

B3 Accounting Information

Long form responses to the Information Request from the Commission dated 18 November 2020 that relate to accounting information.

B3.1 A7 – demarcation of base capex, connection capex and opex

B3.2 A25-A28 – asset valuation

B3.3 A30 - capitalisation

Demarcation of base capex, connection capex and opex

A7 Provide a list of and high-level description of each of Chorus's key approaches to the demarcation between proposed base capex, proposed connection capex, and proposed opex

The demarcation of "capex" and "opex" is based on NZ accounting standards, i.e. New Zealand equivalents to International Financial Reporting Standards (NZ IFRS). This includes standards such as NZ IFRS 15 and NZ IFRS 16¹, which since their implementation (and Chorus's early adoption from 1 July 2017) require expenditure that previously was treated as opex to be treated as capex when certain criteria are met.

Chorus forecasts "capex" at an "All of Chorus" (or total) level as part of the annual business planning. "Connections capex" and "base capex" are new concepts driven from the IMs. We first forecast total capex, then identify which elements of that total capex meet the IM definitions of connections capex. We then deduct the connections capex numbers from total capex to derive the base capex figure.

Proposed connection capex

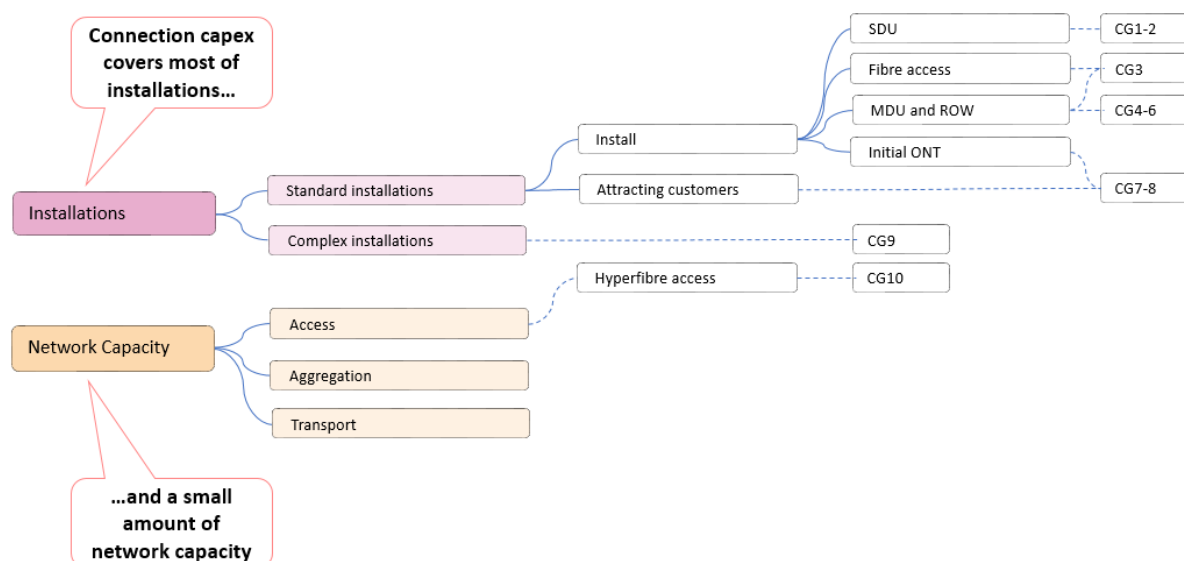
Connection capex is expenditure that is demand-driven and has a direct relationship with new installations for end-consumers onto the fibre network. Our connection capex groups are listed in the attachments to the Commission's information request dated 18 November 2020. Our connection capex proposal report describes our approach to developing our proposed connection capex.

Connection capex is defined using the cost groups agreed with the Commission – i.e. connection capex is equivalent to unit rate multiplied by connections volume across all cost groups, plus the non-linear cost determined using the cost group 10 formula.

