Cross-submission in response to the Commerce Commission's Fibre input methodologies: Draft decision – reasons paper dated 19 November 2019 and Draft fibre input methodologies determination 2020 dated 11 December 2019

17 February 2020

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OVERVIEW

1 This cross-submission responds to submissions on the Commerce Commission's Fibre input methodologies draft determination 2020 (**IM Rules**) and Draft Decisions (**Reasons Paper**). We have focused our comments on key themes and arguments, rather than restating points made in our previous submissions, in particular where they have been conclusively addressed by the Commission.

2 The UFB initiative has given New Zealanders world-leading connectivity ahead of demand and enabled a critical infrastructure backbone to be developed at a very low cost to taxpayers, with the vast bulk of the project funded privately. The new regulatory framework needs to ensure the right incentives to innovate, invest, and allocate risk appropriately to provide ongoing benefits for New Zealand and our ability to compete in an increasingly global world.

3 As we move toward completion of the establishment of the input methodologies (**IMs**) we are seeing a greater degree of alignment across the fundamentals of the regime. In particular, there is broad alignment across the economic principles that underpin the Commission's decision-making. We observe several themes emerging across submissions which we address below.

4 There was agreement from Atlas Infrastructure, Black Crane Investment Management, Cooper Investors, Investors Mutual, L1 Capital and TelstraSuper that the Commission's approach to the pre-implementation cost of capital is not aligned, either with expectations, or the reality of Chorus' ability to fund the Ultrafast Broadband (**UFB**) network build. These submissions support Chorus' view that our pre-implementation regulated rate of return (**RROI**) should be considered as one regulatory period from May 2011.

5 There is a consistent view among investors and other infrastructure providers that the overall impact of the draft decisions is likely to underestimate the cost of capital for Chorus' fibre fixed line access service (**FFLAS**) business. While submitters cover a range of relevant inputs to the cost of capital calculation, there is particular alignment that:

5.1 The asset beta is too low and out of step with comparators internationally, including Ofcom's recent decision and estimates from Crown Infrastructure Partners (**CIP**) at the start of the build. The asset beta should also be higher in the pre-implementation period to reflect higher risks during the build phase;

5.2 The mid-point estimate of the cost of capital doesn't appropriately reflect the risk of a FFLAS-only business or provide sufficient incentives for additional investment to meet future demand and service/quality expectations; and

5.3 The treatment of the pre-implementation period as a series of individual annual adjustments doesn't reflect the commercial reality of how a project like the UFB build would be funded or investor expectations at the time. It is also inconsistent with the Commission's usual approach to estimating cost of capital in ways that have not been adequately explained or justified.

6 We encourage the Commission to consider these perspectives as they reflect the reality of the investment environment for Chorus. Getting these issues right is critical

for meeting the financial capital maintenance (**FCM**) objective and for ensuring that risks are appropriately balanced between regulated fibre suppliers and consumers.

7 A focus for retail service providers (**RSPs**) through the current consultation, and in previous steps of this process, has been the lack of certainty as we transition to the new regulatory framework. We are moving from a framework where contract terms are settled and, depending on whether services are copper or fibre-based, the Commission or CIP have played prominent roles in dealing with any changes to those terms.

8 We remain of the view that the transition should occur smoothly without shocks for anyone and acknowledge that this transitional period creates uncertainty for both RSPs and Chorus. However, the decision to move to an incentives-based regime was a deliberate one and attempts to introduce prescriptive requirements undermine the design of the framework.

9 While we understand the RSPs' objectives, we do not agree that increasing regulatory involvement in wholesale contract negotiations will better serve consumers. The anchor service regulations will set a baseline for ensuring consumers can benefit from certainty on service and pricing as we transition into the new framework. Having flexibility to innovate across our remaining portfolio of services and allow us to meet the changing demands of our customers and consumers is a key function of the new regime.

10 Submitters raised a number of points in relation to timing, the use of an independent verifier and the types of information we will be required to provide the Commission for our regulatory proposals. We agree that there is significant time pressure for Chorus to produce, and for the Commission to approve, a regulatory proposal for the first regulatory period (**RP1**). Ensuring that the Commission has the best available data is the reason we have engaged Cutler Merz as an independent expert in the absence of the Commission being able to engage in a tripartite agreement for an independent verifier.[1]

11 With regard to data granularity and the requirements in place for the Commission's scrutiny, we note the importance of the principle of proportionate scrutiny. This will be important as the Commission considers the need to ensure the regime can be implemented in the time-frames available and continues to mature and develop.

