

Fibre ID and PQ draft decisions

Cross-submission | Commerce Commission

5 August 2021

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Executive Summary

Thank you for the opportunity to provide feedback on the draft Price-Quality (**PQ**) path and Information Disclosure (**ID**) draft decisions (**the draft**).

Estimated forecast allowable revenue

Chorus does not support the estimated forecast allowable revenue path set out in the draft, believing it does not provide the revenue uplift it needs to support its future plans. It argues that the Commission should reverse proposals to omit unsupported expenditure claims and identifies new expenditure that should be added to the proposal.

It is difficult to know what to make of Chorus' proposal. This is the regulatory framework that Chorus has consistently asked for over the last 10 years and the Commission is simply applying the framework and IMs as it said it would, focusing on the costs to provide the fibre network and removing unsupported and uncertain expenditure. The fact that Chorus does not like the outcomes of that framework is not a relevant consideration for the Commission.

In its communications with the Commission, Chorus further appears to be suggesting that the Commission should calibrate the framework outcomes against valuations implied by the Chorus share price.

The Commission can not engage on the basis set out in Chorus' letters and submissions; Part 6 does not seek a specific number or revenue uplift, the Commission can't omit unsupported expenditure and replace it with equally unsupported expenditure elsewhere, or boost FFLAS revenues to support Chorus' other commercial concerns. For example, while Chorus accepts that previously identified "Innovation" expenditure is unsupported by the Act, it proposes that the exact same provision should instead be spread across other cost categories that updated analysis suggests should have additional spend.

If the Commission were to adopt the proposed approach, it would inevitably result in an uncertain regulatory framework, undermining certainty for our sector and also all other Part 4 sectors regulated by the Commission. The only approach open to the Commission is to apply the BBM approach anticipated by the Act, accepting only well supported and assured expenditure claims, and applying the approach anticipated by the IMs and 2020 process and approach paper.

Connection incentives

We do not agree that the connection incentives are permitted by the Telecommunications Act 2001 (**the Act**), nor can they be included in any expenditure path. We further disagree with Chorus suggestions that the only issue is the level of connection incentive, and that because the current levels have been in the market for some time they should be taken forward.

We asked Russell McVeagh to advise us on the appropriateness of the Commission's approach, and to identify whether there are legal risks for the Commission if it decided to change its draft position on incentive payments in response to the Chorus submissions. The attached Russell McVeagh opinion outlines concerns that the connection incentive credits: (a) are clearly part of the FFLAS price and that the practice is inconsistent with the s201 requirement to offer the same FFLAS price for materially the same service regardless of the geographic location of an access seeker or end-user (b) are inconsistent with Chorus' non-discrimination obligations; and (c) are likely to impact competition in telecommunications markets and as such their inclusion may be inconsistent with the Commission's obligations under s166 (2)(b). The s201 and non-discrimination protections are fundamental components of the regulatory framework designed to prevent harm to competition and

including an allowance for recovery of incentives that violate those protections through a PQ determination would risk breaching the Act's purpose statement.

Further, Chorus' claimed drivers and approach are inconsistent with implementation of the incentives and this further puts in to question that validity of the practice. For example, our analysis suggests that contrary to Chorus' claims:

- The concerning incentives are not a long-established market practice and have been subject to continual change. The concerning bonus credits and hurdle rates were launched in April and September 2020 respectively, and there has been 4 further variants with different qualifying criteria or credits since then.
- The credits are targeted at the most active retail customers who have shown a willingness to adopt alternative network services. The most inert or difficult to move retail customers are, in practice, served by the legacy copper lines. The incentives target the first group (active retail customers) not the latter.
- The new entrant RSPs that Chorus is seeking to support are, in practice, large businesses that offer their own electricity or pay-TV bundles. The bundling of telecommunications with other services is a feature of our market and the only practical difference between Chorus' preferred retailers and others is that these retailers are not investing in competing telecommunications infrastructure.

Other feedback

In our cross-submission we recommend that the Commission also:

- Reject calls to build costs back into the expenditure path. Chorus has provided no evidence to support increasing FFLAS costs as implied by the proposal, and this would be inconsistent with expectations that costs fall as fibre is deployed. Chorus should submit individual capex proposals that resolve the uncertainties in current proposals.
- Consider more closely BBM border issues that raise competition and investment concerns. We set out our concerns that the proposed BBM scope risks over-building competitive fibre infrastructure and undermining the collaborative industry deployment model. This comes right at a time when we are investing to strengthen our regional transport routes, in competition with Chorus, and at a time when Government is promoting regional resilience.
- Consider applying accelerated depreciation more broadly. We agree the Commission has flexibility to set depreciation, but recommend it apply an approach that takes into account the relevant purpose of Part 6 - maximising consumer welfare - and focused across a broader range of assets. From a practical perspective, if the FLA is smaller and there is an increased need to smooth the first regulatory period revenues as we expect, the current bounded approach may not be sufficiently flexible for the Commission's needs.
- Strengthen rather than roll back Information Disclosure requirements as suggested by Chorus and LFCs. Increased transparency is required to understand actual Part 6 outcomes (which are highly uncertain for the first regulatory period), and to enable the Commission to resolve parked issues, i.e., to facilitate pricing principles, potentially permit future "innovation" capex proposals and make claims of increasing costs transparent.
- Further consider omitting possible over estimated costs. The Commission should check whether fibre roll out and connection costs have been appropriately included in the expenditure proposal.

Introduction

1. Thank you for the opportunity to provide feedback on the submissions made on the draft Price-Quality (**PQ**) path and Information Disclosure (**ID**) draft decisions (**the draft**), and proposed IM amendments.
2. We do not believe that submissions raise any issues that require the Commission to depart from its articulated PQ process and approach. It is the Commission's responsibility to apply the IMs and Act in light of the approach set out in the Reasons Paper and communicated process.

Estimated forecast allowable revenue

3. Chorus submits that the Commission has not had enough regard to Chorus' operating context. For example, that Chorus it is already a lean organisation¹, submitted a proposal based on an efficient business plan reflecting competitive pressures, and is constrained by competition from fixed wireless services (**FWA**) that can be attractive proposition to cost-conscious customers and a close economic substitute for fibre².
4. Chorus submits that the draft assumes, however, that Chorus is a traditional monopoly provider with likely opportunities to reduce costs³. Accordingly, Chorus has asked that the Commission add back in the omitted expenditure - including connection incentives - and increase the stranding risk premium to 60 percent points⁴.

The Commission is tasked with applying the building block model that Chorus asked for

5. It is difficult to know what to make of Chorus' proposals. The Commission is simply applying the regulatory framework that Chorus asked for⁵, focusing on the costs to provide FFLAS services and removing unsupported and uncertain expenditure.
6. Chorus is in effect asking the Commission not to apply the Act on the assumption that Chorus will act in end-users' interests. For example, Chorus asks the Commission:
 - a. Not to apply the considerations and assurances that it would normally apply to price-quality regulation⁶ and set out in the September 2020 process and approach paper⁷.

Even a lean and efficient regulated business has incentives to maximise their regulatory position and must expect its proposals to face scrutiny as the expenditure is inevitably funded by end-users.

- b. To take an "expenditure substitution" approach to approved expenditure, spreading the original provision for unsupported - and deferred to an individual capex path - "Innovation" across other costs in equally unsupportable cost categories, and
- c. To add a margin to the Part 6 revenue path in order to support Chorus' future business plans that have yet to be scoped and defined, let alone may or may not relate to FFLAS.

