One NZ submission on Chorus' proposed expenditure for PQP2

14 December 2023

Introduction

1. We welcome the opportunity to comment on the Commerce Commission's (**the Commission**) consultation on Chorus' proposed expenditure for the 2025-2028 price-quality path regulatory period (**PQP2**). Our submission is focused on the key aspects of Chorus' proposal, including proposed expenditure for further fibre expansion, resilience, marketing and incentives.
2. To the extent that the Maximum Allowable Revenue (**MAR**) enables increased charges by Chorus, these will typically be passed through to end users of fibre services. In its determination of Chorus' for PQP2, the Commission therefore needs to be convinced that all elements of expenditure deliver real and tangible end user benefits, as well as ensuring that the expenditure best gives, or is likely to best give, effect:
    a. to the purpose in s 162 of the Telecommunications Act 2001 (the Act), as specified in s 166(2)(a) of the Act; and
    b. to the promotion of workable competition in telecommunications markets for the long-term benefit of end-users of telecommunications services, as specified in s 166(2)(b) of the Act.
3. The Commission must also ensure that the only categories of costs that Chorus is allowed to include in the MAR are costs that are directly related to FFLAS, and that double recovery is avoided.
4. There are a number of areas where the independent verifier couldn't confirm whether Chorus' proposed expenditure is consistent with the capex Input Methodology (**IM**). Where the independent verifier has expressed doubt or didn't reach a firm conclusion that supports Chorus' proposals, the Commission should be extremely cautious accepting those proposals and should only do so if there is strong and compelling evidence that they are justified.

Summary of key points

5. Summary of One NZ's key points
    a. The Commission should allow expenditure on further fibre expansion in areas where the proposal is aligned with the principle of 'outcomes delivered in a competitive market', meaning where the incremental revenue derived from expansion areas exceeds the incremental costs of the investment.[1]
    b. We support Chorus' proposed investment on resilience. However, this expenditure should be considered and allocated under a separate 'individual capex' proposal to help ensure that spending is allocated to deliver genuine resilience outcomes. This individual capex approach is consistent with the project specific nature of the three key areas of resilience expenditure identified by Chorus: i) dual fibre paths; ii) functional limits; and iii) critical spares.[2]
    c. The Commission should request economic analysis to be carried out to support Chorus' proposed marketing expenditure to demonstrate that the level of expenditure is more than offset by the resulting increased revenue resulting from the marketing activity, as supported by the independent verifier. If the Commission decides to accept Chorus' marketing expenditure proposal after this analysis is completed, the Commission should also ensure that Chorus' marketing activity is limited to 'general awareness of fibre' or alternatively that Chorus is required to be subject to the same regulatory framework around broadband marketing as retailers. Enabling Chorus to be an 'active wholesaler' and engage in expanded market activity under asymmetric regulatory conditions has clear potential to distort competition contrary to the purpose in s166(2) of the Act. The disparity needs to be addressed by the Commission through the application of conditions on the use of marketing expenditure that

[1] This economic test was previously endorsed by the Commission in *Chorus' individual capex proposal for customer incentives 2023 – Final decision – Reasons paper* (12 December 2022).
[2] Chorus *Our fibre assets,* paragraph 7.6.

replicate the specific rules that apply to retailers when marketing services directly to end users.

d. The Commission should not allow Chorus to offset capex on incentive payments against the MAR. Incentives do not increase the cost of delivering network services, and therefore must not result in an increase in the revenue allowance.
e. The Commission should not accept Chorus' proposal to change the breach threshold of the performance quality standard from 90% to 95% to help avoid end users being exposed to an unacceptable level of fibre service performance.

Fibre expansion

6. Chorus proposes to spend $201.0 million over PQP2 to expand the fibre network into rural areas. This investment would increase the overall fibre coverage from 87% to 89% of the population.
7. As noted in our previous submission on the proposed approach for PQP2 determination, improving rural connectivity is an important priority. Our view is that a mixed technology approach is required to achieve enhanced rural connectivity outcomes in the most efficient and cost-effective way. Fibre has a role to play in areas with a minimum existing population density or firm projected growth to this density. Outside these areas, the incremental cost of new fibre deployment is likely to exceed the incremental revenue derived from these assets, such that fibre provision in these areas cannot be viable or sustainable without external subsidy. Expenditure to deploy fibre in these areas would not be consistent with the efficient costs that a prudent fibre network operator would incur to deliver PQ FFLAS.[3] In such areas, we believe that connectivity will be delivered most effectively and efficiently by alternative access technologies, i.e. terrestrial mobile networks and satellite.