Long-term benefit of end-users

12 The positions we set out below are those that are most likely to promote the long-term benefit of end-users. These interests will be advanced by the Commission weighing carefully the wider and enduring consequences of the decisions it takes to implement the regime. These interests will also be advanced by the Commission first carefully considering *whether* a particular intervention or requirement is justifiable before moving to *how* it should be specified. This will avoid actions that do not

[1] https://comcom.govt.nz/__data/assets/pdf_file/0033/183948/Commerce-Commission-Letter-on-Chorus-independent-expert-for-capital-expenditure-proposal-24-October-2019.pdf

promote the long-term benefit of end-users. For example, the long-term benefit of end-users are likely to be advanced by:

12.1 Establishing the regime's initial settings (including the initial regulated asset base (**RAB**)) so they not only comply with the Telecommunications Act (**Act**), but also produce an objectively fair outcome for investors. Fair treatment of *past* sunk investments will go a long way to ensuring investors continue to be willing to undertake *new* irreversible investments essential to meeting consumers' expectations, as will ensuring that the returns on those new investments are consistent with market requirements;

12.2 Giving Chorus operational flexibility, leaving Chorus and the RSPs to resolve matters commercially where possible, and focussing on the incentives needed to achieve this; and

12.3 Always keeping in mind the direct and indirect costs of regulation, which ultimately will be borne by consumers. This includes when interpreting the definition of the regulated services and setting information collection requirements.

13 Keeping these principles in mind will also help to ensure that the IMs are durable and provide the requisite certainty as the market continues its transition to fibre.

Areas of alignment

14 There's alignment amongst submissions on a number of topics raised in the Commission's Reasons Paper. For example:

14.1 **Competition screening** – Submitters agree with the Commission adopting a competition screening test to determine whether section 166(2)(b) is relevant to a particular decision when exercising its discretion.

14.2 **Economic principles** – Support for the Commission adopting the three key economic principles: real FCM, allocation of risk and the asymmetric consequences of over- and under-investment to guide the design of the IMs.

14.3 **Crown financing** – Local fibre companies (**LFCs**) and investors agree with the Commission that the character of Crown financing was 'debt-like', and its approach of calculating the benefit received by fibre providers of concessionary Crown financing based on the avoided cost of debt.

14.4 **Deregulation** – General agreement that at the point of deregulation, assets should be removed from the RAB, including a portion of the financial loss asset.

14.5 **Cost of capital – asset beta** – LFCs and investors agree the asset beta comparator set isn't representative and is inconsistent with Ofcom's recent decision on asset beta for Openreach's fibre network.

14.6 **Cost of capital – uplift** – Telecommunications and electricity infrastructure suppliers are aligned that a cost of capital uplift is required to mitigate the risk of under-investment. In addition, they caution the Commission against 'command and control' mechanisms for influencing investment, for example through quality standards.

14.7 **Asymmetric risk** – LFCs and investors support the Commission's draft decision to apply an *ex-ante* allowance for the risk of asset stranding. However, they agree the Commission has under-estimated the risk.

14.8 **Capital expenditure (capex)** – Submitters agree with the Commission's starting point based on Transpower's Capex IM, and the Commission's decision to adopt a propose-approve model. There is also general alignment on the Commission's draft decision to have base, connection, and individual capex categories.

Our response to matters others have raised

15 We disagree with other submissions for the reasons explained below:

15.1 **Scope of the regulated service** – The statutory definition, underlying policy to transition UFB services[2] to the new regulatory framework and the application of good regulatory principles to ensure regulation is appropriate and proportionate, point against backhaul, network services and new property development services being included as FFLAS. Other LFCs don't object to the inclusion of backhaul services and potentially network services and property development services, which may reflect a matter of convenience for them given their smaller scale and that they are only subject to ID. However capturing contestable unregulated services does not reflect the transition from the contractual model to a regulatory model, bypasses usual market analysis processes and has the potential to distort competition.

15.2 **Asset valuation** – While we support the Commission prescribing a minimum level of asset granularity that regulated suppliers must provide when recording assets in the RAB, asset granularity should align with existing data, accounts and systems unless there is justification to depart.

15.3 **Related party transactions** – We disagree with RSPs' suggestions that the Commission has departed from Part 4 on related party transactions. We support rules for related party transactions to be consistent with GAAP.