In the IFP Investment Summary report, we introduce narrative categories that we use to explain how we have built up our forecasts. The diagram below shows how *cost groups*, *connection capex*, and *narrative categories* relate to each other.

¹ Please also refer to our response to Information Request A30 for further details on our capitalisation policies, including NZ IFRS 15 and NZ IFRS 16.

B3.1 A7 – demarcation of base capex, connection capex and opex



Proposed base capex

Base capex is all forecast capex that is not listed as part of connection capex. Our base capex expenditure categories and sub-categories are listed below.

Proposed opex

Opex is operating costs across all functional units that do not result in the creation of an asset. The functional units at Chorus as of 1 December 2020 include:

- CEO/Board
- Chief Financial Officer
- General Counsel's Office
- People & Culture
- Product, Sales and Marketing
- Customer & Network Operations
- Chief Technology Officer

Our list of proposed opex categories and sub-categories is in line with the attachments to the Commission's Information Request dated 18 November 2020 and is shown below for reference.

As explained above, our approach to demarcation of capex and opex follows NZ accounting standards treatment.

B3.1 A7 – demarcation of base capex, connection capex and opex

Our proposed cost categories

For the avoidance of doubt, our cost categories are as per the below lists.

Base capex sub-category groups	Base capex sub-categories
Extending the Network	Augmentation
Extending the Network	New Property Developments
Extending the Network	UFB Communal
IT and Support	Business IT
IT and Support	Corporate
IT and Support	Network & Customer IT
Installations	Complex Installations
Installations	Standard Installations
Network Capacity	Access
Network Capacity	Aggregation
Network Capacity	Transport
Network Sustain and Enhance	Field Sustain
Network Sustain and Enhance	Relocations
Network Sustain and Enhance	Resilience
Network Sustain and Enhance	Site Sustain

Opex sub-category groups	Opex sub-categories
Customer	Customer operations
Customer	Product, Sales & Marketing
Network	Maintenance
Network	Network Operations
Network	Operating costs
Support	Asset Management
Support	Corporate
Support	Technology

Asset Valuation

A25 To the extent Chorus forecast capex information relates to commissioned assets or the methodologies in relation to asset valuation are relevant in producing capex forecasts, Chorus must apply the relevant methodologies and definitions in Part 3 Subpart 3: Asset valuation of Attachment B of the IM Determination, including:

A25.1 **commissioned** and **employed**;

A25.2 **easement, easement land** and **fixed life easement**;

A25.3 **finance leases**;

A25.4 **identifiable non-monetary assets**;

A25.5 **network spares**;

A25.6 **related party transaction**;

A25.7 assets employed by **Chorus** in providing **services that are not regulated FFLAS** that are now forecast to be **commissioned for FFLAS**;

A25.8 **vested assets**; and

A25.9 **works under construction**.

A26 Where these concepts are relevant to Chorus’s capex proposal, Chorus must provide additional information that explains how the forecasts in relation to the matters listed in A25 are based on relevant and demonstrably reasonable assumptions, data, methods and judgements.

Chorus response to A25 & A26:

Methodologies and definitions in Part 3 Subpart 3: Asset valuation of the IM Determination that are relevant to our forecast are as follows:

IM Ref	Requirement	How we’ve complied
Part 3 Subpart 3: 3.3.1(3)(a)	All forecasts... must be... “based on relevant and demonstrably reasonable assumptions, data, methods and judgements.”	Refer to ‘Modelling and Cost Allocation Report’, modelling section for details on our forecasting approach and how it meets these criteria. Each investment report chapter also talks to the assumptions, methods and judgements at a sub-category level.
Part 3 Subpart 3: 3.3.1(4)	CPI must be determined in line with this clause.	Refer to ‘Modelling and Cost Allocation Report’, modelling section, under heading ‘Modelling done in regulatory templates’ for details on CPI and how we have complied with this requirement. CPI is also explained and stepped out through the regulatory templates, particularly RT02:

B3.2 A25-A28 – asset valuation

IM Ref	Requirement	How we've complied
		Cost Escalation, which details how each of (a), (b) and (c) of this clause are applied in the CPI forecast.
Part 3 Subpart 3: 3.3.1(8)(c)(i)	All forecasts... "in respect of any disclosure year (or part thereof) prior to the implementation date"... must be... "based on relevant and demonstrably reasonable assumptions, data, methods and judgements."	Relates to the 18 months from 1 July 2020 to 31 December 2021. Same as response to 3.3.1(3)(a) above.

