus.[14] We again find ourselves in the position of having concerns that "It doesn't appear that Chorus has met the Commission's requirement that "The choice of allocators must also be objectively justifiable and demonstrably reasonable". The approach Chorus is proposing for allocators/proxy allocators appear to systematically result in a higher allocation of shared costs/assets to FFLAS."[15]

This may simply reflect the Commission's observation that "… regulated providers have incentives to increase the allocation of shared costs to regulated FFLAS, and recover the revenue relating to these costs following implementation".[16]

We do not consider the Chorus' cost allocation/allocator proposals to be well justified, including in Chorus' Incenta report. It appears Chorus' proposed allocators have the effect of maximising the amount of costs that would be allocated to fibre services. We consider that review of allocators should include a range of different possible options, including quantified impact, rather than simply Chorus' preferred (profit maximising) option.

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[11] One NZ submission on fibre price-quality regulation: proposed process and approach for the 2025-2028 regulatory period, 28 September 2023.
[12] Incenta, Cost allocation issues for RP2, October 2023.
[13] Incenta, Cost allocation issues for RP2, October 2023.
[14] We also previously raised concerns about Chorus allocating 100% of various shared assets to its fibre business: 2degrees, Chorus' price-quality path from 1 January 2022 – Draft decision Reasons paper, 8 July 2021.
[15] 2degrees, Consultation on Chorus' initial price quality RAB proposal, 28 May 2021.
[16] Commerce Commission, Fibre input methodologies: Draft decision - reasons paper, 19 November 2019, paragraph 3.174.

The Commission should be particularly careful to ensure the impact of the proposed changes is not simply to increase FFLAS prices and loosen the limitations on excessive profits.

Marketing

2degrees has concerns about the use of regulated revenue from provision of monopoly services in order to ‘compete’ with RSPs using alternative technologies.

We note the independent verifier wasn’t able to verify “Product, sales, and marketing” expenditure of $115 million against all assessment factors.

We do not consider Chorus’ argument that “large RSPs have an incentive to promote alternatives to fibre” is an argument for its own marketing.[17]

We also do not see it as Chorus’ role to act as a de facto regulator and use marketing to help resolve what it considers “a sometimes-confusing range of technology and product alternatives available to end-users.”[18]

We are similarly concerned about Chorus’ “strong interest in ensuring end-users in Aotearoa understand the relative merits of fibre”.[19] Regulated revenue effectively gives Chorus a ‘free’ option for use of marketing targeted at end-users and targeted at minimising the extent to which end-users consider alternative and competing technologies. This goes well beyond “raising awareness of fibre as a category” and blurs the line between Chorus’ role as a provider of a wholesale platform into actively engaging in retail activity.

We do not consider that all the information Chorus has provided is fair and, overall, it seems to create a more negative impression about other technologies than justified, including in areas outside Chorus’ fibre footprint. In this respect, given the Commission’s position on RSP marketing and promotion of other technologies, we consider that Chorus should be subject to the same rules and requirements as RSPs for any end-user facing marketing it may engage in or that may be provided for under its regulated price-path.

Just because Chorus is a wholesaler, rather than a retailer, does not mean that the TCF Broadband Marketing Code’s requirement that providers to “[Present] fair and accurate information about the speed and performance of broadband plans in marketing collateral” and to “Not mislead consumers on speed and performance indicators” is in anyway less relevant or applicable.[20] The LFC letter of commitment is limited in its scope compared to the Code as it focusses on what the LFCs will say about the quality of fibre services but is silent on representations they may make about other technologies and services.

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[17] Chorus, Our Fibre Assets 2023.
[18] Chorus, Our Fibre Assets 2023.
[19] Chorus, Our Fibre Assets 2023.
[20] https://www.tcf.org.nz/industry-hub/industry-codes/broadband-marketing-code

Network resilience expenditure

The storms and cyclones the North Island experienced this year highlight the importance of robust and resilient network infrastructure.