¹ Chorus 8 July 2021 submission at 3.1

² Chorus at 4

³ Chorus at 3.2-3.3 and 3.4

⁴ Chorus at 7, 15 and 23

⁵ For example, see Chorus' *Submission on the Review of the Telecommunications Act 2001 Discussion Document* (13 September 2013)

⁶ I.E., across both Part 4 and Part 6 sectors

⁷ Commerce Commission "Fibre information disclosure and price-quality regulation: Proposed process and approach for the first regulatory period" (15 September 2020)

7. However, the Commission cannot do any of this. The Commission cannot engage in a negotiation of this nature as this would inevitably result in an uncertain regulatory framework, undermining certainty for our sector and also Part 4 sectors regulated by the Commission.
8. The only approach open to the Commission is to apply the BBM approach anticipated by the Act, accepting only well supported and assured funding claims that meet the requirements of the Act and applying the protections against over-recovery anticipated by the IM Reasons paper and 2020 process and approach paper. Further, Chorus concerns relating to emerging competition should be considered through a s210 review if warranted.

Chorus' criticisms and proposed adjustments are unsupported by evidence

9. In any case, when we looked at the Commission proposed approach (see Table 1 below), the adjustments relate predominantly to the omission of unsupported and highly uncertain expenditure and seek to apply the most up to date volume forecasts. The Commission has applied current spend run rates in the absence of any explanation for increasing unit costs and spend, requested individual capex proposals where Chorus has failed to justify an expenditure proposal, and has applied the latest reputable demand forecasts.
10. These are not excessive, poorly justified, or arbitrary cuts that imply unrealistic efficiency gains as Chorus suggests, but appropriate Commission adjustments reflecting the information it has available to it.

Table 1: analysis of Commission proposed adjustments, Chorus proposal and comments

Expenditure	Value	Draft	Chorus proposal	Spark Comment
"Innovation"	\$37M	Lack of specificity and uncertainty means this should be subject to an individual capex proposal.	Small, committed proportion should be in the expenditure path (\$3M). The residual should be added to other cost categories such as network resilience, IT and network extensions that Chorus has identified as being, with further analysis, under-funded.	Makes no sense that a provision for unspecified innovation should be reallocated to other cost categories, these need to be considered in their own right (no evidence is provided). Identifying additional costs at this late stage without assurance, questions the integrity of the current claim and original Chorus proposal. What should we take of the assurance reports that concluded the original proposal was appropriate?
Connection incentives	\$43.7M	Not clear will be spent and questionable that it is permitted by the Act. To be considered through an individual capex proposal.	It permitted and the current spend should be adopted for BBM purposes.	Is not permitted by the Act and cannot be included in the PQ path.
Demand driven	\$28.8M capex, \$9M opex	The latest forecast suggests lower demand and this is reflected in demand driven expenditure.	The Commission has adjusted spend that is not actually demand driven. The prior forecast is better. Should revert to the original version.	As the Commission has acted on Chorus signalled demand drivers, it highlights concerns with Chorus' underlying claimed causal activity drivers and cost allocators. The Commission should form a view of demand based on the most reliable information available to it.
Unit costs driven	\$63.5M	Chorus has proposed unsupported increases in cost and effort far beyond that currently achieved in practice. Under these circumstances, the best approach is to base the forecast on current expenditure.	Chorus' costs are increasing and, if not for efficiencies, they would have been even higher.	We are not aware of any evidence provided to the Commission that supports higher unit costs (beyond general indexed increases). The Commission should expect compelling evidence to accept increasing unit costs, yet none has been provided.
Operating cost reductions		The Commission has reduced opex to capture anticipated savings from proposed capex.	The savings were already built into the operating costs forecast, which would have otherwise been higher.	This suggests, without the capex, Chorus costs would have otherwise been even higher. The Commission is right to assume a cost reduction. Should be omitted unless Chorus can provide assured evidence to support both the claimed cost increase and project cost reduction benefits.

11. Further, it cannot have been a surprise to parties that the Commission would apply the approach set out in its September 2020 process paper⁸. That process, for example, anticipates specific steps for determining the RAB:

5.135 Our approach at this time on the form and extent of scrutiny and assurance is to:

5.135.1 Use Chorus modelling of the financial loss asset value, the initial unallocated PQ RAB, and the initial PQ RAB as a starting position.

5.135.2 Specify audit and assurance requirements to ensure information provided to us applies the IMs appropriately and proper processes have been applied, including;

5.135.2.1 director certification;

5.135.2.2 independent audit opinions covering data inputs, modelling mechanics, and compliance with IMs; and

5.135.2.3 evidence of internal governance processes and Chorus internal assurance activities.

5.135.3 Use an independent expert to review aspects of the initial PQ RAB with the particular focus on the approach to cost allocation.

5.135.4 Develop a suite of high-level models to undertake cross checks of Chorus modelling and scenario modelling.

5.135.5 Determine the initial PQ RAB value (which might differ from Chorus calculated value).

5.136 Our approach relies on Chorus modelling that is complemented by a comprehensive package of assurance. [...]

12. And a similar assurance and processes were anticipated for the expenditure proposal⁹.
13. Accordingly, it should not be a surprise that the Commission would critically review proposals and omit - or adjust - unsupported expenditure. We would be surprised if the Commission didn't.
14. Nonetheless, while we agree that the Commission should adjust the expenditure path to correct for factual errors and these should be considered, we have real concerns with Chorus' substantive proposals to increase claimed FFLAS costs:

- a. Chorus hasn't provided any evidence to support increasing FFLAS costs. The Commission can't include costs in the expenditure proposal that are not supported by detailed evidence. For example, while Chorus' submission asserts that base year spend and forecasts are "lean", "efficient"¹⁰ and that \$31.4 of new expenditure is "appropriate"¹¹, there is no real evidence or supporting analysis that shows this to be the case.
- b. Conversely, the information available to us suggests that FFLAS costs should fall over time:
 - i. Benchmarking of the expenditure proposal suggests significantly higher claimed FFLAS costs than that of any other wholesale fibre provider

⁸ Commerce Commission Proposed process and approach for the first regulatory period paper, (15 September 2020)

⁹ Set out in the process paper from 5.150 and 5.167

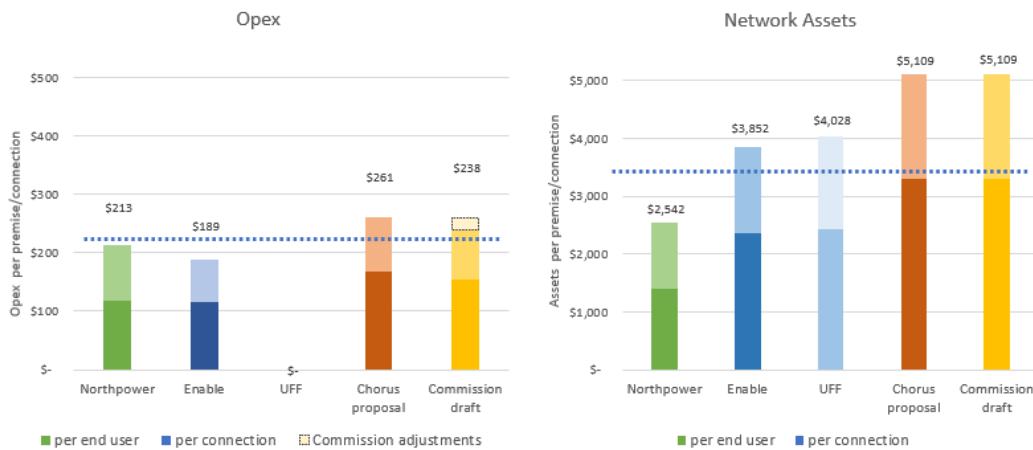
¹⁰ For example, Chorus from 84

¹¹ Chorus at 107

(Figure 1). Fibre networks are further expected to have a significantly lower cost structure than legacy copper networks.