Part 3 Subpart 3 also refers back to the input methodologies specified in Part 2 Subpart 2. The clauses relevant to our forecast are as follows:

IM Ref	Requirement	How we've complied
Part 2 Subpart 2: 2.2.13(1) and (2)	Value of commissioned assets (prior to implementation date and those with a commissioning date on or after the implementation date) means the cost as of the commissioning date under GAAP in constructing or acquiring the asset, net of capital contributions.	Our forecasts have been built based on GAAP treatments and net of capital contributions, where relevant. Refer to the Modelling and Cost Allocation Report, modelling section for further details of our modelling approach, including treatment of capital contributions, IDC and the difference between capital expenditure and value of commissioned assets.
Part 2 Subpart 2: 2.2.13(3)	This clause steps out specific requirements for different types of asset in relation to value of commissioned assets.	Refer to the breakdown below by category of assets as identified in the information request.
Part 2 Subpart 2: 2.2.13(4) to (5)	These clauses detail rules relating to the calculation of IDC.	Refer to the 'Modelling and Cost Allocation Report', modelling section for further details of our modelling approach.

The below table then specifically addresses the asset classes identified in the information request and how we have ensured compliance with the IMs:

Information Request Ref	Requirement per IMs Part 2 Subpart 2 (13): Value of commissioned assets	How we've complied
A25.1 commissioned and employed;	Not specifically referred to in this clause, but is defined by the IM interpretation clauses as follows: " Commissioned means employed by the regulated provider in providing regulated FFLAS or services that are not regulated FFLAS (whether or not the asset is also employed in providing other services", and " Employed means available for use."	Our underlying forecasts are based on capital expenditure, which is when the cost is incurred, whereas commissioning is when the asset in question is available for use. The calculation of commissioned values from the capital expenditure forecasts is done in regulatory template RT01, using an approximation of time spent in works under construction, and discussed further in the 'Modelling and Cost Allocation Report', modelling section, under heading 'modelling done in regulatory templates'.
A25.2 easement, easement	"For the purposes of subclauses (1)-(2), the value of commissioned asset of-	Our only easements are under lease contracts. The GAAP treatment is under NZ IFRS 16 and they are accounted for on that basis as capex.