[3] *Fibre Input Methodologies Determination 2020* [2020] NZCC 21, clause 3.8.5(2).

8. In the Fibre Frontier report, Chorus states, 'The government's 2022 rural strategy paper 'Lifting Connectivity in Aotearoa' highlighted the growth in urban-fringe areas, and noted that the original footprint for UFB was set a number of years ago and population growth has occurred in and around our towns and cities since that time. It is largely these populations that we are intending to cover as part of our PQP2 network expansion proposal.'[4] We support deployment of fibre in those areas where investment reflects costs that a prudent fibre network operator would incur and promotes workable competition for the benefit of end users. However, elsewhere in the Fibre Frontier report, Chorus focuses on extension of fibre beyond these areas and into rural, sparsely populated locations more generally. Here, Chorus would need to demonstrate that in each area where fibre is extended on a standalone basis (i.e. without Crown grant funding), the incremental revenue exceeds the incremental costs (both capex and opex).
9. Before making a determination on Chorus' expenditure proposal for fibre expansion, the Commission should closely assess and consider the following:
    a. As it stands, Chorus is uncertain as to the demand profile and commercial business case for fibre expansion: 'We need to consider up-to-date market conditions when confirming the business case for discretionary and demand-based investment. This includes considering how changes in government funding or policy – particularly for rural areas - could help accelerate or reshape our investment plans.'[5]
    b. Chorus has noted that the business case for fibre extension is challenging and that government funding for rural areas 'could help accelerate or reshape' their investment plans[6]. We question whether fibre extension is consistent with Capex IM if Government subsidy is required to enable it. Reliance on a subsidy that may not be available, and of unknown quantum if made available, is not consistent with an

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[4] Chorus, *Our Fibre Assets*, https://comcom.govt.nz/__data/assets/pdf_file/0024/334239/04.-Chorus-Our-Fibre-Assets.pdf, *p.* 269
[5] Chorus Annual Meeting 8 November 2023 Chair's Address.
[6] https://assets.ctfassets.net/7urik9yedtqc/nzx-doc-406647/c3adddbaab9def3153ff8f2bdb8f0bf9/Chorus_ASM_-_Chair_s_Speech.pdf

investment approach of a prudent fibre operator. Nor is any reliance on government intervention to stimulate demand for fibre. Indeed, assuming the presence of either subsidy or demand stimulation would be contrary to the economic test previously endorsed by the Commission for expenditure proposals, i.e. that the expected incremental revenue **derived exclusively** from the incremental end users of extended fibre would exceed incremental costs.

c. In the event that any subsidy were provided, the Commission would need to consider how this funding should be treated in the context of the MAR during the relevant period.

d. Chorus' demand forecasting, including demand from end users on installed networks to activate their connections. Are adoption forecasts premised on current prices of fibre products? What is the sensitivity to price change? Ability to pay in fibre frontier areas is lower and demand more finely balanced. Access seekers and consumers should not bear the cost if demand uptake is not achieved.

e. Cost of operating the copper network remains embedded in Chorus and is highly uncertain. Access seekers and consumers are covering these costs through FFLAS charges. Any capex allowance for further fibre expansion should require that legacy copper costs are first removed to support Chorus' fibre frontier proposal.

10. The Commission needs to consider dynamic features of the sector, including the implications of rapid technology evolution, when evaluating Chorus' expenditure proposal, and whether it is prudent in light of uncertainties as to demand for fibre services. Indeed, this assessment is critical to properly assess Chorus' proposal against the Capex IM. The Commission must avoid incentivising fibre expansion in areas where connectivity improvements can be provided efficiently by other technologies, and where demand is likely to be met by these technologies. This could be achieved by requiring Chorus to share specific areas where it plans to deploy fibre and, in each case, to satisfy the Commission that new fibre deployment will deliver incremental revenues that exceed costs on a standalone basis (without any assumption of external subsidy or demand stimulation).