- ii. We believe that applying proportionate allocators and an allocation cap as anticipated by the IMs will likely align costs more closely to those of other wholesale fibre providers.
 - iii. The Commission’s proposed PQ methodology itself results in the loading of excessive and sunk legacy costs on to FFLAS, and these costs should fall away as the legacy systems expire and fit for purpose FFLAS systems deployed.
- c. The new analysis and proposals to replace omitted expenditure with higher provisions in other cost categories further puts into question Chorus’ original proposal and independent assurance. For example,
- i. The original Chorus proposal was reviewed by its advisors and certified as meeting the expenditure objective, but these provisions are not now expected to meet the objectives. What does this mean for the original Chorus “independent” assurance and what reliance can the Commission place on these reviews?
 - ii. As concerning is the new information relating to Chorus’ chosen causal drivers and cost allocators. The Commission has acted on the cost drivers submitted to it but is now told these drivers are unreliable and can’t be relied on for understanding the proposal.

Figure 1: Comparison of claimed assets and opex expenditure proposals (with/without the proposed adjustment)



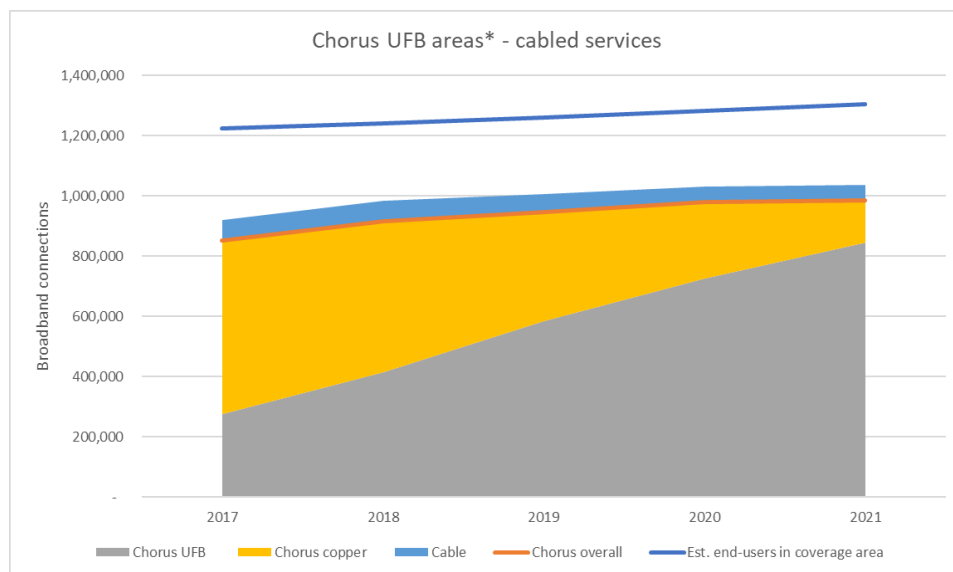
15. Accordingly, we do not believe the Commission has the evidence, at this stage, to accept Chorus’ claimed additional costs and the disputed expenditure should be considered through individual capex proposals as proposed.

Chorus over-states the impact of wireless competition on FFLAS

16. Chorus further submits that the Commission should, reflecting FWA competition, apply “low touch” regulatory settings.

17. While wireless competition is not particularly relevant where applying PQ regulatory processes - this would be a matter for any s210 deregulation review - we believe that Chorus likely overstates the impact of FWA competition on FFLAS services.
18. We accept that there is likely nascent wireless competition for some customers. However, there is no evidence to suggest a material impact on FFLAS at this time. As set out in Figure 2, we continue to see customers on poorly performing legacy copper-based services migrating to both fibre and wireless alternatives, and strong growth for fibre services. CIP recently observed that current UFB take-up of over 62% is well ahead of the original UFB forecast of approximately 44%¹². Chorus continues to see strong fibre growth in its UFB franchise areas, contributing to the overall 130,000 broadband growth in these areas since 2017.

Figure 2: Chorus broadband access volume in Chorus UFB franchise areas¹³

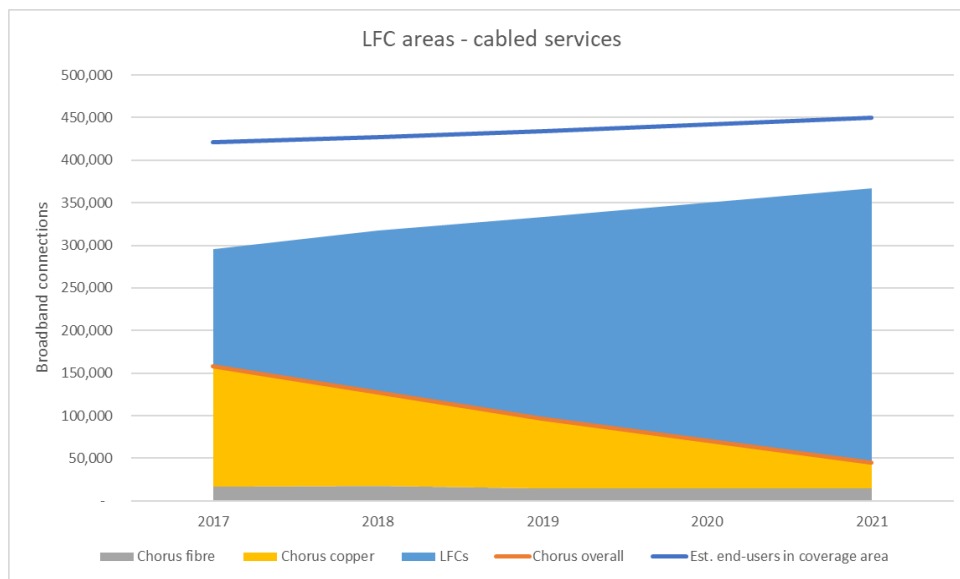


19. Conversely, as expected, Chorus has seen declining copper demand in LFC areas as customers migrate to LFC fibre services. As shown in Figure 3, LFCs have seen strong growth in fibre connections largely at the expense of Chorus legacy copper services. Again there is no indication that FWA has materially impacted fibre demand in these areas.