Information Request Ref	Requirement per IMs Part 2 Subpart 2 (13): Value of commissioned assets	How we've complied
land and fixed life easement;	<p>(a) an easement, is limited to its market value as on its FFLAS commissioning date as determined by a valuer;</p> <p>(b) easement land is nil;"</p>	<p>In line with Information Request A28.1, we have translated leases into cashflows for the proposal. This is to facilitate historic and forecast trend comparison and to avoid the year-on-year irregularity of the NZ IFRS 16 capex presentation.</p>
A25.3 finance leases;	<p>Not specifically referred to in this clause, but is defined by the IM interpretation clauses as follows: "Finance lease has the same meaning as under GAAP."</p>	<p>Chorus is a lessee and lessor of certain network assets under lease arrangements. "Finance leases" are now under the scope of NZ IFRS 16 and Chorus accounts for them on that basis as capex.</p> <p>In line with Information Request A28.1, we have translated leases into cashflows for the proposal. This is to facilitate historic and forecast trend comparison and to avoid the year-on-year irregularity of the NZ IFRS 16 capex presentation.</p>
A25.4 identifiable non-monetary assets;	<p>Not specifically referred to in this clause, but is defined by the IM interpretation clauses as follows: "identifiable non-monetary asset has the same meaning as under GAAP (which, for the avoidance of doubt, includes right-of-use assets) except that it excludes goodwill."</p>	<p>This is a very broad category of capital expenditure. We have compiled our forecast on the basis of GAAP-compliant treatment of both capex and opex.</p>
A25.5 network spares;	<p>"For the purposes of subclauses (1)-(2), the value of commissioned asset of-</p> <p>(c) a network spare is nil, where it is not held in accordance with good telecommunications industry practice;</p> <p>(d) a network spare whose cost is not treated wholly as or part of the cost of a core fibre asset under GAAP, is nil;"</p>	<p>Chorus has applied a consistent GAAP treatment of network spares historically and through the forecast period</p> <p>When capital projects build assets which Chorus anticipates will require spares, spares are purchased as part of that capital project and included as part of initial asset</p> <p>The spares are tracked at nil value in the Spares Management System (SMS). Where a faulty asset is removed from the network and is able to be repaired, the test and repair costs are typically treated as operating expenditure (unless the asset class is largely fully depreciated due to age in which case the repair costs are capitalised).</p> <p>The level of national network spares that are held is determined initially by a Sparing Calculator tool and recorded in each Spares plan. Ongoing national spares levels are calculated by the Materials Replenishment Process (MRP) to ensure there are sufficient national spares to meet two months forecast demand, which is based on the last three months usage.</p>

Information Request Ref	Requirement per IMs Part 2 Subpart 2 (13): Value of commissioned assets	How we've complied
A25.6 related party transaction;	Part 2 Subpart 2 (15) states the value of an asset "acquired in a related party transaction must be determined on the basis that: (a) it must be given a value not greater than if that transaction had the terms of an arm's-length transaction ; (b) an objective and independent measure must be used in determining the terms of an arm's-length transaction ; and (c) the value that qualifies for recognition as the cost of the core fibre asset or the component of a core fibre asset must not exceed the actual amount charged to the regulated provider by the related party ."	Our process for transactions undertaken with a related third party uses the same rigour as a non-related party transaction in Chorus. This involves reviews and checks and must be compliant with the Chorus Delegated Authority policy. The related party in Chorus would be excluded from any decision making to ensure an arm's length transaction. Unlike most Part 4 utilities, Chorus is listed on the New Zealand Stock Exchange (NZX), where listed companies are required to have governance policies and practices that meet or exceed the required standards of that market, including in relation to related party transactions. Our forecast does not contain any transactions not at arms length.
A25.7 assets employed by Chorus in providing services that are not regulated FFLAS that are now forecast to be commissioned for FFLAS;	n/a – our forecast does not assume any change to existing asset treatments. All forecast capex relates to either FFLAS, non-FFLAS or shared assets. Cost allocation approach is discussed in the Modelling and Cost Allocation Report, cost allocation section.	
A25.8 vested assets; and	n/a - no vested assets within our forecast proposal.	
A25.9 works under construction.	Clauses (13)(4)-(13)(5) contain specific details about the treatment of works under construction, specifically with respect to costs of financing.	Refer to Modelling and Cost Allocation Report, modelling section, under heading 'modelling done in regulatory templates' for how we have applied Interest During Construction (IDC).

We believe we are compliant with the requirements of A25 and A26.

Capitalisation

A30 Provide a summary of Chorus’s approach for capitalising labour costs and any other costs Chorus capitalises.

Our approach to the capitalisation of costs is captured in our ‘Capitalisation Policy’ (refer ‘C1. A30 annex - Asset Capitalisation Policy January 2020’). The main categories of cost capitalisation are described below:

Capitalisation of labour costs

The intention of our labour rate principles/assumptions is to accurately capture costs related to the internal labour force who are directly involved in creating assets, in order to accurately reflect the cost of assets Chorus creates.

Our policy is aligned with accounting standard NZ IAS 16 Property, Plant & Equipment.