11. Finally, Chorus argues that the Commission should ignore the impact of geographically consistent pricing and instead focus on consumers' willingness to pay as consumers' willingness to pay is a better measure of the value consumers place on fibre services and therefore the competitive price of fibre in rural areas. One NZ would not support any relaxation in the requirement for Chorus to provide geographically consistent prices, which is fundamental architecture of the existing regulatory regime.

Resilience

12. We support investment in the telecommunications sector to achieve resilience outcomes and support Chorus' proposal to fund resilience in principle, subject to spending being allocated to projects and programmes that have genuine resilience outcomes. This requires Chorus to engage with access seekers on specific proposed projects and programmes to establish demand/support ahead of committing spend - Chorus should run a written consultation process on resilience initiatives before they are finalised. This approach will assist in providing transparency as to whether resilience expenditure is consistent with forecast demand.
13. Another way of ensuring that resilience spending is allocated to deliver resilience outcomes is for Chorus to submit an 'individual capex' proposal. We consider that this individualised approach would be consistent with the resilience expenditure approach that Chorus has proposed across three key areas:
    a. dual fibre paths: this relates to creating fibre route diversity in specific areas of resilience vulnerability. An individual capex proposal is suitable for expenditure of this type which will need to be scoped out and evaluated on a project-by-project basis.
    b. functional limits: this involves building or upgrading network specific site which will also require specific project evaluation and assessment to determine viability.
    c. critical spares: this area is focussed on recovery as opposed to proactive resilience investment ('putting measures in place to support rapid recovery if connection is lost'). We accept that the distinction between investment is remediation vs. resilience is a narrow one, and may focus on similar outcomes. We also accept that the procurement and location of critical spares will be a general ongoing programme rather than project/location specific investment. Despite this, we believe this area of resilience investment should be subject to an individual capex proposal at a point where the nature and extent of investment in critical spares can be more fully articulated.

Product, sales and marketing

14. Chorus is proposing to spend $115.3m on product, sales and marketing over the 2025-28 period. Total opex spending in this area is greater than both network operations and technology opex. It appears that marketing spend will constitute a significant chunk of this, with Chorus historically spending around $13m on marketing annually.
15. The independent verifier's report highlights the lack of 'economic analysis demonstrating the level of expenditure is more than offset by the resulting increased revenue resulting from the marketing activity.' The independent verifier goes on to state that they 'consider such a piece

of analysis as necessary in definitively determining if prudence and efficiency are satisfied.'[7] One NZ agrees with the independent verifier on this point. The Commission should ensure this analysis is completed before making a determination on this expenditure proposal.

16. Moreover, this level of proposed expenditure is linked to Chorus' strategy to be an 'active wholesaler'. Chorus generates a vast quantity of direct-to-consumer advertising that is specifically intended to influence the choices made by end users regarding alternative services.
17. The purpose of s69O of the Act was to prevent Chorus re-entering retail markets after separation, as this would recreate the same incentive problems that structural separation was designed to remove. Parliament's intention was for Chorus to operate a wholesale-only business and for competition between RSPs to provide innovation and diversity in retail offerings. However, Chorus is increasing its level of influence in the retail market through direct-to-consumer marketing (and previously the offer of incentives directly to end users[8]). As noted above, this activity occurs under asymmetric regulatory conditions with clear potential to distort competition contrary to the purpose in s166(2) of the Act. While retailers must comply with specific standards regarding the presentation and comparison of different technology types, these do not apply to Chorus except on an optional basis – i.e. it chooses whether it aligns with these and to what extent.[9] The Commission must address this disparity

[7] https://comcom.govt.nz/__data/assets/pdf_file/0025/334249/13.-Chorus-C2A0Report-from-the-Independent-Verifier.pdf, p. 234

[8] See, for example, conduct described in Vodafone letter dated 9 November 2020: Commerce Commission - Line-of-Business restrictions (comcom.govt.nz)

[9] Chorus is not signatory to the TCF Broadband Marketing Code. It has committed to follow **some** of the principles of the Commission's Guidelines in a separate letter, but has not followed them at all times. For example, Chorus are using 'up to' speed claims in its advertising of hyperfibre (the Commission's guidelines have specifically directed RSPs to stop using 'up to' speed claims). The fact that Chorus are not signatory to the Code means that they are not held accountable for their marketing activity. Chorus has argued that the Commission's guidelines were issued under Part 7 of the Act and as such do not apply to them. This would be true if Chorus did not participate in direct-to-consumer marketing activity. However,

by applying conditions on use of any marketing expenditure that replicate exactly the rules that retailers are now operating under.