2degrees is supportive of expenditure where: (i) the extent to which it will increase network resilience can be measured; and (ii) the benefits to end-users from the improvement outweigh the costs i.e. the investment better ensures FFLAS services are of a quality that reflects end-user demands (section 162(c) purpose).

The Commission has noted “the independent verifier … believed that greater confidence in the allowed amount of expenditure proposed would be provided if there was greater transparency around the build-up of the PQP2 forecasts.” We consider this should be resolved before the expenditure is approved.

We agree with One NZ that:[21]

> Recent weather events have underlined the need for strengthened resilience across the critical infrastructures system and we are supportive of investment in the telecommunications sector to achieve resilience outcomes provided that it is proportionate and directly connected with verifiable resilience outcomes.
>
> Our starting point is that access seekers expect that fibre services already have a level of resilience, and Chorus needs to demonstrate why standalone additional expenditure is required to increase resilience and how this benefit flows to access seekers and end users.
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> Chorus must not be given a blank cheque for resilience investment. The resilience outcomes that Chorus is seeking to achieve need to be clearly defined and Chorus must demonstrate that expenditure they are incurring has a direct link to the achievement of these outcomes. Chorus should also be specifically measured on the achievement and performance of these outcomes.

We also agree with Spark that “any substantive new investment programme [should] be considered through individual capex proposals”.[22] This would help ensure the approved expenditure is tagged to specific investment rather than a general ‘bucket’ of revenue allowance for capex (or total expenditure). The expenditure appears to fit within the Capex IM section 3.7.22(3) and (5) conditions. It may be useful for the Commission to clarify when expenditure should and should not be proposed through an individual capex proposal.

We agree with One NZ that resilience expenditure needs to be “proportionate and directly connected with verifiable resilience outcomes”, “access seekers expect that fibre services already have a level of resilience”, and “Chorus needs to demonstrate why standalone additional expenditure is required to increase resilience and how this

[21] One NZ submission on fibre price-quality regulation: proposed process and approach for the 2025-2028 regulatory period, 28 September 2023.
[22] Spark, Fibre price-quality regulation: process and approach for the 2025-2028 regulatory period, 28 September 2023.

benefit flows to access seekers and end users".[23] We agree with the issues One NZ raised cited at paragraph 2.13.2.

There needs to be a clear line of sight between proposed resilience expenditure and improved service quality expectations/requirements. The expenditure proposals to improve resilience or service quality need to have a focus on end-user outcomes and deliverables.

We consider the Commission's evaluation criteria of the "linkages between proposed capex and quality, including the impact the capex would have on PQ FFLAS quality outcomes (assessment factor (h))"[24] to be particularly important.

Network extension

2degrees shares Spark's view that Chorus' expenditure proposal for network extension is not 'business as usual' and should be dealt with through an individual capex proposal rather than as part of the expenditure proposal for the price-quality path determination[25,26] or otherwise through the established Crown Infrastructure Partners (CIP) process for funding fibre coverage.[27]

The proposal to spend $201 million to supply a further 40,506 customers (at nearly $5,000 per premise) is considerable additional expenditure well in excess of the $5 million threshold for individual capex proposals. This is one of the most significant expenditure items in Chorus' proposal. Standard installation is the only expenditure item that is larger. The expenditure appears to fit within the Capex IM section 3.7.22(3) and (5) conditions.

We are concerned about the lack of transparency with the proposed extension and consider that the proposed expansion locations should have been made available to stakeholders. It is difficult to determine whether an undefined extension would be to the long-term benefit of end-users.

The Chorus network extension proposal appears to result in supply to customers that would be commercially non-viable based on geographically-averaged prices and, in all likelihood, at unregulated prices. Chorus' justification for the expenditure seems to be largely reliant on public policy argument/social objectives that fit more naturally with the Government's connectivity strategy and are unlikely to be consistent with the Telecommunications Act purposes.