¹² CIP FY20 annual report at page 7

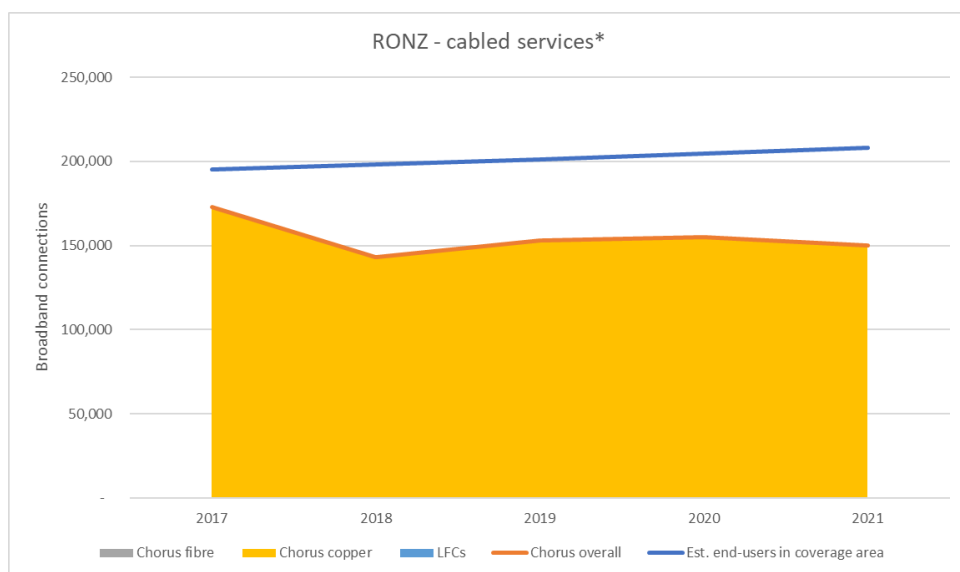
¹³ Sources Statistics NZ (dwelling estimates), CIP (connections and coverage), Chorus (quarterly connections report) and Commerce Commission market monitoring reports. *2018 impacted by UFB2 expansion of coverage.

Figure 3: Chorus and LFC broadband access volume in LFC franchise areas



20. Finally, as shown in Figure 4, Chorus' copper broadband connections are static to declining in areas outside UFB.

Figure 4: Chorus broadband access volume in the rest of New Zealand (RONZ)



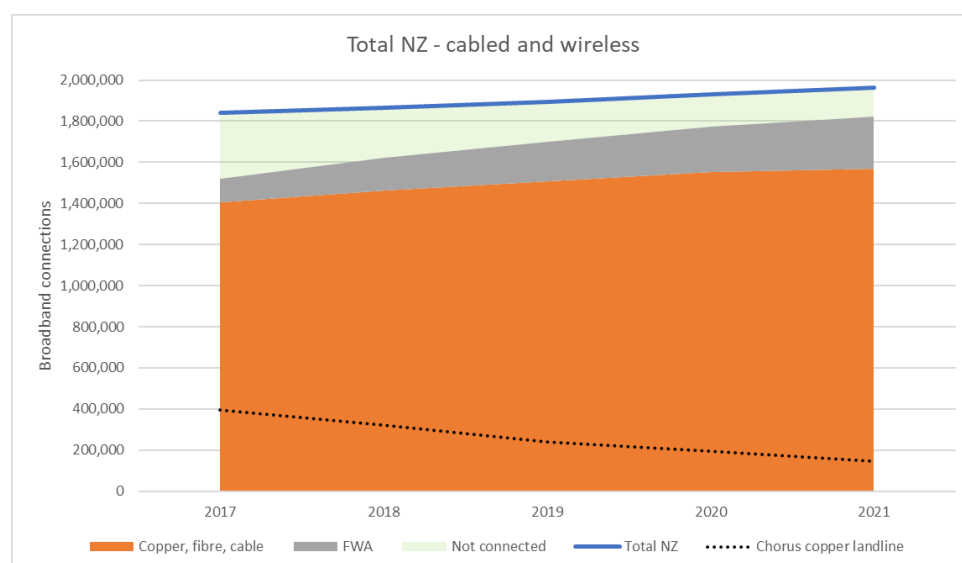
21. This suggests that the migration from legacy copper to alternative and better technologies is a long-term and consistent trend. As expected, Chorus copper broadband customers are migrating to fibre in LFC areas, and households relinquishing their landline, Chorus copper voice access demand has fallen by 250,000 lines since 2017. Contrary to Chorus' letter to the Commission¹⁴, these trends were known and anticipated when the UFB programme was initiated.

22. The regional breakdown also highlights FWA's important role in expanding the market, connecting customers that have previously had no broadband service. For example, Figure 5

¹⁴ Chorus letter to Commission 18 June 2021 at page 2

shows that, while we continue to see overall growth for “cabled” services, FWA importantly provides a valuable broadband option for many customers.

Figure 5: total broadband market by cabled and wireless technologies



23. We see a consistent picture in the market. For example:

a. []SPKCI

24. The Commission cannot and shouldn't seek to manage these market transitions through Part 6 of the Act. Policy makers established Part 6 specifically for the regulation fibre networks - avoiding legacy copper related costs and impacts being brought into fibre services - with a separate Commission review of copper regulation by 31 December 2025.

Chorus investment threat

25. While a number of PQ decisions have yet to made, Chorus has further written to the Commission setting out that the indicative expenditure profile at this stage is unsustainable for Chorus and will have an impact on services and investment.

26. Chorus notes that it has paused any further fibre roll out¹⁵ and, while it has hasn't decided on its specific response to the draft¹⁶, plausible actions include a slowing in fibre adoption if incentives are excluded¹⁷, reductions in efficient lifecycle, asset management and network extension, product, technology and service quality innovation¹⁸, and an erosion of investor confidence in PPPs¹⁹.

27. It's unclear what Chorus is seeking from the Commission. The Commission cannot agree:

a. Not to apply the Part 6 regulatory model and IMs as anticipated by the Reasons Paper.

¹⁵ Chorus July letter to the Commission

¹⁶ Chorus submission at 10

¹⁷ Chorus at 10.1

¹⁸ Chorus at 10.2

¹⁹ Chorus 10.3

- b. Not to apply the processes and assurances set out in the September 2020 process paper to ensure end-users are not over-paying for FFLAS services, simply accepting unsupported proposals for costs that will be passed on to end-users, or
 - c. To apply Part 6 regulation to address Chorus' other business concerns and commercial objectives.
28. The Commission is simply applying the regulatory model that Chorus asked for – the same utility regulatory framework that applies to Part 4 regulated firms such as electricity lines companies.
29. At this stage, there is no real prospect of the proposed revenue path driving useful efficiency benefits. The Commission has already indicated that it won't implement specific incentive measures in the first regulatory period, has proposed only high-level PQ path quality measures and an unlimited wash-up, and these measures provide no material incentives for the purposes of the first PQ path. The incentives of a regulated firm facing a pure revenue cap and wash-up as proposed are clear, to minimise actual expenditure while filling any permitted revenue headroom through price increases. In our context, Chorus can further maximise revenue by optimising demand between its copper and fibre networks.
30. Accordingly, we doubt Chorus' proposed revenue uplift materially changes these incentives and, adding an uplift to the current revenue path, can only increase prices to end users further. The Commission has limited options. In light of the risks highlighted by Chorus, we recommend it consider:
- a. Ensuring that ID requirements makes transparent both:
 - i. Chorus investment and operational changes so that it can identify whether concerning changes are occurring. This can inform specific incentives for the second regulatory period, and
 - ii. Established robust FFLAS asset management and development/innovation baseline roadmaps. If we had robust information the Commission would be less reliant on individual capex proposals in the second regulatory period.

Accordingly, we do not support Chorus and LFC proposals to wind back ID obligations – transparency will be essential for the first regulatory period where limited beneficial incentives are anticipated.
 - b. Bringing forward current Commission workstreams relating to fibre unbundling and deregulation guidelines – these are fundamental components of the regulatory framework. In particular:
 - i. Major infrastructure providers and investors – Vector, Vodafone and Vocus – all announced investment in fibre networks. However, they also report that their respective proposals have been blocked by Chorus practices that they believe are anti-competitive and have made complaints to the Commission.