15.4 **Financial loss asset** – Some submitters question the legislative requirements by arguing pre-2011 assets should be excluded from the RAB and argue the Commission should take copper revenues into account when assessing Chorus' financial losses. However, this would be inconsistent with the Act. In addition, virtually any new infrastructure project would make a 'financial loss' (as defined in the Act) over the first decade of its operation. Contrary to some submissions, there is nothing unexpected about the existence of financial losses in the construction and early growth phase of the UFB initiative.

15.5 **Rate of return on investment (RROI) for financial losses** – The term of the risk-free rate application to the calculation of financial losses should match the period for which the fibre prices have been set – from May 2011 to the implementation date. In addition, we disagree with submitters who say the

[2] UFB services don't require Chorus to provide backhaul, network services or new property development services.

Commission has over-estimated the asset beta and that it should be closer to zero in the pre-implementation period.

15.6 **Crown financing** – Some suggest without Crown financing, Chorus wouldn't have been able to maintain an investment grade rating when delivering UFB. So the Commission's analysis should assume Chorus has avoided the need to borrow at a sub-investment grade credit rating. This proposal is unrealistic as, without Crown financing, the decision to invest in UFB assets would have been deferred until it was both commercially feasible and financeable.

15.7 **Treatment of taxation for financial losses** – In response to concerns raised, the method employed by Incenta was a valid means of ensuring that taxation effects were properly counted when assessing the net benefit of Crown financing.

15.8 **Incentives to inefficiently incur losses** – Chorus doesn't have incentives to incur inefficient losses in the period prior to the implementation of the regime. As a publicly listed company we have a strong efficiency incentive to meet cashflow needs and to maintain our financeability.

15.9 **Cost allocation – benchmarking and sensitivity testing** – It was proposed in submissions that Chorus be required to provide high level benchmarking in information disclosure (**ID**) and/or produce sensitivity testing over the choice of cost allocators. We disagree, as such an exercise is impractical and wouldn't promote the objective of Part 6.

15.10 **Double recovery** – RSPs continue to raise concerns regarding the double recovery of costs shared between copper and fibre services, advocating for a reconciliation of TSLRIC and the building block model (**BBM**). However, even if the analysis was attempted, there is no reason to believe that it would show double-recovery. To the contrary, it could show under-recovery, as explained by TERA[3] and Analysys Mason.[4]

15.11 **Cost of capital – asset beta** - We disagree that the Commission should revert to CEPA's recommendation of 0.49 or below. This is inconsistent with the allocation of risk principle. It does not compensate LFCs for the level of systematic risk that they would be exposed to in a workably competitive market (**WCM**) and raises the risk of future under-investment.

15.12 **Asset stranding risk** – While RSPs support the real FCM principle, there are some contradictory statements claiming that the Commission doesn't have a role in keeping Chorus whole for the period of regulation. However, to mirror the outcomes of WCM, consistency with real FCM needs to be achieved over the life of the assets. This requires considering the potential consequences of deregulation.

[3] TERA (31 July 2019), *Study on potential cost over-recovery in the BBM model for fibre services*, p3.

[4] Analysys Mason (24 January 2020), *Response to TERA paper on "over-recovery"*, p12.

15.13 **Quality dimensions** – RSPs have suggested a prescriptive approach to quality regulation, including Commission oversight of wholesale services agreements (**WSA**) through a regulated process for setting or changing service terms. We are moving to an incentives-based regulatory framework and away from previous regimes requiring detailed prescription and oversight of non-price terms. Non-price terms will be baselined by anchor service and direct fibre access service (**DFAS**) regulations. Prescribing non-price terms is also beyond the legislatively permitted scope of the IMs.

15.14 **Capex IM** – A number of submitters raise concerns, including:

(a) Information asymmetries and limited oversight of the price-quality proposal for RP1 will work in Chorus' favour. However, we are voluntarily doing many of the things submitters are suggesting, including engaging an independent verifier.

(b) Chorus' incentive to over-forecast. We disagree, as Chorus has a solid history of forecasting and delivering to plans on the UFB rollout, in line with market guidance as a listed company. We have also had to manage our expenditure effectively in the context of a fixed price contract which has created a strong efficiency imperative.

(c) The need for a quantified cost benefit analysis (**CBA**) for all investment. This isn't necessary as for most expenditure the key consideration is whether there are good processes in place for systematically prioritising and co-optimising programmes of work.

