Chorus submission on "Fibre input methodologies – further consultation draft reasons paper"

13 August 2020

CHORUS

EXECUTIVE SUMMARY

1. This is Chorus' submission on the Commerce Commission's (**Commission**) *Further Consultation Draft - Reasons Paper* (**Revised Paper**), and *Further Consultation – Fibre Input Methodologies Determination 2020*. The Revised Paper primarily relates to the post-implementation issues, with a further paper on pre-implementation issues still to be released.

2. The power of fibre high speed connectivity continues to be demonstrated by our recent COVID-19 experience, with New Zealand's fibre to the home foresight being the envy of many other countries.

3. The settings from this regulatory process – to transition into a fibre regime under Part 6 of the Telecommunications Act 2001 (**Act**) – will set the ongoing incentives to drive continued innovation on, and uptake of, fibre products for kiwi consumers. This process also sends strong signals to investors more broadly about New Zealand.

4. The development of Input Methodologies (**IMs**) is a significant and complex process. We also acknowledge the Commission's reasons for staggering the release of consultation papers.

5. Unfortunately, not seeing the full suite of IMs hinders our ability to assess the full impacts across all IMs and provide a fully informed view of all the Commission's proposed changes at this time. This also makes the tight timeframes on significant consultation issues more challenging. At this stage, a number of key matters and how they will be implemented in the final IMs drafting, are missing. As such we may need to comment further on matters consulted on in this process when responding to the Commission's next consultation.

6. The cumulative impact of decisions on the treatment of Crown financing, calculation of financial losses, cost of capital parameters and the allowance for Type II asymmetric risks will directly impact the starting valuation of Chorus and the Maximum Allowable Revenue (**MAR**) outcomes that will impact incentives ahead.

7. The starting Regulatory Asset Base (**RAB**), including the financial losses, cost of capital and the MAR will significantly affect incentives ahead.

8. While the MAR is a common feature of any regulatory framework for utilities, there are unique features of the telecommunications sector and the regulatory framework being applied to Chorus that need to be considered by the Commission to ensure it sets the incentives intended and the regime is sustainable.

9. Although a revenue cap regime is commonly applied to other utilities, there are many differences in the dynamic telecommunications sector and clear intentions that Chorus be incentivised to strive to increase broadband uptake and to continue to innovate and invest for the benefit of consumers. In particular it is essential to consider the following differences to other utilities:

    - There are multiple services being provided. The ability to achieve revenues at the cap depends on the relative mix of take up and forecasts of the different services;

- We are required to have a price-capped and quality-defined anchor product. It follows that there is also a clear intent that Chorus is incentivised to commercially innovate other services in order to be market and consumer responsive and in order to reach the MAR. This makes sense for an active wholesaler that provides open access settings for retailers and in a dynamic sector where the quality of base level broadband usage continues to change rapidly; and

- In our industry, technology is always evolving and there is recognised competition in the supply of services from alternative technologies such as fixed-wireless access and the potential for retailers to self-supply or competitively supply.

10. The complexity of this framework, and the market dynamics, reinforce the importance of getting the overall outcomes right. They also highlight the significant risks of getting it wrong and setting incentives that do not promote ongoing innovation and investment. In developing principles for the IMs the Commission has highlighted the asymmetric consequences of over and under investment. This aligns with the point highlighted by Professor Yarrow in the original Part 4 IMs, set under the Commerce Act 1986 in 2010 - that the greatest benefits of competitive markets arise from dynamic efficiency.

11. The outcome of establishing the starting RAB and MAR must place the right incentives on Chorus to invest and innovate to promote dynamic efficiency to deliver benefits to end-users and a sustainable regime ahead.

12. The IMs will frame the rules for significant elements of the regime, such as the treatment of Crown financing pre- and post-implementation and the financial loss calculation. We are also concerned that the IMs containing the Commission's current position on cost of capital and Type II asymmetric risk will not meet the purpose of the Act and will ultimately not benefit end-users.

Key Issues

Crown financing

13. We do not support the Commission's decision to revert to its Emerging Views decision of last year regarding the treatment of Crown financing. We also await the further consultation document on the pre-implementation period on this issue.

14. We repeat our previous submissions on this matter. The revised/reversed proposal suggests that Crown financing was costless. This is simply wrong. It does not align to the principle of real financial capital maintenance (**FCM**) or the purpose of the Act. The Commission's own economic advisor calculates a benefit for Crown financing that is aligned with the view presented by Incenta economics.

15. Notwithstanding the circumstances outlined above, we encourage the Commission to consider the broader signal its proposed approach to Crown financing sends to investors. Chorus partnered with government to build a world class fibre network. The Commission's apparent position is to go beyond removing any benefit from Chorus' deal with the Crown to imposing a cost. Had investors been aware of this before the network was built it is unlikely the project would have ever proceeded.

This sends a strong negative signal both to existing investors and any prospective investors considering partnership with government and/or investment in New Zealand.

Cost of capital and Type II asymmetric risk

16. While the Commission has not asked for views on these elements of the IMs we think it is important, given all decisions will ultimately add up to outcomes and send incentives, to note that:

    - The allowance for Type II asymmetric risk should be applied for the pre and post-implementation periods and should be in a range of range of 31 to 87 basis points rather than the 10 basis points proposed by the Commission; and

    - We do not support the cost of capital parameters contained in the IMs for the PQ path. In particular: asset beta should be 0.60, credit rating should be BBB (consistent with leverage of 31%), debt issuance cost should be 0.25% (for a 5-year term) and the 67th percentile should be applied to reduce the probability of under-estimating the cost of capital and to maintain incentives for further investment and innovation in FFLAS.

17. We don't object to the Commission's intention to monitor the effects of the COVID-19 pandemic to ensure the cost of capital IMs remain fit for purpose. However, the Commission should ensure it has not time bound itself and can make appropriate changes beyond April 2021 for future regulatory periods.

18. Parliament made a decision to have a separate regulated regime for telecommunications services, reflecting the different dynamics and characteristics of this industry. We therefore propose that the Commission should not seek to converge processes under Part 6 of the Telecommunications Act 2001 and Part 4 of the Commerce Act 1986 for other industries.

Transitional initial RAB

19. If a transitional initial PQ RAB is used, the most recent and reasonable actual data should be used – i.e. one forecast year only. This better promotes certainty for first regulatory period (**RP1**) and represents the best estimate available at the time of setting the initial RAB.

20. The use of a transitional initial PQ RAB (with forecast values of potentially two-years) also raises questions with respect to recovering the actual return of, and on, capital of our value of our initial RAB. We expect that, consistent with section 177 of the Act, the Commission will address this through a symmetric and unconstrained wash-up mechanism as required by section 196 of the Act.

Regulatory certainty and workability

21. The revised IMs include significant drafting changes that improve the workability of the IMs. We propose further refinements to improve the balance of workability, flexibility and certainty in the IMs. This includes changes to the interpretation of the regulated service, asset valuation changes, less prescriptive cost allocation processes, more flexible and targeted capital expenditure information requirements, and regulatory rules and processes changes to cater for an enduring regime.

22. We have attached a table of proposed drafting changes at Appendix A of this submission. The drafting changes are intended to assist the Commission in relation to relatively simple changes. They do not address all the points in our submission (as some require complex drafting changes that we're unable to consider within this short timeframe).