[23] One NZ submission on fibre price-quality regulation: proposed process and approach for the 2025-2028 regulatory period, 28 September 2023.
[24] Commerce Commission, Fibre Input Methodologies extermination 2020, clause 3.8.6(1).
[25] Spark, Fibre price-quality regulation: process and approach for the 2025-2028 regulatory period, 28 September 2023.
[26] Spark make a sensible distinction between expenditure on network extensions and ""BAU" expenditure for extending fibre to, for example, new sub-divisions".
[27] Spark, Fibre ID and PQ draft decisions, cross-submission, 5 August 2021.

For example, Chorus relies on arguments about “the inequality faced by the 650,000 New Zealanders caught on the wrong side of an ever-growing digital divide”, “rural programmes … are likely to require ongoing subsidies for capacity upgrades”, “Improving rural connectivity is in line with [the previous] government policy”, and “The Fibre Frontier investment was deemed by [survey] participants to “directly address fairness & equity and regional economic growth”.

Despite Chorus’ reliance on these types of arguments, we agree with them that “A Public Net Benefit test is … out of scope… the Commission must limit its analysis to the “long-term benefit of end-users in markets for fibre fixed line access services” (s162) and the “long-term benefit of end-users of telecommunications services” (s166(2)), rather than the benefits of the public as a whole.”

2degrees similarly agrees with Spark that “To the extent there are wider benefits that justify policy intervention, these should be considered by Government rather than through the Commission and Telecommunications Act”[28] and “Any rural expansion that can’t be justified on commercial grounds is unlikely to be consistent with the Telecommunications Act purposes which require efficiency, competitive market outcomes and the promotion of competition.”[29] The Commerce Commission is a regulatory agency not an economic development or social agency.

We consider that the Commission’s subsidy-free test that “the expected incremental revenue exclusively from the incremental end-users/upgrades … outweigh the incremental costs …”[30] may be used as a bright line for where network extension could be justified under Telecommunications Act.

We are concerned about Chorus’ suggestion this should be loosened, such as using a subjective (and, for stakeholders, non-transparent) willingness-to-pay (WTP) tests.

It is not clear from the information Chorus has provided (noting critical elements have been treated as confidential) that the potential new fibre customers' WTP would exceed the cost to supply.

Ultimately, it doesn’t matter for Chorus whether such calculations are valid or accurate as the expenditure will be paid for/subsidised across all FFLAS customers regardless. How does Chorus’ claim that “The research provides strong support of existing fibre end-users’ willingness to pay higher prices to enable the proposed network extension” marry up with promoting outcomes that are consistent with outcomes produced in workably competitive markets?

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[28] Spark make a sensible distinction between expenditure on network extensions and ““BAU” expenditure for extending fibre to, for example, new sub-divisions”.
[29] Spark, Fibre price-quality regulation: process and approach for the 2025-2028 regulatory period, 28 September 2023.
[30] Commerce Commission “Chorus’ price-quality path from 1 January 2022 – Final decision: Reasons paper” (16 December 2021), paragraph C63.

It is also not clear from the information Chorus has provided that fibre would be the lowest cost supply option, despite Chorus' commentary on competing technologies and supply options. We share One NZ's view that "… determination of Chorus' capex and opex allowances for PQP2 must not enable or incentivise inefficient deployment of fibre in areas where connectivity services can be more efficiently supported by alternative access technologies, such as mobile or satellite."[31]

We are also concerned about the implications for promotion of workable competition (section 166(2)(b)). Allowing Chorus to supply fibre services on a subsidised basis (geographically averaged prices) would prevent alternative providers (mobile/fixed wireless etc) from supplying those customers.

We agree with One NZ that "The competition consideration is highly relevant when making allowance for Chorus' proposed rural fibre expansion. It is critical that this allowance does not incentivise inefficient investment or distort the market in favour of fibre in areas where it makes more sense to use other technologies to deliver connectivity more efficiently."[32]

[31] One NZ submission on fibre price-quality regulation: proposed process and approach for the 2025-2028 regulatory period, 28 September 2023.
[32] One NZ submission on fibre price-quality regulation: proposed process and approach for the 2025-2028 regulatory period, 28 September 2023.