The structure of our cross-submission

16 A number of the matters raised by submitters have already been set out at length in our earlier submissions. Our cross-submission responds to new issues as follows:

- **Part 1** – Asset valuation and cost allocation;
- **Part 2** – Cost of capital and asymmetric risks; and
- **Part 3** – Quality dimensions and capital expenditure.

PART 1: ASSET VALUATION AND COST ALLOCATION

Asset valuation

- While we support the Commission prescribing a minimum level of asset granularity that regulated suppliers must provide when recording assets in the RAB, asset granularity should align with existing data, accounts and systems unless there is justification to depart.

- Chorus supports rules for related party transactions to be consistent with GAAP.

Financial loss asset

- A higher asset beta is appropriate in the pre-implementation than the post-implementation period as there is higher systematic risk in the build period due to higher operating leverage, higher demand risk and longer term cashflows.

- Consistent assumptions should apply between estimating the avoided cost of debt for the Crown financing adjustment and the estimation of the RROI.

- Chorus doesn't have incentives to incur inefficient losses in the period prior to the implementation of the regime. As a publicly listed company we have a strong efficiency incentive to meet cashflow needs and to maintain our financeability.

Cost allocation

- A requirement to perform benchmarking and/or sensitivity testing on cost allocators is inconsistent with a BBM framework.

Asset valuation

Asset granularity

17 Submitters have questioned whether the level of asset granularity proposed is sufficient for the purpose of price-quality regulation (**PQR**). Asset granularity should instead align with existing data, accounts and systems unless there is good reason to depart. If changes are necessary for the collection of information in future, then the transitional principle[5] should apply.

[5] Transitional principle – if any changes from existing requirements today are required, then the intended objective needs to be clear so the level of granularity is fit for purpose and unnecessary changes aren't imposed – where changes are appropriately justified, then it's important to bear in mind that any transition is likely to take time.

Related party transactions

18 Related party transactions for the provision of goods and services should be aligned with the Part 4 approach. We disagree with suggestions there is no equivalent safeguard in Part 6.[6] The Commission's draft decision addresses related party transactions for the purpose of commissioning assets, which is consistent with Part 4. The Commission has yet to consult on ID requirements.

Financial loss asset

Asset valuation

19 There is general alignment on the treatment of assets being removed from the RAB on deregulation, as well as a portion of the financial loss asset. However, the Commission should reflect the higher systematic risks in the asset beta and the higher stranded asset risk in the Type II asymmetric risk allowance.

RROI in the pre-implementation period

20 An RSP[7] proposes the asset beta during the pre-implementation period should be close to zero. We remain of the view that a higher asset beta is required for the pre-implementation than the post-implementation period as there is higher systematic risk in the build period due to higher operating leverage, higher demand risk and longer term cashflows.

21 We also remain of the view that the RROI should reflect the risk environment faced by investors in the UFB initiative.

Crown financing

22 In our submission, we noted the importance of consistency in the approach to calculating the avoided cost of Crown financing and estimating the RROI, and identified the inconsistent assumption about the credit rating as a particular concern.

23 In response to other submitters:

23.1 We agree with Enable and Ultrafast Fibre[8] that the characteristics of Crown financing may differ between LFCs and it's appropriate to consider whether the nature of financing for each regulated supplier is debt or equity. However, we remain of the view that the approach to estimating the avoided cost of debt or equity should be consistent with the approach to estimating the RROI. In other

[6] Vocus (28 January 2020), *Draft fibre input methodologies determination: submission to the Commerce Commission*, at [31]-[34].

[7] Vodafone (28 January 2020), *New regulatory framework for fibre: submission on fibre regulation draft decision*, p2.

[8] Enable Networks and Ultrafast Fibre Limited (28 January 2020), *Submission on NZCC fibre input methodologies: draft decision – reasons paper and draft fibre input methodologies determination*, at [8.13].

words, the avoided cost of debt and avoided cost of equity rates must be consistent with the notional cost of debt and cost of equity rates used in estimating the RROI.

23.2 We disagree with the RSP[9] suggestion that without Crown financing Chorus would have been forced to borrow for the UFB initiative at a sub-investment grade credit rating. This is unrealistic, as it would have been impossible for a privately-owned firm with a high yield bond rating to raise the necessary finance to deliver UFB. In reality, without Crown financing the decision to invest in UFB assets would have been deferred until it was both commercially feasible and financeable.