18. Setting these conditions on expenditure in this area is consistent with the purpose of the Act being to promote competition in telecommunications markets for the long-term benefit of end-users, and would address the very real risk (as illustrated by Chorus' historic conduct) that it will apply incentives and marketing expenditure in a way that harms competition and to consumers.
19. Chorus' allowance for advertising and marketing should be limited to marketing that enables general awareness of fibre but not direct-to-consumer activity that recommends suitability of fibre vs. other access types to individual end users, or that induces rewards decisions by those end users. Chorus argues that 'other market participants, including the RSPs without their own mobile networks and the smaller local fibre companies, are too small to promote the fibre category nationally or at an effective scale.'[10] This argument is inconsistent with the growth of smaller market participants that sell fibre only. 'Smaller participants' referred to by Chorus include Contact, Nova and others with significant resources and marketing capability.
20. It is vital that Chorus in not permitted to treat direct-to-consumer rebates and competitions as a "costless" activity that is subsidised within a regulated monopoly revenue cap. The Commission cannot on the one hand allow Chorus to offset significant marketing spending against the MAR while on the other hand continuing to allow Chorus to conduct its direct-to-

they do and given their expenditure proposal clearly plan to continue this activity at scale. If Chorus intends to advertise to 'resolve confusion', then it needs to sign up to the Code. This is particularly important given Chorus' 'grow hyperfibre' strategy (Chorus has also proposed to spend $28m in the 2025-28 regulatory period on customer incentive payments to upgrade existing fibre users to faster plans): there is a clear risk of misselling hyperfibre to consumers who don't actually need it. This is exactly the type of activity that the Commission's retail service quality work programme aims to address.

[10] Chorus, *Our Fibre Assets*, *https://comcom.govt.nz/__data/assets/pdf_file/0024/334239/04.-Chorus-Our-Fibre-Assets.pdf*, *p.* 225

consumer marketing activity outside of the broadband marketing regulatory framework that RSPs are subject to.

Incentive payments

21. Chorus has proposed a $54.1m capex allowance for incentive payments. Chorus describes the role of marketing and customer incentives as being to encourage migration to fibre, encourage offnet households to connect to their network, optimise consumer experience by moving end-users up the portfolio of fibre plans, and retain end-users on their network, given the availability of alternative services.[11]
22. In the past, Chorus' incentives have been directed at access seekers (e.g. rebates on wholesale list prices) and end-users (e.g. prezzycards for signing up to fibre). Chorus' incentives are not about creating awareness of availability of fibre services, they are aimed at influencing (and distorting) choices made by end users in a competitive downstream market. Some of the examples of activity that was aimed at distorting the market include:
    a. Sending prepaid MasterCard to households not connected to Chorus fibre that could be activated on 'Chorus Cards Portal' and used to place a fibre order with their preferred retail service provider (pilot run in June – July 2019).
    b. Sending Prezzy cards directly to end-users who sign up to fibre.
    c. Mix-It-Up Extension offer to RSPs (available in July – December 2021) that included a requirement that specific 'fibre-focused' advertising must be adopted by any retailer who wished to be eligible for credits. In order to take part in the incentive programme, RSPs were required to promote fibre over and above other access technologies and avoid any discussion in advertising of the relative merits of different access types.
23. As discussed in our past submissions on this issue, allowing incentive payments as part of capex for the purpose of determining the MAR would enable Chorus to earn monopoly profit

[11] Chorus, *Our Fibre Assets*, https://comcom.govt.nz/__data/assets/pdf_file/0024/334239/04.-Chorus-Our-Fibre-Assets.pdf, *p. 77*

by resulting in increased revenue allowance exceeding the normal rate of profit. Incentives do not increase the cost of delivering network services, and therefore must not result in an increase in the revenue allowance. It is not necessary for Chorus to offer incentives to actively promote fibre uptake. It can promote uptake of fibre services, for example, through general advertising campaigns to achieve awareness about the attributes and quality of fibre without directly offering inducements to end users that involve Chorus providing something of value directly in a manner that distorts competition and sways customer choice. A level playing field between providers of broadband infrastructure requires that any incentive offered by Chorus to drive fibre demand comes off its bottom line and does not create headroom that Chorus can recoup from captive customers. In a normal market, a rebate or other discount would come off the provider's bottom line.