Summary of submission

Regulatory framework

23. We support:

- Distinguishing between FFLAS subject to PQ and FFLAS subject to ID, as well as ID-only FFLAS given there are specific rules for depreciation and cost of capital.
- Not imposing further classes of FFLAS until after RP1. If this changes in the future, a clear purpose should be outlined for workability and certainty.
- The approach to implement the section 226 regulations that define the geographic extent which PQ and ID regulation exist.
- The view that geographically consistent pricing only applies in areas where price-quality regulation (**PQR**) applies.
- The exclusion of network services from the definition of FFLAS.
- How assets (that are built and become available to provide FFLAS) are to be treated in the RAB. We agree with the Commission that any assets related to new property development (which become available for use to provide FFLAS) will enter the RAB with any capital contributions deducted from their asset value. This is a separate issue from constructing a network in a new property development, which is unregulated today and contestable.

24. We don't support:

- The Commission's interpretation of legal definition in the Act for FFLAS. The Commission's translation of definitions of legal definitions in the Act also do not align with market and competitive reality, policy intent or workability in the whole scheme of the rules in place.

Asset valuation

25. We support:

- The Commission's proposal to align the timing of the value of commissioned assets with GAAP, revised requirements for a minimum level of asset data, and the definition of network spares.

- An *ex-ante* allowance for asset stranding but remain of the view that (in line with the expert report before the Commission) a range of 31 to 87bps is more appropriate than the Commission's 10bps.

26. We don't support:

- The Commission's proposal to revert to its Emerging Views decision regarding the treatment of Crown financing.

- The proposed use of two forecast years for a transitional initial RAB and propose that only one year needs to be forecasted to increase certainty.

Cost allocation

27. We support:

- That an accounting-based allocation approach be used to allocate costs between PQ and ID-only FFLAS, and that the Commission does not need to prescribe the allocator types used.

28. We don't support:

- The Commission's prescribed "two-step" approach. This will increase time and additional costs in exchange for no real benefits and raises substantial workability concerns.

- A cap on shared costs. We maintain the view that the proposed cap is not workable and has not been adequately outlined. We don't have granular data on existing assets to determine what costs are unavoidable when non-FFLAS ceases to be supplied.

Capital expenditure

29. We support:

- The Commission's revisions that improve the workability of the capex IM and the 31 December 2020 deadline for our first expenditure proposal. However meeting this date is at risk if the mandatory assessment factors or audit requirements remain as drafted. A one-off RP1 transitional provision, allowing the deadline to be moved if necessary, is needed as a prudent backstop.

30. We don't support:

- Mandatory assessment factors. They should be discretionary to allow the Commission to apply a flexible, tailored and targeted approach. This would better reflect best regulatory practice and is more consistent with the principle of proportionate scrutiny.

- Extended audit requirements, which would preclude submission of our first expenditure proposal by 31 December as they significantly alter the nature of the audit. We continue to propose that the requirements reflect Transpower's audit practices.

Rules and processes

31. We support:

    - The inclusion of local council rates and dispute resolution costs as pass-through costs. However, there should also be a provision to allow future unforeseen costs and recoverable costs – this is consistent with Part 4.

    - The building blocks revenue definition. However, this should also provide for revenue smoothing within a regulatory period to be determined during PQR.

    - The changes to improve the workability of the reconsideration reopener event process but suggest removing the exclusions to the catastrophic event definition and adding a new consideration factor instead. This would allow for a more nuanced Commission response.

Quality

32. We support:

    - The Commission's revised quality dimension definitions, and consider these changes improve the workability of the quality regime.

Cost of capital

33. We support:

    - The Commission's intention to monitor the effects of the COVID-19 pandemic to ensure the cost of capital IMs remain fit for purpose. This goes to the heart of the economic principles. However, the Commission should ensure it is not time bound itself and can make appropriate changes beyond April 2021.

34. We don't support:

    - Aligning the cost of capital review processes across regulated industries and different legislative regimes.

    - The post-implementation cost of capital parameters because they don't adequately reflect the balance of risk associated with investors, consumers and Chorus.

REGULATORY FRAMEWORK

Overview

1. The Commission has proposed several new decisions to implement regulation 5 and 6 of the Telecommunications (Regulated Fibre Service Providers) Regulations 2019 (**Regulations**). Regulation 6 provides that all Chorus' FFLAS is subject to price-quality regulation (**PQR**), other than where another regulated fibre provider (i.e. a local fibre company (**LFC**)) has installed a UFB fibre network. Regulation 5 provides that all Chorus' FFLAS is subject to information disclosure regulation (**IDR**).

2. The following sections set out our response to these Commission decisions. In summary we think the Commission has:

    2.1. Made sensible proposals for implementing the Regulations and how the distinction between services subject to ID and PQ, and services subject to ID only should be treated. Some minor clarifications are required; and

    2.2. Moved in a positive direction with respect to the services which fall within the definition of FFLAS. But there are still some services for which we think a different approach is required, in particular new property development. We maintain that these are not regulated today and are not in themselves FFLAS. But we agree with the Commission that new property developments that result in assets available for the provision of FFLAS to retail providers are the assets that become regulated under Part 6.

Implementation of the regulations

Geographic extent of price-quality regulation

3. A key implementation issue is finding a workable way of identifying the geographic areas where Chorus' PQR applies and does not apply. We agree with the Commission's proposed approach to implementing regulation 6 where:

    3.1. A service is considered to be provided at the end-user's premises or access point; and

    3.2. The extent of other LFCs' networks should be determined based on their coverage obligations in their respective UFB agreements.

4. We note that the end-user's premises or access point may not be the location of the end-users who are the ultimate recipients of FFLAS. For example, where a FFLAS terminates at an access point that is a mobile base station, the ultimate end-users will be those with mobile devices in the base station's coverage area. So, for the purpose of regulation 6, it's important to be clear that the service is provided at the end-user's premises or access point where the FFLAS terminates.

5. We agree with the Commission that an interpretation based on the idea that a service is provided at a Point of Interconnection (**POI**), or where the relevant assets are located, would produce odd incentives around how we design and build our network and services.

6. Similarly, determining geographic areas on any basis other than where LFC fibre services are available would not be workable. A more granular examination of actual connections would also be inconsistent with both regulation 6 and the policy it is intended to implement.

7. It makes sense to use data provided for the purpose of determining specified fibre areas (**SFAs**) to determine the extent of ID-only areas since this will provide the Commission with information on the extent of LFC networks. However, the exercise of making an SFA declaration is a process from a different part of the Act with a different purpose. So, while the underlying data on fibre network location is useful, the actual SFA process and declaration should not be used to guide the determination of ID-only areas. Rather the Commission should consider a process predicated on the principle that PQR should only be imposed to the extent a provider faces insufficient competitive constraint.

8. A potential issue arises from the Commission's expansive view of what constitutes FFLAS. For fibre access services it will be relatively straightforward to determine whether the location of the end-user premises or access point is within an LFC's UFB area. For other services which the Commission currently considers to be FFLAS the exercise may be less clear.

9. For instance, we would expect that any transport / backhaul services (which have no end-users and are not access services) within an LFC's UFB coverage area (e.g. Chorus ICABs inside an LFC's coverage area) would be subject to ID only.[1] Similarly a co-location service at a location inside an LFC's coverage area would be subject to ID only. It would not be workable to try to determine the location of end-users supported by transport, or co-location services. Even if it were possible, these services can support multiple end-users in different locations and could potentially result in services which are partly subject to PQ and partly subject to ID-only. This is not a practical outcome.