Effective unbundling will promote competition and investment in the fibre networks – these are major providers looking for an opportunity to further invest in the market.

 - ii. The Commission has indicated that it would consider its approach to deregulation under Part 6 of the Act after the price-quality regime has been

implemented²⁰. The Commission may wish to bring forward this work as the Act permits a s210 from 1 January 2022.

We believe that Schedule 3 deregulation guidelines would provide a useful starting point for Part 6 and anticipated copper regulatory review.

Incentive payments

31. Chorus' current offers RSPs credits of up to \$960 per fibre connection for connecting specific customers to fibre, including its "mix it up" and "bonus credit" schemes (summarised in Figure 6 below). These credits are cumulative and include specific rules. For example,

- a. A "mix it up" credit is paid for a new fibre connection or upgrading an existing an existing fibre 30M customer, provided that 85% or more of an RSP's new fibre connections are for 100M variants and above. The "hurdle" threshold for accessing this credit has increased over time, from 70% through to current 85%.
- b. A "bonus credit" is also available for a new fibre connection, ranging from \$50 (i.e., whether the premises is currently served by a Chorus copper connection) through to \$600 (where the premises is connected to another network).

The available credits and specific addresses at which it is offered have varied over time, i.e., prior to 1 July 2021 the maximum credit was \$450 per connection for around 270,000 addresses while from 1 July to 31 December 2021 the maximum credit is \$600 per connection (to around 80,000 addresses)²¹.

- c. Sitting alongside the core incentives are additional constraints (RSPs must provide fibre specific marketing support) and a pro-active fibre installation programme.

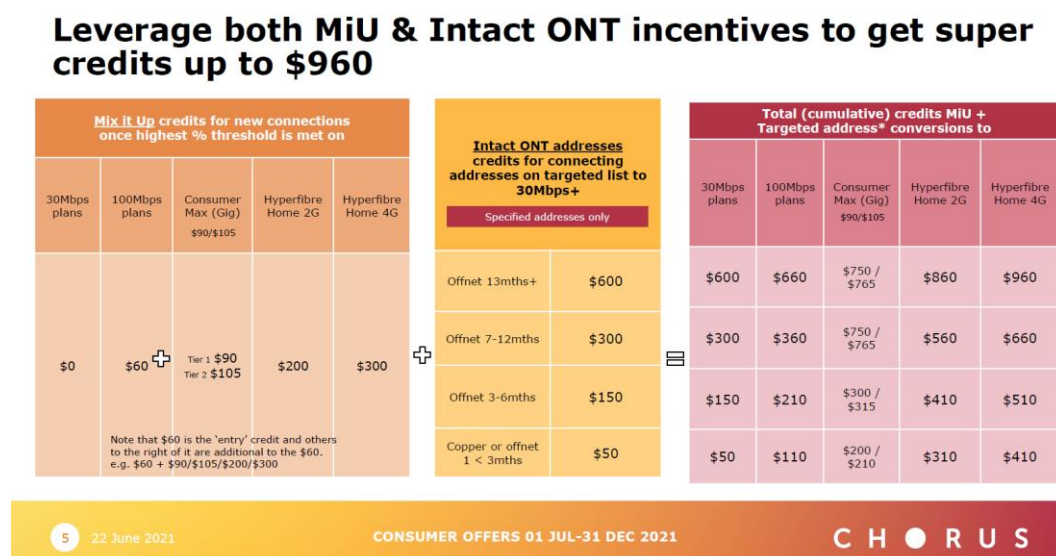
The bonus credits are only available at specified addresses, and the list of specified addresses is significantly weighted towards premises where fibre has been pro-actively installed (i.e., without a customer request). For example, of the 270,000 addresses at which additional credits were offered up to 30 June 2021, around 190,000 were premises without a connected ONT suggesting they are the result of a pro-active installation programme (and over 2/3 of these addresses were not connected to the Chorus network, i.e., were likely customers served by other networks²²).

²⁰ Commerce Commission Final decision on whether to commence an investigation under clause 1(3) of Schedule 3 of the Telecommunications Act 2001 (12 May 2021) at para 47.

²¹ The additional credits have been made available for specific periods (from 2 to 6 months) and to different customers premises. We do not know what credit or addresses will apply from 1 January 2022.

²² See Copy of Fibre Bonus Credit Eligible List (Cleaned Data) June 2021_0 downloaded 12072021

Figure 6: Chorus connection incentive offer²³



32. Through the connection incentive initiative, Chorus is able to segment and differentiate prices in the market. For example, the incentives are structured to:

- a. Segment that market between end-users who are on Chorus copper, on Chorus fibre and on alternative networks, and price discriminate between these end-users.
- b. To identify and segment “active” end-users who are more likely to become customers of alternative networks, and price discriminate between these customers and Chorus’ other customers, and
- c. Segment the market between RSPs who support entry level fibre variants in the market and others, providing incentives that undermine low performing fibre services in the market.

The Commission cannot determine a PQ path that is inconsistent with the Act

33. The Commission has proposed that, given uncertainty around the incentives and RSP concerns, if Chorus wishes to pursue the connection incentives it should make an individual capex proposal.

34. We asked Russell McVeagh to advise us on the appropriateness of the Commission’s approach, and to identify whether there are legal risks for the Commission if it decided to change its draft position on incentive payments in response to the Chorus submissions.

35. The attached Russell McVeagh opinion outlines concerns that the connection incentive credits:

- a. Are clearly part of the FFLAS price and that the practice is inconsistent with the s201 requirement to offer the same FFLAS price for materially the same service regardless of the geographic location of an access seeker or end-user
- b. Are inconsistent with Chorus’ non-discrimination obligations; and

²³ See Chorus Info pack RSP Incentives for Consumer Fibre and Hyperfibre Connections 01 July-31 Dec 2021 (12 May 2021)

- c. Are likely to impact competition in telecommunications markets and as such their inclusion may be inconsistent with the Commission's obligations under s166 (2)(b). The s201 and non-discrimination protections are fundamental components of the regulatory framework designed to prevent harm to competition and including an allowance for recovery of incentives that violate those protections through a PQ determination would risk breaching the Act's purpose statement.

36. We believe the incentive payments are clearly inconsistent with the Act and cannot form part of a PQ path:

- a. It makes no sense to define "price" so that key elements of the regulatory framework have no effect. For example, if this were the case, then FFLAS related "credits" could easily be applied to differentiate prices (s201), implement discriminatory practices or shift revenue in or out of the BBM.
- b. Connection incentives are inconsistent with s201 and non-discrimination.
- c. Connection incentives are a rational anti-competitive pricing strategy because recoupment through the fibre BBM is guaranteed while, by targeting only active customers of other networks with large one time only discounts, it undermines nascent competition from wireless networks and reducing fibre stranding risk.

Chorus is able to limit wireless ability to grow and provide more competition to its current copper customers and future fibre customers, and

- d. The practice is unlikely to be in end-user interests because:
 - i. Incentive hurdle rates distort retail markets, undermining retailers' ability to support entry level fibre services.
 - ii. Chorus' form of pocket pricing undermines competition and, gain by targeting only active customers for discounts, it can sustain higher copper and fibre prices to consumers. Chorus' approach is consistent with the behaviours identified by the UK FMA and CMA as concerning and warranting investigation.