A labour capitalisation rate is calculated for each business unit as an hourly rate per employee. The rate has two components – a base rate, and an on-cost rate. The base rate reflects the total remuneration package across all staff within the functional unit, and the on-cost reflects a cost of corporate property and general IT costs, which are incurred for all staff.

There are also some functional units that have an additional cost that is unique to their area (e.g. Customer and Network Operations (CNO) for layer 2 management, where team leaders are specifically managing a full team of timesheeting/capitalised staff labour).

Rates are then loaded into the SAP finance system. Staff use timesheets to code their hours to projects. The hourly labour rate assigned to each staff member is then used to calculate the cost of their time and effort to be capitalised to projects/assets.

Labour rates are refreshed on an annual basis in line with the business planning process.

Capitalisation of Lease costs

We are a lessee and lessor of certain network assets under lease arrangements.

For reporting periods within FY2012 to FY2017 we accounted for leases under NZ IAS 17. For FY2018 we early adopted NZ IFRS 16 with a date of initial application of 1 July 2017.

For all leases we recognise assets and liabilities in the statement of financial position, except those determined to be short-term or low value. On inception of a new lease, the lease payable is measured at the present value of the remaining lease payments, discounted at our incremental borrowing rate at that date. Practical expedients within NZ IFRS 16 Leases have been applied to allow a single discount rate for a portfolio of leases with similar characteristics. Lease costs are recognised through interest expense over the life of the lease. The corresponding right of use asset incurs depreciation over the estimated useful life of the asset.

Prior to adoption of NZ IFRS 16 (FY2012-17), only leases considered finance leases were recognised on the statement of financial position per the method described above. All other leases (operating leases) were disclosed as a commitment at face value, in the ‘Commitments’ note of the financial statements.

B3.3 A30 – capitalisation

'Right of use assets' is a new asset category in the fixed asset register (FAR), created for leases on adoption of NZ IFRS 16 (FY2018).

We have applied a single discount rate to a portfolio of leases across the two main portfolios of leases ('Property' and 'poles') due to the long-term nature of the underlying assets used to service the same network. This is reflective of the longer-term nature of infrastructure assets. The nature of these assets is similar enough that borrowing rates on commercial debt would not change asset to asset. The incremental borrowing rate is reviewed annually.

We note that leases/right of use assets are referred to in Information Requests A27 and A28 as well.

Capitalisation of IT costs

We capitalise IT costs where they meet the criteria of our Capitalisation Policy. Software and other intangible assets are initially measured at cost. The direct costs associated with the development of network and business software for internal use are capitalised where project success is probable, and the capitalisation criteria is met.

Following initial recognition, software and other intangible assets are stated at cost less accumulated amortisation and impairment losses. Software and other intangible assets with a finite life are amortised from the date the asset is ready for use on a straight-line basis over its estimated useful life.

IT systems are assessed as to whether they are used in provisioning activity. Each provisioning IT system is categorised as either fibre provisioning, copper provisioning or shared, and capitalised as part of the related orders.

Capitalisation of customer acquisition and customer retention costs

We adopted NZ IFRS 15 'Revenue from Contracts with Customers' with a date of initial application of 1 July 2017. As a result, we changed our accounting policy for customer retention costs.

Customer retention costs are incremental costs incurred in acquiring new contracts with new and existing customers that we expect are recoverable over the life of the connection and are capitalised as customer retention assets. Following initial recognition, customer retention assets are stated at cost less accumulated amortisation and impairment losses. Customer retention assets have a finite life and are amortised from the month that costs are capitalised on a straight-line basis over the average connection life.

Customer retention assets are amortised to the income statement, either as amortisation expense or operating revenue, based on the nature of the specific costs capitalised.

Examples of costs that fall under this category are internal and external IT and labour costs associated with connecting our customers on the fibre network, cost of service company truckrolls to connect end-customers to the fibre network, and incentives for customers to move onto fibre services and up the portfolio to higher-spec fibre products. We note that customer incentives are referred to in response to other information requests (A23 and A49.1).