Application of geographically consistent pricing

10. We agree with the Commission that geographically consistent pricing does not apply in areas where PQR does not apply. As discussed above, under the Regulations, Chorus is not subject to PQR in respect of FFLAS provided in geographical areas where other LFCs have fibre network under the UFB initiative. Accordingly, Chorus is not required to comply with geographically consistent pricing for services provided in areas in which other LFCs have fibre network under the UFB initiative.

Classes of FFLAS and multiple RABs

11. The Commission proposes to separate regulated FFLAS into classes and introduce reporting of multiple RABs under ID regulation. We agree that, because the Regulations have set different scopes for ID and PQR, it is necessary to distinguish between FFLAS subject to PQ and FFLAS subject to ID, as well as ID-only FFLAS given there are specific rules for depreciation and cost of capital.

[1] We remain of the view backhaul services are not intended to be regulated under Part 6 (see further below).

12. We also agree it is sensible to build flexibility into the IMs by allowing for further FFLAS classes and additional RABs in future, if required. However, it is important to understand that an open-ended discretion to introduce additional granularity adds significant uncertainty and, if this discretion is not exercised cautiously, it could undermine the workability of the regime and the purpose of IMs.

13. A requirement for us to make additional distinctions between types of services and their supporting assets is likely to require material revision to existing records and modelling, driving significant cost. Accordingly, the Commission should have a clear purpose, and be confident there's a genuine need, for further FFLAS granularity or requiring additional RABs as the requirement will ultimately impose increased costs on consumers.

14. For RP1, we agree with the Commission that there's no need to introduce additional classes of FFLAS and additional RABs beyond those required for PQ FFLAS, ID FFLAS and ID-only FFLAS (except where the Act requires UFB versus non-UFB for the purpose of calculating the financial loss asset). We consider this is a sensible position for the Commission to take at this stage because:

    14.1. It would represent a late and significant reversal of the Commission's position signalled in the draft IMs that "there will be no prescriptive cost allocation IM rules for allocating shared costs between different types of FFLAS for the first regulatory period".[2]

    14.2. Given the time constraints, the Commission should focus on distinguishing characteristics of the regime that will be useful from the outset, such as regulated versus unregulated services / costs, and ID and PQ services / costs.

    14.3. The same assets are used to deliver a range of different services – there are few (by value) assets that are directly attributable to specific services. Allocation to a granular level of detail will be largely subjective.

    14.4. Time is required to understand how everything hangs together in this regime before embedding further complexity. On balance, the risk of it becoming overly unworkable and unnecessarily complex is significant – as this is new untested territory.

Scope of the regulated service

15. We welcome the Commission's further elaboration of its views on which services constitute FFLAS. We agree with most of the services the Commission describes as FFLAS: bitstream and unbundled PON services; bitstream and unbundled point-to-point services; and co-location and interconnection services. We also support the Commission's view in the Revised Paper that network services, and certain backhaul services (national/inter-candidate areas backhaul services like Chorus Regional Transport), are not FFLAS.

16. However our view remains that the inclusion of other specified backhaul services and new property development services as FFLAS is beyond the scope of the Act. These

[2] Commission, Draft IM Determination, para 3.332 summary.

services have never been regulated before and there's no basis to expand regulation now to include them.

Transport / backhaul services

17. Our submissions on the Commission's draft decision explained why backhaul services are outside the statutory definition of FFLAS.[3] We don't propose to reiterate those points again here and instead refer the Commission back to those earlier submissions.

New property developments and network services

18. We support the Commission's decision that network services do not fall within the definition of FFLAS in the Act. Equally new property development services should be excluded from FFLAS. Again, we have previously submitted in detail on this point and refer the Commission back to our earlier submissions.[4]

19. We agree with the Commission that it is unnecessary for these services to be regulated for their income to be captured under the regime. This is because once the property build is complete and the new assets are available for FFLAS, those assets will enter the RAB with their value net of any third-party contributions. In other words, the construction of new network assets is different from the provision of FFLAS to retail service providers.

20. There is not, and has never been, any regulation of construction of new telecommunications network in New Zealand. During the extensive policy development and legislative process behind the fibre framework there was never any suggestion of a need, nor intention, to regulate construction of new network.

21. In the standard situation Chorus contracts with a developer to build out network in a subdivision in return for a capital contribution. The developer obtains no rights to use that network nor to any services provided over it. Instead, what is achieved is that the developer – by providing a capital contribution – secures a decision by Chorus to deploy its network into areas where it would not otherwise economically choose to do so.

22. Considering property development to be FFLAS is not consistent with the words used in the Act and there is no contextual information or coherent policy argument for departing from them. If the Commission has any potential competition concerns it has other regulatory mechanisms to address them, like the Commerce Act 1986, in

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[3] Chorus submission on Fibre input methodologies: Draft decision – reasons paper dated 19 November 2019 and Draft fibre input methodologies determination 2020 dated 11 December 2019 (28 January 2020), [11 – 16] and [34 – 46]. In particular, at [46], we explain why the Tail Extension Service (TES) cannot be a FFLAS. This is because TES backhaul is a layer 2 backhaul service that starts at the UFB layer 2 handover point and carries traffic beyond it (no part of the TES backhaul falls between the user-network interface and the layer 2 handover point). In addition, we don't offer a TES service for layer 1 fibre services like DFAS and PON, given it's also impractical to provide a simple layer 1 backhaul service.

[4] Chorus submission on Fibre input methodologies: Draft decision – reasons paper dated 19 November 2019 and Draft fibre input methodologies determination 2020 dated 11 December 2019 (28 January 2020), [11 – 16] and [47 – 57].

addition to oversight of our operating and capital expenditure related to assets used to provide FFLAS.

ASSET VALUATION

Overview

23. In determining the asset valuation IM, the Commission should account for, amongst other things, real FCM, allocation of risk and predictability.

24. We disagree with the Commission's revised view on Crown financing. The Commission has reversed its decision and in doing so has chosen a characterisation of Crown financing that is apparently not supported by its own expert. The revised approach to the treatment of Crown financing is wrong in fact, does not provide us the opportunity to recover real FCM and is inconsistent with the Act.

25. We agree that the Commission's proposed transitional initial PQ RAB (**initial RAB**) improves the workability of the draft asset valuation IM. However, given that audited data will be available, it should use actual data up to 30 June 2020 in order to reduce uncertainty. A "true-up" of the initial RAB is also required to reduce uncertainty and to comply with section 177 of the Act.

26. We also support allowing fibre suppliers to mitigate asset stranding risk with an ex-ante allowance. However, an allowance between 31 to 87 basis points is more appropriate than the 10 basis points proposed. This allowance needs to be applied to both the pre-implementation period and the post-implementation period because those Type II asymmetric risks apply in both circumstances.

Treatment of the benefit of Crown financing

27. We are concerned about the process by which the Commission has arrived at its current position on Crown financing and the lack of evidence supporting its view. In its Emerging Views Paper, the Commission outlined a number of possible approaches to determining the cost of Crown financing. The Commission received submissions from Chorus with a paper from our expert advisor Incenta, advising that Chorus bore a residual risk associated with Crown finance. The Commission also took advice from Dr Lally, who substantially agreed with Incenta on the proper characterisation of Crown finance. The Commission relied on the advice of its own expert in reaching the position set out in its draft decisions paper.[5]

28. The Commission has now reversed its decision – late in the process – and in doing so has staked out a position that is apparently not supported either by its own expert or by Incenta. Contrary to the views of Dr Lally, the Commission now says that it regards Crown financing as an equal mixture of debt and equity.[6] The Commission also says – without reference to supporting evidence – that to the extent Crown financing is equivalent to debt, such debt would be replaced with a mix of finance equivalent to the Commission's estimate of the regulatory cost of capital. The Commission's revised position does not appear to be supported with any evidence or expert advice. It is therefore difficult for us to understand how the Commission has

[5] Commerce Commission (19 November 2019) Fibre input methodologies: draft decision - reasons paper.