37. We are already seeing implications for services to end-users. For example, []SPKCI

38. We accept that Chorus should respond to competition from other providers. There's nothing wrong with Chorus creating competitive alternatives by reducing prices and amending their product constructs to match or meet the market. Chorus already undertakes a range of marketing activities to support fibre services and promote new FFLAS variants²⁴. However, by embarking on a strategy of targeted discrimination against RSPs with alternative infrastructure, and a pocket pricing approach with deep incentive offered exclusively to win over end users already on a competitor's infrastructure, their approach is anti-competitive in the circumstances.

Chorus' behaviour is inconsistent with the claimed purposes

39. Chorus submits the Commission should be wary of accepting our connection incentive concerns, given that network operators investing in telecommunications infrastructure are concerned about the impact of the incentives and resale-based providers support the incentives²⁵.

²⁴ Set out at page page 86

²⁵ Chorus at 130

40. We agree that the Commission should be mindful of incentives and, in a decision, look to the revealed preference of parties and evidence of what is occurring. It is for the same reason that the Commission can't simply act on Chorus claims that it is lean or efficient or that its expenditure proposal is carefully aligned with FFLAS requirements, the Commission has to look to the evidence and reliable assurance supporting the expenditure proposal.
41. In any case, the connection incentive structure is a concern in its own right as the practice differentiates prices on the Chorus fibre network for services that are materially the same, targets active customers who are customers of other networks, penalises captive fibre customers through higher prices and relies on the uneconomic deployment of fibre to premises for which there was no customer connection service order. Accordingly, irrespective of Chorus' claimed motivation, the connection incentives on their own are inconsistent with the Act.
42. Chorus says incentive payments are beneficial and prudent²⁶, are a core part of Chorus' business and commercial positioning²⁷ and have a positive impact on downstream competition. The incentives are taken up in greater proportion by smaller, non-vertically integrated RSPs, which helps them compete with current MNOs²⁸. Accordingly, Chorus argues that the Commission starting point should be whether historical levels are reasonable or if they need to be adjusted, not to set incentive payments to zero²⁹.
43. However, Chorus' claimed purposes appear inconsistent with how the incentives are applied in practice. For example, Chorus submits that the connection incentives:
- a. Are well established and have been a feature of the market for many years³⁰, yet the concerning bonus credit incentives were introduced in April 2020 and higher 85% threshold for accessing credits since September 2020. Earlier schemes did not discriminate between end users or technologies in the same way, and even then we expressed concerns at Chorus' pocket pricing behaviours.
- Further, the incentive and credit structure has been amended a further 4 times since being introduced, with the specific availability of a particular variant varying from 2 to 6 months. RSP medium term plans could not have relied on a settled credit structure as Chorus suggests³¹.
- b. The pre-BBM regulatory context means that it would not have prioritised this investment if it were not cost effective³². However, key policy decisions were made, and legislation was enacted, prior to Chorus ramping up the connection credits. For example, the Government decided in December 2016³³ to provide for past losses and enabling legislation introduced in 08 Aug 2017³⁴. Chorus could act with the comfort that this spend would be guaranteed through the BBM regulatory framework. The Commission is rightly concerned that Chorus' incentive credit decisions are unlikely to be consistent with the purposes of the Act.

²⁶ Chorus at 11

²⁷ Chorus at 12-13

²⁸ Chorus at 14

²⁹ Chorus at 15

³⁰ Chorus at 13, 117 and page 84

³¹ Chorus at 14

³² Chorus at page 85

³³ See EGI-16-MIN-0361 (14 December 2016)

³⁴ https://www.parliament.nz/en/pb/bills-and-laws/bills-proposed-laws/document/BILL_74818/telecommunications-new-regulatory-framework-amendment

- c. Are intended to increase fibre uptake³⁵. However, the incentives provide only a minimal credit for converting a Chorus copper customer to fibre when these customers would otherwise provide the same fibre uptake benefits as a new customer.
- d. Facilitate the PSTN shutdown³⁶. However, our PSTN migration programme is driven by lifecycle concerns and current incentive credits have no impact on this programme. The incentive credits may have an impact if they applied to copper customers moving to fibre in any material way, but they don't.
- e. Are intended to support retailers to overcome customer inertia³⁷, yet the connection incentive credit is targeted at the most "active" customers who have demonstrated they are active by migrating to another network.

If Chorus' purpose was to target inert customers as it suggests, again it would be offering incentives to migrate copper customers because this is where the most resistant customers lie.

- f. Must be good for end-users because they are popular with some RSPs. However, the structure of the incentives means they favour a specific RSP business model – i.e., an RSP who focuses on high end fibre plans and not investing in telecommunications infrastructure – and not a reflection of an RSP gap or need in the market.
- g. Are necessary to support challenger providers such as Trustpower and Sky to compete against established telecommunications providers, enabling these providers to over-come that fact that they can't bundle broadband with other telco services³⁸. However, these are major companies with significant resources who are constructing their own bundles comprising electricity and Pay-TV services with broadband.

44. Put simply, Chorus' proposed purposes and drivers are disconnected from the connection incentive scheme in practice. The Commission is right to defer any consideration of incentive payments to an individual capex proposal, enabling it consider whether the incentive credits are permitted under the Act and implications for end users and competition, and unpick inconsistent claimed incentive purposes.

45. The Commission should further be wary accepting claims that incentives should be used to protect competitors or promote a form of competition in retail markets, particularly where the regulated provider claims a mandate to determine the form of competition in end-user interests.

46. In this case, competition in our market is in part based on bundles and, as set out in Table 2, the providers to which Chorus refer offer their own bundles. There are a range of bundled offers in the market.

Table 2: examples of broadband bundle offers in the market³⁹

Provider	Bundle discount	Offer
Trustpower	\$15 off broadband, option	"A \$15 per month discount has been applied to your broadband price because you are signing up for both

³⁵ Chorus at 10.1

³⁶ Chorus at 121

³⁷ Chorus at page 84

³⁸ NERA at page 11

³⁹ consumer.broadbandcompare.co.nz and provider websites

Provider	Bundle discount	Offer
	of 12 months half price or a TV/appliance	power and broadband. This broadband bundle discount will apply to your broadband price as long as you also have your power with Trustpower. "Your choice of Samsung joining reward - Offer only available to new residential customers who join Trustpower for power and broadband services at the same address."
Sky	\$20 off broadband	"Price only for customers on at least Sky Starter with a Sky Box in the home. From \$89 per month for non Sky customers."
Contact	\$30 off broadband	"Bundle Fibre 100 Plan, Electricity, and Gas and you'll get \$30 off the standard monthly cost of broadband."
2Degrees	\$10 off broadband	"Unlimited broadband for only \$65/mth when you have a 2degrees Pay Monthly Mobile Plan"
Vodafone	\$10	"bundle your broadband and Vodafone Pay Monthly mobile plan and get an extra \$10/mth off"
Slingshot	10% plus \$5 for active mobile plan	"bundle your broadband and power and get 10% bundle discount on both services. Get \$5/mth off for each active mobile plan you bundle with your broadband"

47. Chorus notes that a key benefit of the incentives is that they help retailers overcome the inability to bundle broadband with other telecommunications services, yet these providers are major commercial entities with their own alternative and unique bundles. In practice, the only difference between Chorus' preferred new entrant retailers and others is that they are not investing in competing telecommunications infrastructure that risks constraining Chorus current copper and future fibre returns.