Crown financing – treatment of taxation

24 In response to the RSP[10] raising concerns that Chorus' expert, Incenta Economic Consulting, had made a material error regarding the treatment of taxation when calculating the avoided cost associated with Crown financing:

24.1 We agree with the Commission's proposed approach to dealing with the tax effects of Crown financing, whereby the loss of interest deductions or imputation tax credits are incorporated into the calculation of the notional tax allowance, rather than being affected via an adjustment to the relevant interest rates as Incenta assumed. We note that this is consistent with the other draft decisions in relation to taxation.

24.2 However, the method employed by Incenta was a valid means of ensuring that taxation effects were properly counted when assessing the net benefit of Crown financing.

Tax benefit from past losses

25 We agree with the Commission's proposal to carry-forward the notional tax losses during the pre-implementation period and disagree with the criticisms[11] made, noting that:

25.1 The Commissions' draft decision is consistent with their practice under Part 4; and

[9] Vodafone (28 January 2020), *New regulatory framework for fibre: submission on fibre regulation draft decision*, p13.

[10] Vodafone (28 January 2020), *New regulatory framework for fibre: submission on fibre regulation draft decision*, p13.

[11] Spark (28 January 2020), *Fibre input methodologies: draft determination*, at [39]-[42].

25.2 The alternative of recognising the wider group when modelling tax for regulatory purposes requires assumptions to be made about the tax status of services out of scope of FFLAS, which is inappropriate.[12]

Incentives to inefficiently incur losses

25.3 It is also suggested that we have incentives to incur inefficient losses in the period prior to the implementation of the regime.[13] As a publicly listed company we have a strong efficiency incentive to meet cashflow needs and to maintain our financeability. Our investments have been made against the backdrop of ongoing regulatory uncertainty. As we move towards implementation, regulatory uncertainty will decrease but not disappear. In addition, the financial losses asset provides an expectation, but no guarantee, of recovery. It is unrealistic to suggest Chorus would have deliberately forgone revenue that it is not guaranteed to recover in the future.

26 In addition, most of Chorus' investment was incurred in the context of a fixed-price funding model that included caps on the prices we could charge for UFB services, so we were not in a position to finance a gold-plating strategy. This structure means that Chorus has a strong efficiency imperative.

Cost allocation

Benchmarking of key cost categories

27 We disagree with suggestions[14] that LFCs should be required to provide high-level benchmarking to demonstrate whether the shared costs allocated to FFLAS include unavoidable costs.

28 While we consider the cap on shared costs based on the unavoidable cost is unnecessary, such a requirement would require an assessment of whether Chorus acting prudently:

28.1 Would incur fewer shared costs than those allocated to FFLAS if it (hypothetically) ceased to provide non-FFLAS services; or

28.2 Could avoid a much greater amount of shared costs as the provision of non-FFLAS services declines or ceases (i.e. copper services).

29 We don't interpret the cap on shared costs based on the unavoidable costs as requiring an inquiry into the cost that would be incurred by a hypothetical entity (in the sense of a TSLRIC-style hypothetical new entrant). Applying such a test would

[12] *See* Chorus (16 July 2019), *Fibre emerging views submission*, at [72].

[13] Vector (28 January 2020), *Submission to the Commerce Commission Fibre Input Methodologies Project,* at [15]-[16]

[14] Spark (28 January 2020), *Fibre input methodologies: draft determination*, at [20].

also be at odds with the BBM framework. In addition, benchmarking is unlikely to provide useful information and more likely to be a distraction.

30 We also disagree with the view[15] that we may have an incentive to delay reducing costs as services are withdrawn. To the contrary, as noted in our submission on the Reasons Paper, we will have an incentive to minimise costs under our regulatory regimes (i.e. as a consequence of being subject to a revenue cap for FFLAS and price cap for the regulated copper services), and these incentives are further strengthened by the risk of asset stranding.

Sensitivity testing of different cost allocators

31 We disagree with the suggestion[16] that sensitivity testing over the choice of cost allocators would be likely to promote the objective of Part 6. While we appreciate the Commission may request information on the effects of different allocators, the production of sensitivity testing:

31.1 Has the potential to impose considerable cost, and may not be possible or sensible in many cases (e.g. where there is no obvious alternative to the proposed allocator); and

31.2 Would encourage the analysis and debate to move away from the question of which allocator best meets the requirements of the IMs (i.e. the allocator that most accurately reflects causation, or where such a relationship cannot be established, the most appropriate proxy allocator) to one where participants instead merely fix upon the option that provides them with the greatest benefit.