[6] Commerce Commission (23 July 2020), Fibre input methodologies: Further consultation draft – reasons paper, at [3.37].

arrived at this point, or how it proposes to defend a view that conflicts with all the evidence it has received.

29. In our view the Commission is incorrect in fact and its revised decision on the treatment of Crown financing does not provide us the opportunity to recover real FCM or meet the purposes of the Act. We note that both the Commission's and our own expert advisor agree with the characterisation of CIP financing.

30. We disagree with the Commission's revised decision, whereby:

    30.1. **Pre-implementation** – the financing rate is the regulatory cost of capital; and

    30.2. **Post-implementation** – the financing rate is the regulatory cost of capital with a modest discount of 25 basis points applied.

31. We note that there are clear interdependencies between the treatment of Crown financing in the pre-implementation period and the calculation of financial losses. However due to the sequencing of the consultation processes, our comments are made in the absence of an adequate opportunity to understand the Commission's end-to-end proposal for the pre-implementation period. The two issues cannot be fully addressed in isolation, and so the views we set out below should be read in parallel to our response to the next consultation paper.

32. The Revised Paper represents a significant change from the views presented in its draft decision:[7]

> *The Emerging Views Paper method 1 effectively regarded the benefit of Crown financing as a stream of avoided returns on the same risk-adjusted cost and mix of debt and equity as faced by Chorus in its commercial financing. In light of submissions, we have concluded that this approach overstates the benefit of Crown financing by incorporating an equity element into the Crown financing, which as we have earlier said, is debt like in nature for Chorus.*

33. The Commission now appears to be reverting to method 1 in the Emerging Views Paper, with little evidence to justify this change. The Commission's reasoning has only focussed on:

    33.1. Interpreting Crown financing in economic terms as equity, when the Commission's expert adviser (Dr Lally) agreed with our adviser (Incenta) that the character of Crown financing was 'debt-like'. We agree with Dr Lally and Incenta that Chorus bears a residual risk in relation to investments funded with the Crown financing. The Commission's proposed approach leaves Chorus uncompensated for this risk, undermining the principle of NPV neutrality.

    33.2. Framing the question of the nature of the finance Chorus would have raised, and the cost of that finance, had there been no interest-free loan. However, we believe there is a logical flaw in the Commission's reasoning. The UFB

[7] Commerce Commission (19 November 2019) Fibre input methodologies: draft decision - reasons paper, at [3.113].

project was not commercially viable in 2011, and so the project would have been unfinanceable in the absence of Crown financing.

33.3. The assumption ratings agencies treat Crown financing as equity. We disagree, rating agencies don't look at debt characteristics, rather they have noted there is no absolute requirement to repay the funds at the prescribed dates, as Chorus has some high-cost alternative options. We note that Dr Lally and Incenta agree the alternatives are unlikely to happen.

33.4. The treatment of Crown financing in Chorus' annual accounts, which has led the Commission to the conclusion that Chorus does not treat the CIP equity securities as debt.[8] The Commission's interpretation is not correct. CIP equity securities are treated as a 'compound instrument', which means they have both equity and debt characteristics. Chorus' auditors (KPMG) require us to treat CIP equity securities as a liability, and they are not accounted for as 'equity'.

33.5. A view that the core characteristics of the CIP equity securities are akin to those of a preference share. The Commission's interpretation is incorrect. One of Chorus' options is to allow it to convert the CIP equity securities to a preference share after the prescribed dates. However, before that eventuality, the CIP equity securities are free capital that ranks behind senior debt but ahead of equity in a wind-up scenario. This is clearly explained in Incenta's report.[9]

34. Finally, we note that the Commission's proposed treatments of Crown financing and liquidated damages under the UFB agreements are inconsistent. The effect of the Commission's proposed treatment of Crown financing is that it was costless for Chorus. The Commission's proposed treatment of liquidated damages arising from the UFB agreements is a clear acknowledgement that the Crown financing was part of a set of arrangements that imposed significant risk on Chorus, with actual and potential cost implications.

Transitional Initial PQ RAB

35. We understand the reasons for an initial RAB but consider it should bet set using the most available actual data to promote certainty and workability. This could be achieved using our FY20 audited results. How this will be set and how it will be "trued-up" to reflect actual values of the initial RAB, remains a key uncertainty. As a key fundamental input into the MAR, it's important to ensure it's as clearly defined as possible.

36. The composition of the initial RAB must be determined in accordance with section 177 of the Act. Section 177 requires that the calculations for the initial RAB and financial losses asset must be based on actual information.

[8] Commerce Commission (23 July 2020), Fibre input methodologies: Further consultation draft – reasons paper, at [3.38.2].

[9] Incenta (July 2019) Chorus's actual financing cost for Crown-financed investment.

Shorter period for forecast values

37. We support an approach to the initial RAB that uses the most available actual data. In its draft decision the Commission did not specify a transitional arrangement for the initial RAB. In effect this required the initial RAB to be set using actual data up until the implementation date (1 January 2022). We agree this is not a workable solution as the statutory accounts covering the pre-implementation date would not be ready until after the implementation date.

38. The Revised Paper proposes to fix this by allowing for an initial RAB for RP1. This is specified by setting the implementation date to "1 January 2019"[10] and disclosure year to the regulatory year 2019, for RP1.[11] This would result in the initial RAB being determined using actual values until 31 December 2019, and forecasts for remainder of the pre-implementation period to 1 January 2022.

39. Our primary concern is that using two years of forecast values would produce significant uncertainty for RP1 and would not represent the best estimate reasonably available at the time. Chorus' financial year 2020 audited results (with actual values to 30 June 2020) could be readily used by the Commission for determining the initial RAB.

40. Therefore, we support the Commission's alternative recommendation that actual values should be used to forecast the initial asset values for RP1. This would not change the definitions of "implementation date" and "regulatory year 2020" or require actual values based on calendar year.[12]

41. Using actual data for the period up to 30 June 2020 would reduce uncertainty around the value of the initial RAB by reducing the potential size of any forecast error and any resulting wash-up. This is important because it is not only asset values that would require forecasting but also revenue and expenditure required for the financial loss asset. This approach is workable and robust as Chorus' audited statutory accounts will be available for use.

42. In applying the alternative approach, we recommend the Commission confirm how it intends to forecast the remaining period required for the initial RAB (i.e. 1 July 2020 to 31 December 2021). We expect that it will require the forecasts to be consistent with applying the ID IMs and cost allocation IMs for PQ paths.

Wash-up mechanism must "true up" the initial RAB forecast to actuals

43. While we agree that forecast values must be used for the initial RAB to some extent, the Commission must provide for a true-up of the initial RAB to reflect actual values as

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[10] We note that the date used in clause 3.3.1(6)(c) of the IMs is "1 January 2019" which appears to be an error. The date should be "1 January 2020" as this would align with actual data values being used for regulatory period 2019 which ends on 31 December 2019.