24. The expert report from Frontier Economics (**the Frontier Report**), which we have provided to the Commission previously, clearly shows that this 'costless' discounting would result in substantial over-recovery of costs by Chorus. Incentive payments are functionally equivalent to a discount, (e.g. One NZ pays $45 and Chorus gives $3 back as an incentive payment. This is equivalent to One NZ paying Chorus $42). But incentive payments are obviously discretionary. Chorus alone decides whether to give incentives at all and, if it does, controls both the amount that is paid and the eligibility conditions that apply. The Commission has no ability to control Chorus' future application of incentive payments and cannot reach a decision based simply on assurances about how its incentive payment scheme might operate.
25. The Frontier Report states, 'If there is a revenue cap, the effects of a simple reduction in price and an incentive payment are different because an incentive payment increases the RAB whereas a reduction on price for the first year of a contract does not. If there is a revenue cap, offering incentive payments enable the provider to earn some monopoly profit.' Allowing Chorus to include incentive payments within the MAR would be contrary to the purpose of Part 6 of the Act as it would allow Chorus to thwart the very purpose of the revenue cap, which is to limit its ability to extract excessive profits.
26. PQP2 outcomes that enable Chorus to distort competition in favour of its own fibre network are inconsistent with the purpose of the Act. This is the case regardless of whether incentives are attractive to access seekers: they distort competition in favour of one access technology relative to other technologies (e.g. by subsidising or reducing 'list price' for Layer 2 services). Allowances need to be considered in light of Chorus' 'active wholesaler' intent and desire to grow hyperfibre connections. This strategy creates high potential to fund and enable misselling.
27. Allowance for incentives is also not consistent with relevant criteria as set out in Fibre IMs. They are not an efficient cost that a prudent fibre network operator would incur to deliver PQ

FFLAS of appropriate quality, during the relevant regulatory period and over the longer term and not consistent with good telecommunications industry practice.

Quality

28. We do not support Chorus' proposal to change the breach threshold of the performance quality standard from 90% to 95%. As stated in our previous submissions, we consider 90% utilisation rate as a good threshold for an unacceptable level of performance. Port utilisation above 80% will result in a poor customer experience, so raising the threshold to 95% could have significant implications on customer experience. In its determination for PQP1, the Commission said, 'We consider 90% port utilisation to be the right measure as it will capture deteriorating performance before consumers are adversely affected. Further, Chorus itself applies 90% port utilisation to plan for augmenting capacity and its investment decisions. In our view, this is preferable to a 95% port utilisation threshold where quality has already deteriorated to such a degree that consumer experience is impacted.' The Commission added, 'We consider that this creates meaningful incentives for Chorus to continue investing in network capacity, consistent with s 162(a), in addition to promoting incentives for Chorus to continue to deliver service at a level of quality that meets end-user demand.'[12] There is no reasonable basis for the Commission to change its position on this matter. This proposal is also not supported by the independent verifier.
29. Chorus has also proposed to remove the impact of port utilisation events caused by network failures from their performance against the quality standard. We agree with the independent verifier's assessment that 'an all-cause equipment failure exclusion could potentially capture

[12] Commerce Commission, *Chorus' price-quality path from 1 January 2022 – Final decision, Reasons paper,* 16 December 2021, pp. 244 – 245

failure events that are reasonably withing Chorus' control and hence should not be an exclusion from reported data.'[13]

30. In addition to the existing mandatory quality standards, we reiterate our view that the Commission should create an additional provisioning quality standard for PQP2 (as set out in our submission on the Commission's proposed approach for PQP2)[14]. 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 and poor workmanship.

31. Please contact the following regarding any aspect of this submission.

Head of Legal and Regulatory *Senior Public Policy Advisor*

[13] https://comcom.govt.nz/__data/assets/pdf_file/0025/334249/13.-Chorus-C2A0Report-from-the-Independent-Verifier.pdf, p. 6

[14] https://comcom.govt.nz/__data/assets/pdf_file/0025/330892/One-NZ-submission-on-Process-and-approach-paper-for-the-2025-2028-regulatory-period.pdf