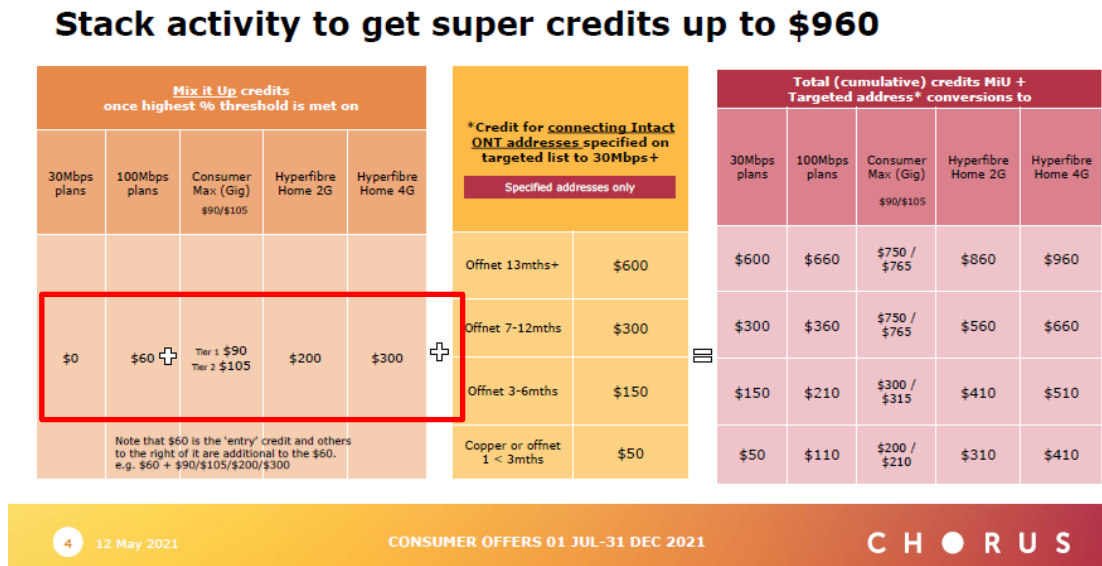
The NERA report

48. NERA has prepared a report for Chorus, observing that incentive payment schemes are a feature of workably competitive markets to address customer inertia, and can promote uptake and consumer outcomes⁴⁰. NERA further concludes that competition concerns are overstated because predation requires recoupment, non-discrimination requirements imply that cross subsidy isn't possible, and any Commerce Act concern would be caught by Chorus internal compliance checks.

49. It is unclear what can be taken from the NERA report. On the face of it, NERA has focused on only a subset of Chorus' connection incentives and, by doing so, misses key concerning elements of the incentive scheme. For example, NERA refers in its summary to "Connect to 100M+", "Get to Gig" and "Hype it up" credits which primarily promote high speed fibre variants, but fails to mention the calibration of the credit threshold, differences in available credits between migrating Chorus copper connections rather than customers from other networks to fibre, and the important role pro-active fibre installation has for the incentives (see Figure 7).

⁴⁰ NERA at page 1

Figure 7: summary of connection incentives with NERA scope highlighted in red



50. Chorus uses the missing elements from NERA’s summary to segment the market and differentiate prices, and this puts in to question a number of NERA’s recommendations. For example, NERA

- a. Refers to a commercial rationale to reduce copper demand and support the early shutdown of the copper network⁴¹.

However, minimal incentives of are offered to migrate a copper customer to a fibre service (nothing if it is to the entry level fibre, \$50 if it is to a 100M plan) whereas credits of up to \$600 apply a customer migrating from another network. Further, bonus credits are generally only available at premises served by other networks. It is highly unlikely that copper shutdown is a material driver for the incentives.

- b. Notes that incentives can be a means of addressing customer inertia⁴².

However, the incentives target the most “active” customers, not the inert customers that NERA is concerned about. Customers of other networks are the most active customers, demonstrated by their willingness to adopt new technologies. If the incentives were to address inertia costs, then the incentives would target residual copper served customers as these are the most inert.

- c. Notes that to implement an anti-competitive incentive would require Chorus to discriminate between captive and non-captive customers, but this is not possible due to non-discrimination obligations⁴³.

However, the connection incentives are price discrimination because they differentiate between customers that are on the Chorus copper network, fibre network and those of other networks. NERA’s assumption is further surprising in light of Chorus’ FY20 report highlighting the incentives are based on customer segment, plan and volumes (Figure 8 below). This is price discrimination.

⁴¹ NERA at page 2

⁴² NERA at page 1

⁴³ For example, page 14 third para where NERA talks about the prerequisites to implement an anti-competitive strategy.

Figure 8: Chorus report that incentives are based on segments, plan and volume

Lifting our open access wholesaler programme another level

- > **Migration and winback incentives**
 - upweighting retailer incentives based on customer segment, plan and volumes (up to \$300 for targeted copper 'late adopters'; up to \$500 for winback of offnet connections)
 - direct to consumer incentives (e.g. prezzy cards)
- > **Managed migration programme**
 - record month in July with 5,000+ installations, up from an average of ~3,000 per month
 - proportion of installation orders for offnet customers increased from 35% (July 2019) to 50% (June 2020)
 - targeted campaigns: UFB2 townships, MDUs

Fibre campaign: putting the focus on badnet

40 24 August 2020 FY20 FULL YEAR RESULT CHORUS

- d. Suggests that Chorus does not have a commercial rationale to predate rival networks due to an inability to recoup the costs, and that demand risk falls solely on end-users.

However, even within the fibre BBM, Chorus remains exposed to the risk of future competition from wireless (it has been compensated upfront for any stranding risk) and, therefore, it has an incentive to undermine future FWA competition.

Further, in practice, Chorus' incentives are to optimise across both its regulated fibre and non-regulated copper and future businesses. It is rational in this case because the costs of the practice fall in to the RAB with guaranteed recoupment, while the benefits are taken as reduced competition for its copper and backhaul businesses, and future competition for its fibre business and new markets Chorus anticipates expanding in to.

- e. Referring to Trustpower and Sky submissions, notes that the incentives may have a positive effect on downstream competition (although it hasn't fully tested this)⁴⁴.

However, as noted above, these are major providers in their own right offering bundles based on electricity and Pay-TV services. We doubt that economy efficiency supports subsidising a providers on the basis of their bundle offering.

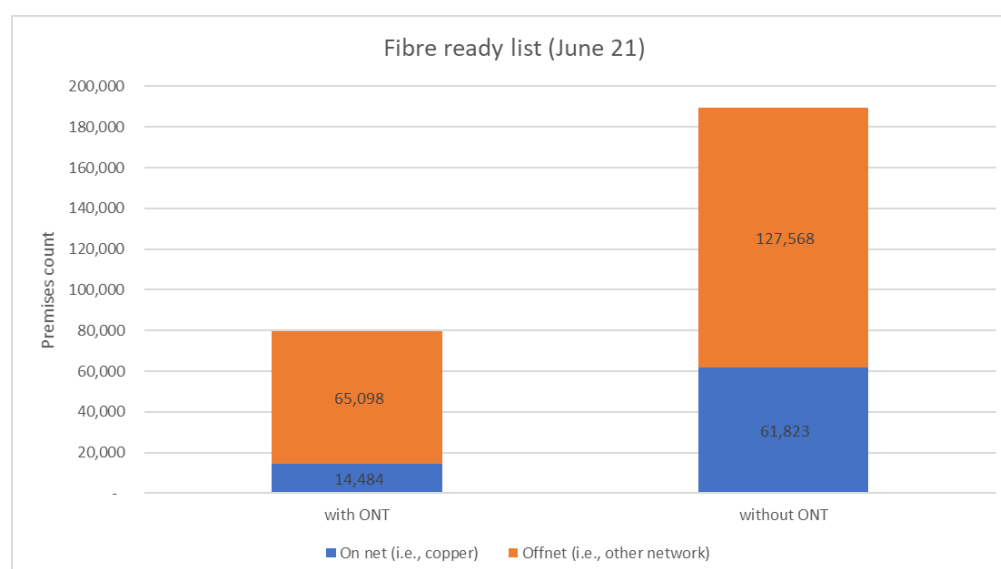
51. It is further unclear what the implications of Chorus' pro-active installation programme are for NERA's advice. The programme represents a significant Chorus investment ahead of demand, but only 50% of these installations have led to a customer connected to date⁴⁵. As set out in Figure 9, these installations are heavily weighted towards customers of other networks, and the most aggressive credits are only available for connections at these premises⁴⁶.