[11] Commerce Commission (23 July 2020), Fibre input methodologies: Further consultation draft – reasons paper, at [3.79].

[12] Commerce Commission (23 July 2020), Fibre input methodologies: Further consultation draft – reasons paper, at [3.87].

of 1 January 2022. If it does not, the PQ path for RP1 will not reflect the actual value of the initial RAB as of 1 January 2022, as required by section 177.

44. The Commission's proposal appears to be that forecast values will only be superseded by actual values for the purposes of determining the opening RAB for the second regulatory period. As a result, Chorus would earn a return based on forecast values, not actuals, which implies there will be a windfall loss or gain.

45. The Commission must provide for a wash-up for RP1. This is consistent with the existing precedent in Part 4. Opening RABs for Transpower are based on forecasts, and a wash-up mechanism is applied to update the RAB to actual values.

46. The Commission has not yet provided any clarity around how it envisages a wash-up mechanism working despite continued industry requests to consult on the mechanism well before the PQ stage. This would allow stakeholders to understand how the MAR will be adjusted, and therefore the impacts of financial line-of-sight. Having said that, we expect the Commission will ensure the wash-up mechanism it adopts is consistent with the *ex-ante* opportunity for Chorus to earn normal returns over the lifetime of the investment in FFLAS.

47. Consistent with our previous submissions, we encourage the Commission to achieve improved certainty by including principles in the Price Specification and Revenue IM, thereby preserving flexibility at the PQ stage. That is, the principles regarding the inputs to the MAR will wash-up (i.e. building blocks, allocations, foreign exchange rates and CPI), and over what periods our revenue wash-ups will be recovered. This is paramount for ensuring a clear line-of-sight to real FCM, and for ensuring a regime that incentivises investment and innovation in the long-term interests of consumers.

Non-standard installation fund

48. The Commission has decided that the non-standard installation (**NSI**) fund should be netted off the RAB as a capital contribution, which it assumes is up to $20m.[13] The NSI fund was established to provide free installations for non-standard connections. We disagree on the facts assumed by the Commission in its treatment of the NSI fund but propose to engage further with the Commission during the determination process.

Ex-ante allowance for asset stranding

49. We support the Commission's recognition that asset stranding risk is potentially material and allocating some of the risk to fibre suppliers by allowing them to in turn mitigate the risk with the relevant tools.

50. We note the fibre IMs include provision for asset stranding, including an *ex-ante* allowance. As we have previously noted, while the Commission is proposing an allowance of 10 basis points, our independent economic experts[14] have considered the application of the framework to Chorus' circumstances.

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[13] Commerce Commission (23 July 2020), Fibre input methodologies: Further consultation draft – reasons paper, at [3.64].

[14] NERA (22 January 2020), Assessment of Type II asymmetric risk for Chorus' fibre network.

51. Their analysis using the same model based on more evidence as to the risk of asset stranding and considering how that risk varies for different asset categories, results in an illustrative allowance in the range of 31 to 87 basis points[15] (with a more precise result able to be calculated once the RAB is determined).

52. We recommend that the allowance should be applied to both the pre-implementation period and the post-implementation period because those Type II asymmetric risks apply in both circumstances. The exact magnitude of the allowance, and the difference between the pre-implementation period and the post-implementation period, could also be determined using the fair bet principle, as recommended by our independent economic experts.[16]

[15] NERA (22 January 2020), Assessment of Type II asymmetric risk for Chorus' fibre network, at [98].

[16] Oxera (15 July 2019), Compensation for asymmetric type 2 risks.

COST ALLOCATION

Overview

53. We agree with the Commission's decisions to use ABAA to allocate costs to PQ and ID-only FFLAS as this is consistent with the Commission's chosen approach for FFLAS and non-FFLAS allocation. We also agree that it's not necessary to prescribe the allocator types that should be used to allocate cost to PQ and ID-only FFLAS. We recommend the Commission include a definition for "ID-Only RAB" to ensure it is appropriately incorporated into the ID regime.

54. However, we don't consider there to be any justifiable need for the Commission to prescribe a two-step allocation approach. It is unnecessary and will only drive further time, cost and complexity into the regime.

55. We also don't support a cap on shared costs. We maintain the view that the proposed cap is not workable and has not been adequately outlined. We don't have granular data on existing assets to determine what costs are unavoidable when non-FFLAS ceases to be supplied.

Two-step cost allocation between FFLAS classes

56. We don't support the proposed two-step process to allocate costs between PQ FFLAS, ID-only FFLAS and non-FFLAS. The process requires:

    56.1. Costs to be allocated between FFLAS and non-FFLAS; then

    56.2. FFLAS costs are allocated between ID-only and PQ FFLAS.

57. We are concerned with the potential modelling implications of a two-step approach, driving unnecessary costs that are passed on to consumers in return for little or no benefit.

58. We agree that the ABAA allocation approach should be used to allocate cost to PQ and ID-only FFLAS based on consistency with the Commission's chosen approach chosen for FFLAS and non-FFLAS allocation.[17]

59. We also agree that the Commission does not need to prescribe the allocator types that should be used to allocate cost to PQ and ID-only FFLAS, which:

> *Will allow for Chorus to choose and us to review and approve cost allocators that reflect the causal drivers for the relevant shared costs. We consider that this flexibility should allow Chorus to address the geographic aspects of the PQ and ID-only allocation as well as those aspects driven by connection numbers.*[18]

60. The Commission has defined an ID RAB and a PQ RAB, which relate to ID FFLAS and PQ FFLAS, but has not defined an equivalent ID-only RAB for ID-only FFLAS. However, as we understand it, the cost allocation process will require regulated providers to allocate shared costs between PQ FFLAS and ID-only FFLAS.

61. The Commission's cost allocation methodology therefore implies the existence of an ID-only RAB, comprising those assets (directly attributable or an appropriate share) that relate to the provision of ID-only FFLAS. We suggest that the Commission include a defined term for the ID-only RAB and make the consequential amendments to Part 2 of the IMs to enable the ID-only RAB to be incorporated in the ID regime, as appropriate.

Process for allocating costs

62. The Commission's primary concern is that shared costs could be over-allocated[19] to PQ FFLAS (consequently under allocating costs to ID-only FFLAS or services that are not regulated FFLAS).

63. However, the two-step process does not need to be specified in the IMs to prevent over-allocation since the allocators chosen are more important to determining the allocation of shared costs. Allocators must already be suitable to allocate costs between PQ and ID-only RABs because:

    63.1. Cost allocators are already defined as being based on a causal relationship; and

    63.2. Proxy cost allocators are required to be *"objectively justifiable and demonstrably reasonable".*

64. These definitions ensure that costs must be justifiably allocated to PQ FFLAS, ID-only FFLAS and non-FFLAS services, regardless of the number of steps (and their order). As noted above, the Commission has expressly said that it will review the drivers used to allocate between PQ and ID-only FFLAS which makes it unlikely costs will be misallocated.

65. We agree with the Commission's worked example in Table 3.2 that the first application provides a justifiable cost allocation when compared to counter applications 1 and 2. However, this is because the allocators chosen at each step have a suitable scope. In fact, counter application 2 would produce the same result as the first example if the scope of the floor area allocator in step 2 had not been limited such that ID-only were not allocated to non-FFLAS services.

66. Therefore, it is the choice of allocators, and their scope, rather than the order of the allocation steps that has changed the results. We also note that the scope of the cost in all three applications is already defined based on location before the allocation between FFLAS and non-FFLAS services is performed.