[15] Spark (28 January 2020), *Fibre input methodologies: draft determination*, at [19].

[16] 2degrees (28 January 2020), *Commerce Commission fibre input methodologies submission*, p9.

PART 2: COST OF CAPITAL AND ASYMMETRIC RISK

Cost of capital

- ☐ Investors and infrastructure providers are aligned that the impact of the draft decisions is likely to underestimate the cost of capital for Chorus' FFLAS business.

Asymmetric risk

- ☐ Material Type II asymmetric risk will exist even without an active policy of regulatory asset stranding, and such a policy would necessitate a substantial increment to the *ex-ante* allowance to ensure *ex-ante* FCM is preserved.

- ☐ We support how the Commission proposes to detail with Type I asymmetric risks but agree with Unison that a material Type I asymmetric risk (e.g. a catastrophic event) may exacerbate Type II risks, and this should be factored into the Type II asymmetric risk allowance.

Cost of capital

Asset beta

32 We disagree with suggestions[17] that the Commission should revert to CEPA's recommendation of 0.49 or below. This is inconsistent with the real FCM principle. Without the correct measure of exposure to systematic risk associated with investment in FFLAS, Chorus will not have the opportunity to earn normal returns on investment in fibre assets.

Asymmetric risk

Type II asymmetric risk

33 RSPs advocate that Chorus won't face Type II asymmetric risk unless the Commission seeks to identify and write-down assets that are deemed to be under-utilised. This position is incorrect. As a matter of principle, and as the Commission has appropriately recognised:

33.1 Even with some flexibility over depreciation and pricing, Chorus faces a risk that we may not be able to recover our costs because of economic stranding resulting from competition and factors that may drive competition (such as technological change); and

33.2 This creates an asymmetry in our potential future returns:

(a) If these risks eventuate, then we risk failing to recover cost;

[17] Spark (28 January 2020), *Fibre input methodologies: draft determination*, at [60]-[64].

(b) However we would not earn an offsetting benefit if the fibre services are more successful than expected because the application of the BBM will limit us to a normal return; and

33.3 Preservation of real FCM requires compensation for this asymmetric risk.

34 If the Commission was to consider a more active policy of asset stranding then a substantially higher premium for stranded asset risk would be required.

Interaction of Type I and Type II risks

35 While we note[18] the interaction between Type I and Type II risks:

35.1 We support the Commission’s approach to address Type I risks ex-post; and

35.2 The Commission should be mindful that major Type I risks have the potential to exacerbate Type II risks (i.e. by raising Chorus’ costs to a point where Chorus is materially constrained by competition in its ability to recover costs) and factor this into the *ex-ante* allowance.

[18] Unison (28 January 2020), *Unison submission on draft fibre IMs*, p3-4.

PART 3: QUALITY DIMENSIONS AND CAPITAL EXPENDITURE

Quality dimensions

□ RSPs have suggested a prescriptive approach to quality regulation, including Commission oversight of WSAs. We are moving to an incentives-based framework and away from previous regimes involving detailed prescription and oversight of non-price terms. Non-price terms will be baselined by anchor service and DFAS regulations.

Capital expenditure

□ Concerns have been raised about information asymmetries and limited oversight of the price-quality proposal for RP1 will work in Chorus' favour. However, we are voluntarily doing many of the things submitters are suggesting, including engaging an independent verifier.

□ Some suggest Chorus has an incentive to over-forecast. We disagree, as Chorus has a solid history of forecasting and delivering to plans on the UFB rollout, in line with market guidance as a listed company.

□ We disagree there is a need for a quantified cost benefit analysis for all investment. This isn't necessary as for most expenditure the key consideration is whether there are good processes in place for systematically prioritising and co-optimising programmes of work.

Quality dimensions

36 We support the draft decision that the Commission doesn't have a role in determining the non-price terms in our WSAs with RSPs. In addition, it's not necessary for the Commission to introduce a quality standard and measure relating to negotiations of commercial terms. This is outside the scope of PQR, and not required for the following reasons:

36.1 The open access deeds under Part 4AA, to which all LFCs are subject, include existing requirements to produce and disclose fibre Reference Offers.

36.2 The Act explicitly allows for Anchor service and DFAS regulations to set conditions of service which will baseline non-price terms for other services.