⁴⁴ NERA at page 10

⁴⁵ Chorus HY20 results pack

⁴⁶ Chorus has offered different variants of the bonus credit scheme over-time and each offer is available for a specific financial quarter or period. The bonus credit scheme that applied to "fibre ready" homes expired at the end of June 2021, and a revised "intact ONT" variant will apply from 1 July to 30 December 2021. It is uncertain what offers if any there will post 2021, but it could be either approach or an alternative.

Figure 9: Chorus fibre ready list June 2021



52. While we do not have access to Chorus’ net benefit analysis, recognising the costs of pro-actively installing fibre to homes would likely have a significant impact on the results. For example, our high-level analysis using public information, suggests that each bonus credit connection on its own likely delivers a negative return of over \$400 per annum⁴⁷.

Defining FFLAS scope

53. Chorus has clarified that the list of FFLAS services used for the Commission consultation was not intended by Chorus to indicate its view on FFLAS services. Chorus sets out a revised list of services and, while it omits some services such as CRT which is clearly not a FFLAS, some disputed services remain. The services we believe should be omitted are set out in Table 3.

Table 3: services that are not FFLAS

Service to be omitted	Comment
HSNS	This is a legacy service that is not part of FFLAS.
HSNS TES	This a tail extension service that extends beyond the service provider handover. It is not FFLAS.
Commercial Backhaul	This is a regional backhaul service that is not part of FFLAS. This service is not a “commercial” service in practice, it is available at STD determined prices and backhaul routes.
RGW ONT	The ONT is already part of a Bitstream service. As set out in our submission, the RGW ONT is a direct replacement for the competitive service provided by RSPs. It is not a FFLAS.

54. Chorus’ proposed FFLAS highlights our competition concerns that FFLAS and the expenditure proposal risks unnecessarily bringing competitive parts of our sector into the BBM model, and that this will ultimately undermine competition and established industry practice for sharing the deployment costs of new fibre routes. For example, Chorus’ expenditure proposal sought

⁴⁷ Based on \$1200 per pro-active installation and 50% expected uptake, operating costs from expenditure proposal and 100M variant price.

FFLAS funding for regional transport routes where there are already a number of competing providers.

55. In our earlier submission, we noted []SPKCI
56. These concerns could be mitigated by further transparency relating to Chorus investment decisions in these categories and the allocation of costs between FFLAS and competitive services. However, the draft does not address these competition and investment concerns.
57. Chorus' proposed FFLAS services reinforces these concerns. For example, []SPKCI
58. []SPKCI

Accelerated Depreciation

59. Chorus supports accelerated FLA depreciation. However, it recommends that a tilted annuity approach would better reflect the stranding risk⁴⁸. The Commission could also use straight line as proposed but this should be 8 years⁴⁹.
60. As set out in our submission, while we agree that the Commission can apply accelerated depreciation, we don't support depreciating FLA separately from the underlying asset from which the loss was it is attached. There is also a risk in that, by focusing solely on accounting approaches, that the Commission fails to determine the depreciation path that best promotes the Part 6 purposes. The Commission should rather consider depreciation across all assets, applying an approach that, for example, maximises overall welfare or minimises the scope for inefficient entry⁵⁰.
61. There is also a practical difficulty that, with anticipated Commission decisions later this year potentially resulting in a smaller FLA asset and more need to accelerate depreciation to smooth revenues, there may not be sufficient flexibility in an approach based solely on the FLA asset. Applying accelerated depreciation to the whole asset base would enable the Commission to better manage this risk.

Information disclosure

62. Chorus and LFCs propose that ID be rolled back in key areas, including the provision of asset management and expenditure forecast information (deferred), pricing discounts (incentives), quality reporting, material projects and programmes disclosure and asset condition⁵¹.
63. We do not support proposals to roll back proposed ID requirements. If the Commission were to agree to the proposals, interested parties would be unlikely to have sufficient information to assess whether the Part 6 purposes are being met.
64. Chorus' submissions and expenditure proposals further highlights significant gaps in the information available to parties and this has, in part, driven the Commission's draft approach. For example, Chorus criticised the Commission for requiring an Individual Capex proposal for "innovation" expenditure, when the approach was driven in part by the lack of information and uncertainty relating to the submitted provision.

⁴⁸ Chorus at 20

⁴⁹ Chorus at 21

⁵⁰ Discussed by the OECD in its 2004 Access Pricing report from page 162

⁵¹ Chorus submission on ID summarised at 8

65. We believe that more transparency of regulated activities through ID is a key means for the Commission to mitigate these concerns in the future. For example, ID is expected to help resolve key second regulatory period uncertainties relating to:
- a. Pricing principles that have been deferred until the second regulatory period. Pricing transparency is, in part, intended to mitigate concerns that Chorus has little incentives to efficiently price services consistent with the Part 6 purposes and the potential impact on competition.
 - b. Chorus investment and operational practices. Chorus has indicated potentially significant changes to current practices with implications for end-users, and parties need to be able to assess the outcomes of PQ decisions.
 - c. Chorus' proposed innovation and quality improving expenditure.

Possible over and double recovery of expenditure proposal costs

66. A potential over and double recovery of costs was identified in the course of considering Chorus' submissions and the Commission may wish to review the expenditure proposal further.

Costs for further roll out of UFB fibre

67. Chorus has indicated that it has paused the further roll out of UFB fibre. We agree that Chorus shouldn't plan to roll UFB fibre out further - the current roll out required a government subsidy – and would be surprised if this uneconomic expenditure forms part of the expenditure proposal.
68. There is an established process through CIP for funding fibre coverage and any Chorus proposal should be referred to CIP and brought back in to the BBM as an individual capex proposal if required.
69. Accordingly, we recommend that the Commission review whether the expenditure proposal includes provision to roll out UFB fibre beyond planned infill and new sub-divisions (which is funded through a developer contribution) and adjust where necessary.

Possible overstatement of connections capex

70. The Commission has proposed that connection capex be based on current connection costs and forecast connection demand. However, the Commission may wish to consider whether the unit costs reflect the likelihood that a new connection is to a "fibre ready" premises.
71. The connection analysis highlights that around 270,000 dwellings are already "fibre ready" (Table 4) and it is likely that many existing - albeit unused - connections will be used to meet new demand.
72. If the unit cost drivers do not reflect this possibility, then there is a double recovery as the cost to pro-actively install fibre to a premises is already in the RAB and then added again to the RAB at the time the connection is provisioned in response to a connection service order.

Table 4: services that are not FFLAS

	With ONT	No ONT	Total
MDU	28,353	49,762	
Single premises	51,229	139,629	
	79,582	189,391	268,973

[End]

Attachment: see separate Russell McVeagh legal opinion