[19] Commerce Commission (23 July 2020), Fibre input methodologies: Further consultation draft – reasons paper, at [3.155].

Implications for modelling

67. If the Commission chooses to prescribe a two-step process, it should not require that the RAB modelling is structured as such, only that it can be demonstrated that the allocations comply with the process. Prescribing a modelling structure will limit modelling flexibility and create unnecessary work that comes at a cost.

68. Furthermore, application of the two-step process must also account for allocation required to calculate the financial loss asset, as well as for deregulation and sales adjustments. The proposed process does not consider the modelling required to allocate costs to UFB in the pre-implementation period and that relevant assets are tracked in the post-implementation period.

69. We assume that the Commission is not proposing that costs from different geographies should be mixed together before allocating to FFLAS classes, and then allocated to ID-only and PQ FFLAS. This would increase the requisite work and complexity to gather geographically granular cost data – and would be unnecessary. We note that in the Commission's examples, the scope of the cost to be allocated in all three applications is already defined based on location *before* the allocation between FFLAS and non-FFLAS services is performed.

Cap on shared costs

70. We disagree with the revised decision to impose a cap on the allocation of shared costs to FFLAS at an amount no higher than the unavoidable costs that would have been incurred if the regulated supplier were to cease supplying services that are not regulated FFLAS. We note that the proposed cap would be limited to those costs that materially affect the total cost allocated to regulated FFLAS.[20]

71. The proposed cap is not workable because it would require information that does not exist. We do not have more justifiable information to suggest that more cost could be related to non-FFLAS services.

[20] Commerce Commission (23 July 2020), Further consultation draft – reasons paper, at [3.167].

CAPITAL EXPENDITURE

Overview

72. The Commission's further amendments have increased the workability of the draft capex IM in many respects.

73. We support the 31 December 2020 deadline for submission of our first regulatory expenditure proposal (**RP1 Proposal**) because it provides certainty and will allow for robust evaluation of our proposal by the Commission in 2021. We are working intensively to meet this deadline but are relying on there being no substantive change to requirements between now and the final fibre IMs.

74. The proposed mandatory application of assessment factors significantly shifts the goalposts for our RP1 proposal because it can be read as requiring us to provide information relating to every assessment factor across every element of our proposal. We risk not being able to meet this requirement for RP1.

75. Changes to the audit requirements in clause 3.7.4 of the draft capex IM present a major obstacle to meeting the RP1 proposal deadline.

76. The updated list of potential information requirements should not present a challenge to the 31 December deadline if the Commission places the onus on us to provide a clear, complete and compelling proposal through integrated fibre plan (**IFP**) requirements and the expenditure objective and focuses in the RP1 information notice on opex information (which is not covered in the IMs).

77. We recommend:

    77.1. Audit requirements should be changed to align with Transpower's audit practices, which is what our auditor is working towards;

    77.2. The application of individual assessment factors should be discretionary, as the Commission previously proposed;

    77.3. The Commission should introduce a flexibility mechanism to allow the capex requirements to be amended for workability;

    77.4. If the capex IM remains as currently drafted, we face a real risk of not being able to meet the deadline. As it's in our interest to provide the Commission with all the information it needs to evaluate our proposal, it would be prudent for the Commission to add a one-off transitional provision allowing the 31 December deadline to be moved for RP1; and

    77.5. The rule that requires certain IFP reports to detail the assumptions relied on for the forecasts should be limited to key assumptions.

Impact of rule changes on our first regulatory proposal preparation

78. The 31 December deadline for submission of our RP1 Proposal aligns with our planning and preparation. We have based this planning around a pre-Christmas target date for submission because we recognise the importance of the Commission having sufficient time next year for an effective evaluation and decision-making process.

79. The major risk items for our planned programme are:

    79.1. Final assurance and certification work, which cannot be completed until after IMs are finalised; and

    79.2. Additional information or document creation and/or restructuring being required after the regulatory templates and information requests are confirmed.

80. Below we address some of the challenges we face in our RP1 Proposal preparation and how we intend to approach the changed requirements in the draft capex IM. We also suggest changes that would improve proposal evaluation processes in the long term.

Audit and assurance requirements

81. Overall, the changes proposed to the audit and assurance requirements are pragmatic and will result in a more workable sign-off and assurance processes – such as the change from CEO to director certification of the connections capex annual report.

82. However, the proposed changes to clause 3.7.4 of the draft capex IM present a major obstacle to meeting the 31 December RP1 Proposal deadline. We advocated in our submission on the draft decision for a Transpower assurance approach[21] and factored in the time and resources needed to undertake (and service) that assurance process into our RP1 Proposal development planning.

83. We have engaged KPMG to provide assurance on our RP1 Proposal and support the certification provided by our directors.

84. Clause 3.7.4(1) of the draft capex IM now requires an auditor to state whether:

    84.1. Forecast financial information provided in the capex proposal has:

        84.1.1. Been properly compiled on the basis of relevant and reasonable disclosed assumptions; and

        84.1.2. Examined in accordance with applicable assurance engagement standards issued by the External Reporting Board in accordance with its functions under the Financial Reporting Act 2013 or any equivalent standards that replace these standards or other appropriate assurance standards; and

[21] Chorus (28 January 2020), Submission on the Commerce Commission's Draft Determination, at [387].

84.2. Forecast non-financial information provided in the capex proposal has been properly compiled on the basis of relevant and reasonable disclosed assumptions.

85. KPMG advises that the amended forecast requirements:

85.1. Have shifted towards a presumption of a 'positive' assurance sign-off requiring a significantly greater level of scrutiny effort than assurance on compilation in accordance with input methodologies or against disclosed assumptions (as currently planned);

85.2. Would require an intensive and unanticipated programme of work on Chorus' part to support KPMG's assurance. This is particularly problematic for Chorus at this late and critical stage in our RP1 Proposal preparation process; and

85.3. Are unlikely to add any informational or assurance value to Chorus' proposal, noting:

85.3.1. The extensive substantive review of Chorus' expenditure plans undertaken by the independent verifier, CutlerMerz; and

85.3.2. The comprehensive internal Chorus programme of technical and business review 'treeing-up' to management representations that in turn support director certification of the RP1 Proposal.

86. Together, these factors mean our goal of a pre-Christmas sign-off would not be realistically achievable, which we do not believe reflects the Commission's policy intent.

87. In KPMG's view, its sign-off in respect of forecast financial and forecast non-financial information should contain wording which does not result in a presumption of a positive assurance sign-off.

88. As such, we propose that the assurance requirements are for:

88.1. Historical financial information,

compiled in all material respects in accordance with the IMs and properly extracted from financial records sourced from financial systems and audited in accordance with applicable auditing standards; and

88.2. Historical non-financial information;

88.3. Forecast financial information; and

88.4. Forecast non-financial information,

compiled in all material respects in accordance with the IMs and properly compiled on the basis of the relevant underlying source information and examined in accordance with applicable assurance standards.

89. The two key elements of this sign-off are compliance with the IMs and consistency with business operations in the form of compilation/extraction, based on audited

financial information and underlying source information. These two key elements align with the current director certification requirements.

90. We think our proposed amendments wouldn't alter the information or assurance value of Chorus' RP1 Proposal but would avoid inefficient duplication of effort by KPMG of the independent verifier's work and support the goal of a December submission. This would have the benefit of aligning audit requirements with Transpower, the other entity subject to enduring individual PQR.