36.3 Large RSPs are sophisticated and well-resourced commercial parties who don't need Commission support to achieve a commercial outcome. Non-discrimination means all RSPs get the benefit of the negotiation power of large RSPs.

36.4 Setting quality standards around a commercial negotiation process will give rise to delay and uncertainty where there is disagreement and the Commission is required to decide if the regulated supplier's negotiations are consistent with the standard. During disputes the status of commercial terms will be unclear.

> Delay of new or amended commercial terms will compromise our ability to respond to market changes and jeopardise real FCM.

37 We also endorse the position of ENA[19] and Vector[20] who note the dangers of excessive quality regulation in preference to a cost of capital uplift.

Capital expenditure

38 We support the Commission's principled approach to the capex IM rules. Contrary to some submitters, we believe that, based on the difficulties of overly-prescriptive IMs in the Part 4 context, a principled approach is more likely to be enduring and flexible.

39 The Commission's approach should avoid dated or irrelevant information requirements, while still ensuring the process is robust. Additional prescription doesn't necessarily provide greater rigour.

40 The capex IM and information notices need to work together to provide enough clarity to facilitate timely and efficient preparation of high-quality information. Some submitters have observed that the draft capex IM is less extensive than the Transpower Capex IM. However, the Transpower Capex IM is to some extent a legacy document. Many of the rules have historical origins in the former Electricity Commission regime that applied to Transpower pre-Part 4. Those rules also reflect objectives and principles that are unique to the electricity transmission sector and do not apply in the Chorus context.

Forecasting

41 We support the Commission's recognition of forecast demand uncertainty and the capex regime providing for mechanisms to mitigate that uncertainty by allowing actual volumes to be fed through and wash-ups to occur. We disagree with RSP statements that we have an incentive to over-forecast.

42 We have a solid history of forecasting and delivering to plans on the UFB rollout, in line with market guidance as a listed company, which was essential because we were operating under the discipline of a fixed-price contract. As stated in our submission on the Reasons Paper, any risk to forecasting would be mitigated by having a low-rate incentive mechanism, combined with the ability to wash-up actual volumes against forecast. For example, with a 20% incentive rate we would pass 80% of any savings through to lower the MAR and, in the process, reveal a lower cost base for use in future resets.

43 The suggested mechanism[21] to penalise Chorus for underspending forecasts would be counter-productive. It would deter efficiency gains in the period, which would shift the

[19] Electricity Networks Association (28 January 2020), *Draft fibre IM determination: submission to the Commerce Commission*, at [7]-[15].

[20] Vector Communications (28 January 2020), *Submission to the Commerce Commission fibre input methodologies project*, at [34]-[28].

[21] 2degrees (28 January 2020), *Commerce Commission fibre input methodologies submission*, p13.

onus from revealed efficiency to regulatory assessment. This would be less effective, and not as good for consumers.

44 The connection capex mechanism mitigates a key uncertainty. If this is designed as we suggest (using a P50 estimate of volumes) then we have a balanced exposure to the adjustment mechanism and no incentive to overstate. This approach also supports a broad capture of direct and indirect connection-related capex.

Independent verification

45 We agree that independent assessment of our proposal is important. And we are voluntarily doing many of the things that submitters are suggesting. For example, we have engaged an independent verifier, whose scope covers capital and operating expenditure. We haven’t been able to sign a tripartite deed with the Commission as occurs under Part 4 given the IM process is still underway. However, we’ve modelled the engagement on Part 4 precedents.

46 In addition, we’re planning to consult on our RP1 proposal, and this will include seeking input into the engagement plan we submit with our proposal.

Cost-benefit analysis

47 We disagree a blanket rule requiring quantified CBA for all investments is necessary:

47.1 The way the capex IM is constructed recognises that large, well-run businesses manage the prudency and efficiency of their expenditure through policies, processes and systems. This is because regulatory expenditure proposals for network businesses typically have a much higher proportion of recurrent or programmed work than large, discretionary one-off investments.

47.2 While large, one-off investments may be managed through a one-off CBA, for most expenditure the key consideration is whether there are good processes in place for systematically prioritising and co-optimising programmes of work. These processes will be tailored to the nature of each investment, e.g. compliance, risk management, optimisation, and enhancement. If the management systems are well designed overall, and are effective, then stakeholders can be confident in the prudency and efficiency of the resulting investment plans.