Scope of our RP1 Proposal

91. We have been transparent that for RP1, we are going to find it challenging to deliver our proposal shortly after the IMs are finalised. To make this possible, we need limited divergence between the requirements we are working to as we build our proposal and the requirements following final IMs, agreement of regulatory templates and issue of the information notice for base and connection capex. This is because most of our work in the two months between mid-October and mid-December will be dedicated to final assurance and certification processes.

92. Notwithstanding the challenge, we welcome the certainty of a firm end-of-year deadline for our RP1 Proposal because it is important to allow the Commission and stakeholders adequate time for good-quality evaluation and decision-making during 2021.

93. We have a strong incentive to deliver the Commission a clear, complete and compelling RP1 Proposal. The IMs reinforce this natural incentive by setting out IFP[22] requirements and by requiring us to provide enough information to enable the Commission's evaluation.[23] The IMs provide further guidance by defining an expenditure objective, setting a practice benchmark (good telecommunications industry practice) and listing a set of assessment factors.

94. Those provisions are our primary source of guidance as we pull together our RP1 Proposal. In our view, the information notice has a complementary role rather than being the primary driver of our RP1 Proposal content. The Transpower experience over successive control periods is that the information notice works best when it deals with administrative matters, or as mechanism for following up on areas of interest from prior evaluations.

95. With this in mind, the further draft capex IM includes two types of changes that shift the goalposts for our RP1 Proposal:

    95.1. New IFP requirements. These include an extended forecast horizon, new information requirements (such as quality forecasts and sensitivities) and new packaging requirements. We are confident we can meet these requirements; and

[22] Commerce Commission (23 July 2020), Fibre input methodologies: Further consultation draft – reasons paper, at clause 3.7.7.

[23] Commerce Commission (23 July 2020), Further consultation Fibre Input Methodologies Determination 2020, clause 3.7.8(2)(b).

95.2. The shift from discretionary to mandatory consideration of assessment factors. In our view, this significantly shifts the goalposts because it can be read as requiring us to provide information relating to every assessment factor across every element of our proposal. We risk not being able to meet this requirement by the end-of-year deadline.

96. We discuss below the impact mandatory assessment factors would have on effective evaluation. For both reasons, we strongly recommend the Commission reverts to discretionary application of assessment factors to ensure workable requirements long term, and to support the end-of-year deadline for the RP1 Proposal.

97. The updated capex IM also expands the list of potential information request content. In our view, this should not shift the goalposts because the listed information is discretionary, and we would not expect an extensive information notice for our RP1 Proposal. It makes more sense for the RP1 information notice to focus on opex (which is not covered by the IMs) and place the onus on us to provide a clear, complete and compelling proposal.

Improvements to the Commission's evaluation of price-quality proposals

98. We have two recommendations to improve the workability of the capex IM on an enduring basis:

98.1. A return to allowing the Commission to decide when and how to apply the assessment factors; and

98.2. Introduction of a flexibility mechanism to allow the Commission to amend requirements as needed for workability.

Application of individual assessment factors should remain discretionary

99. We disagree with the change from discretionary to mandatory application of assessment factors and recommend the Commission retain the discretion as to when it is appropriate to apply individual assessment factors.[24] The change is unnecessarily prescriptive and would require the Commission to spread its resources thinly by treating all expenditure the same.

100. Best regulatory practice is for evaluations to take a tailored and targeted approach – that is, for the Commission to retain appropriate flexibility to determine what analysis is relevant and devote more attention to the areas with greatest risk of consumer harm.

101. Reinstating the Commission's discretion to consider relevant factors would also be consistent with the principle of proportionate scrutiny. The Commission would be able to assess where the costs of undertaking the analysis would outweigh the benefits of doing so.

[24] Commerce Commission (23 July 2020), Further consultation Fibre Input Methodologies Determination 2020, clause 3.8.6.

102. This would be consistent with the Commission's evolving approach to evaluating Transpower's regulatory proposals. The Transpower Capex IM has a built-in identified programmes mechanism consistent with proportionate scrutiny. For Transpower's third regulatory control period, this was complemented by voluntary use of an independent verifier to support further targeting of the Commission's evaluation efforts.

103. We are not suggesting an identified programme regime should be transferred to the capex IM, but we do consider that removing assessment factor discretion moves too far in the opposite direction. This is inconsistent with good regulatory practice for effective evaluation.

104. As discussed above, the change to the assessment factors provision also has a knock-on impact for how we frame our RP1 Proposal. Our planning to date had assumed that the assessment factors would be applied in a targeted way, rather than as a pro-forma set of requirements. At this point in our RP1 Proposal development, we do not think we could add the information needed to cover every assessment factor for each aspect of our proposal.

A flexibility mechanism and submission date backstop should be built into the regime

105. The capex IM would be improved in the long run by the Commission introducing a method by which requirements could be adjusted for workability in specific circumstances.

106. Learning from the implementation of Part 4, we expect that applying a complex set of rules in practice – particularly the first time – will turn up challenges that the drafters had not anticipated. The Transpower and EDB experiences[25] show that this is likely both during the initial bedding-in phase, and as an ongoing low-level issue.

107. Provided a variation mechanism was contained to workability, it would not conflict with the certainty objectives of the IMs.

108. We can meet the 31 December proposal submission deadline if the amendments and approaches we set out in this section are adopted. As noted above, our preference is to submit our RP1 Proposal by Christmas, and we are working at pace to deliver to that deadline.

109. However, if the capex IM remains as currently drafted and/or COVID-19 disruptions continue, we face a real risk of not being able to meet the deadline. As it is fundamentally important the Commission receives the information it needs to evaluate our RP1 Proposal, it would be prudent for the Commission to add a one-off transitional provision by which we could agree to move the 31 December deadline for the RP1 Proposal if necessary. This would be a pragmatic backstop in the current climate.

[25] For example, the Commission's 'Issues Register for electricity and gas information disclosure' (30 June 2016).

Expanded IFP reports

110. We support the adoption of a requirement that the IFP covers five years from the start of the regulatory period. This adds two years to the timeframe we had planned to cover in our RP1 Proposal, with the total horizon now 6.5 years (from July 2020 to December 2026). Because we cannot now run another full planning round, we plan to meet this requirement with a suitably high-level, fit-for-purpose approach. This should nonetheless help to illustrate relevant trends.

111. Clause 3.7.7(3)(a) requires certain IFP reports to detail the assumptions relied on for the forecasts. We support this requirement in principle, but suggest that it is limited to the *key* assumptions, given the very large number of different assumptions included in the underlying forecast models.

REGULATORY RULES AND PROCESSES

Overview

112. We welcome the expansion of pass-through costs but maintain the view that Part 6 should have a recoverable cost mechanism to address costs that are reasonably incurred, largely outside our control and challenging to forecast.

113. We also recommend draft IM changes to improve the workability of the regime. These relate to the building block revenue definition (to allow for within regulatory period revenue smoothing) and reconsideration events (removing the exclusions to the catastrophic event definition and adding a new consideration factor instead).

Specification of price and revenues

114. We support the Commission's decision to include levies and local council rates as pass-through costs. However, to be consistent with Part 4, the Part 6 regime should include a process to enable us to pass-through reasonable future unforeseen costs in order to provide for regulatory certainty and an enduring regime. We do not see any reason for the Commission to exclude such a provision from the Part 6 IMs but include it in Part 4.

115. Similarly, the Commission has excluded a recoverable cost category from the Part 6 IMs – we disagree with this approach. We have previously submitted that a recoverable cost category could be used to recover the costs of self-insured events – i.e. those costs which are bigger than would be included in standard maintenance opex forecasts, but which are either below insurance policy deductibles or outside the scope of insurance policies – as well as audit and verifier costs.[26]

116. In order for FCM to be maintained, there needs to be a mechanism that allows us to recover these costs. In the absence of a recoverable cost category we have two options:

    116.1. Expand our insurance cover so that observable premiums are higher and we are no longer carrying material self-insurance; or

    116.2. Estimate self-insurance costs and include these in our proposed opex allowance.

117. We plan to take the latter approach, as the former is unlikely to be cost-effective.

Building blocks revenue smoothing

118. As previously submitted,[27] we also propose that the definition of "building blocks revenue" should provide for revenue smoothing between years. As currently drafted,

[26] Chorus (29 May 2020) Submission on the Commerce Commission's fibre input methodologies – draft decision reasons paper (regulatory processes and rules) dated 2 April 2020, at [32-34].

[27] Chorus (29 May 2020) Submission on the Commerce Commission's fibre input methodologies – draft decision reasons paper (regulatory processes and rules) dated 2 April 2020, at [44-48].

it simply defines this as the sum of the building block components but does not consider the year-to-year volatility that could arise (for example, due to the Commission's treatment of inflation), which could cause unstable prices for end-users. We have suggested alternative drafting in our drafting table.

Reconsideration of reopener events

119. We support the Commission's rewording in relation to the reconsideration of a PQ path which, we agree, improves the clarity of this section.[28]

120. However, we think that the exclusions to catastrophic events create an unnecessarily binary assessment of these potentially complex matters.[29] We recommend removing the exclusions from the definition of catastrophic events and instead adding an additional consideration factor enabling expenditure in response to a catastrophic event to be taken into account.[30] We consider this change would allow for a more nuanced response.

[29] Commerce Commission (23 July 2020), Further consultation Fibre Input Methodologies Determination 2020, clause 3.9.3(2).

[30] Commerce Commission (23 July 2020), Further consultation Fibre Input Methodologies Determination 2020, clause 3.9.8.

QUALITY DIMENSIONS

Revised quality definitions

121. We acknowledge the Commission's drafting changes to the quality IM. The definitions underpinning the quality dimensions IM are much improved from the draft decision IM Determination and we thank the Commission for taking account of submissions. We do not think further changes are required.

122. We note there are a number of interlinking definitions e.g. Downtime, Fault, Outage and Restore. There is also overlap between definitions e.g. Ordering and Switching both cover FFLAS changing from one access seeker to another. This is not a problem of itself, but we urge the Commission to take care when setting measures and standards to avoid regulatory uncertainty and double jeopardy that could be caused by overlapping measures which are functions of each other. This is a particular concern as the Commission has chosen not to incorporate principles for setting quality measures and standards in the quality dimensions IM. We continue to believe such principles are required in order for the IM to provide the necessary certainty.[31]

[31] Chorus submission on Fibre input methodologies: Draft decision – reasons paper, dated 19 November 2019 and Draft fibre input methodologies determination 2020 dated 11 December 2019 (28 January 2020), at [280-290].

COST OF CAPITAL

Overview

123. The Commission has noted that there are benefits to aligning industry views of the cost of capital. We propose to keep these different industry and legislative reviews separate. We expand on this below.

124. We support the Commission's intention to ensure the cost of capital IM remains fit for purpose in face of the economic impacts of the COVID-19 pandemic. But we consider changes may be required beyond April 2021 and encourage the Commission to ensure it can address necessary changes post-April 2021, if required. This proposal aligns with the economic principles, and highlights the need to ensure investment incentives are properly addressed and assessed appropriately.

125. We maintain the view that some of the key cost of capital parameters inadequately reflect the risk of investment in FFLAS, and an uplift is required to reduce the probability that the Commission's best estimate of the cost of capital does not result in Chorus expecting to earn a normal return. Cost of capital for FFLAS at or above the 67th percentile of the range is therefore appropriate.

Aligning cost of capital IM reviews across Part 4 and Part 6

126. The Commission has left open the option to align the industry reviews of the cost of capital IM. If this occurs, it would mean bringing forward the review of the cost of capital IM for Part 6 so it's aligned with the review for Part 4, which is due by December 2023. Otherwise the Part 6 cost of capital IM would be reviewed in 2027.

35. We would not support aligning the cost of capital review processes between different industries and legislative regimes. Parliament made a decision to have a separate regulated regime for telecommunications services, reflecting the different dynamics and characteristics of this industry. Maintaining a separate Part 6 review will help ensure that adequate consideration of bespoke industry characteristics are not diluted.

Impact of COVID-19

127. We support the Commission's acknowledgement that the impact of COVID-19 pandemic is an exceptional event, and its intention to continue monitoring developments in financial markets.

128. Our main concerns are:

    128.1. **Review shouldn't be limited to TAMRP** – in response to the GFC, the Commission reflected the effects on a premium for risk with a temporary uplift to the TAMRP based on advice from the cost of capital Expert Panel. However, as the Commission have noted, currently events appear to be quite different to the GFC; and

    128.2. **Adjustments from an exceptional event shouldn't be time-bound -** while the Commission proposes to make amendments by April 2021 if there is justifiable evidence, the COVID-19 pandemic will impact financial markets for the foreseeable future. We recommend the Commission considers how it will

adjust for COVID-19 impacts beyond April 2021, and before the next Part 6 cost of capital review. We support a regulatory regime that is fit for purpose and encourage the Commission to ensure the framework does not artificially limit its ability to provide for this.

Cost of capital parameters

129. It is paramount that the parameters to ensure the appropriate return on, and return of, capital are set appropriately from the outset of RP1. This is important for preserving our ability to recover real FCM and facilitate the right incentives for on-going investment and innovation that will provide long-term benefits for end-users.

130. Our position remain unchanged for post-implementation, as discussed in previous submissions:[32]

Parameter	Commission	Chorus position
Asset beta	0.49[33]	Using a large sample approach, our independent experts[34], have calculated a post-implementation asset beta of 0.60.
Debt premium	BBB+	BBB credit rating is more consistent with the notional leverage derived from the comparator set and the higher systematic risk for FFLAS relative to the comparator set.
Leverage	31%	Our independent economic expert[35] advises that a leverage of 31% is consistent with a BBB rating. Alternatively, a higher level of leverage (34%) would be consistent with the Commission's proposed credit rating of BBB+.
Percentile uplift	50th percentile	Cost of capital for FFLAS at or above the 67th percentile of the range is appropriate. Our independent economic expert[36] advises that an uplift (margin) of 0.44 standard deviations be applied to reduce the probability of underestimation of the true cost of capital to 33%.

[32] Chorus submission on Fibre input methodologies: Draft decision – reasons paper dated 19 November 2019 and Draft fibre input methodologies determination 2020 dated 11 December 2019 (28 January 2020).

[33] While there is no reference to asset beta in the IM rules as such, the Commission's specified 'equity beta' of 0.71 is based on an asset beta of 0.49 and leverage of 31%.

[34] Sapere (27 January 2020), The cost of capital input methodologies for fibre [128].

[35] Sapere (27 January 2020), The cost of capital input methodologies for fibre [129].

[36] Sapere (27 January 2020), The cost of capital input methodologies for fibre [135].