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Duration of the second regulatory period for Chorus' price-quality path – Draft decision

Reasons paper

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Commerce Commission
Wellington, New Zealand

CONTENTS

Chapter 1 Introduction

Purpose and structure of this paper

1.1 This paper contains our draft decision on the duration of the regulatory period for the upcoming price-quality path for Chorus Limited (**Chorus**) that starts on 1 January 2025.

1.2 We are seeking stakeholders' views on our draft decision to set the duration of the next regulatory period. Further details on how to provide feedback are covered at the end of this chapter.

1.3 The paper is structured as follows:

1.3.1 Chapter 1 provides context to our draft decision and information on how stakeholders can provide their views;

1.3.2 Chapter 2 covers the regulatory and legal framework to our draft decision; and

1.3.3 Chapter 3 outlines the reasons for our draft decision.

Our draft decision

1.4 Our draft decision is to determine the duration of the next regulatory period as four years. This would mean the regulatory period would start on 1 January 2025 and end on 31 December 2028.

1.5 Alongside this paper, we have made a draft determination that specifies the duration of the next regulatory period.[1]

Context to our draft decision

1.6 Chorus is currently the only local fibre company subject to price-quality regulation under Part 6 of the Telecommunications Act 2001 (**the Act**).[2] The Commerce Commission (Commission) determined Chorus' price-quality (**PQ**) path for the first regulatory period starting 1 January 2022 to 31 December 2024 (**PQP1**) on 16 December 2021.

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1 *[Draft] Determination of the duration of the second regulatory period for Fibre Price-Quality Path Determination 2024*.

2 The Telecommunications (Regulated Fibre Service Providers) Regulations 2019, specifies that Chorus is the only LFC that is subject to price-quality regulation.

1.7 The Act prescribes the duration of the first regulatory period as three years.[3] The Act requires the Commission to notify the duration of each subsequent regulatory period in a section 170 determination, and the duration must be between three and five years.[4]

1.8 We must specify a price-quality path for Chorus that includes the maximum revenues that may be recovered by it and the quality standards that must be met by it.[5] In determining the maximum revenues and quality standards, we must make decisions in accordance 166(2). The price-quality path is intended to create incentives for Chorus to act in ways that are consistent with the long-term benefit of end users, such as creating incentives to invest in its network, to innovate and improve efficiency, and to deliver services at a level that meet end-user demands.[6]

Next steps following this consultation

1.9 We are setting out our draft decision and consulting now because the duration of the regulatory period will influence the information, we gather from Chorus to inform our settings for the second price-quality path (**PQP2**). The Fibre capital expenditure (**capex**) input methodology (**IM**) requires Chorus to submit a base capex and connection capex baseline proposal for PQP2 by 31 October 2023.[7] For Chorus to submit its base capex and connection capex baseline proposals, it requires certainty on the duration of the regulatory period for PQP2 in order to propose expenditure and quality forecasts that cover the entirety of the regulatory period.

1.10 To support this process, we will issue a notice to Chorus by 28 February 2023 requiring it to provide the information required to enable us to evaluate Chorus' base capex and connection capex baseline proposal.[8] This information notice also needs to indicate the time horizon for expenditure forecasts ie, the duration of the regulatory period.

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3 Telecommunications Act 2001, s 207(1).

4 Telecommunications Act 2001, ss 194(2)(a), 207(2) and 207(3).

5 Telecommunications Act 2001, s 194(2)(c) and s 195(1).

6 Telecommunications Act 2001, s 192.

7 *Fibre Input Methodologies Determination 2020*, as amended on 29 November 2021, clauses 3.7.8(1)(b) and 3.7.14(1).

8 *Fibre Input Methodologies Determination 2020*, as amended on 29 November 2021, clauses 3.7.8(9)(b), 3.7.9(1), 3.7.14(7)(b) and 3.7.15(1).

1.11 We are required to notify the duration of a regulatory period in a section 170 determination.[9] We will make our final determination on the duration of the regulatory period for PQP2 in February 2023, prior to issuing the notice referred to in paragraph 1.10.

How you can provide your views

Scope of submissions

1.12 The Commission is inviting submissions from interested stakeholders. We will have regard to submissions received, including any relevant further information received, when making our final determination.

1.13 We are interested in your views on our draft decision (and the associated draft determination), including:

1.13.1 Do you agree with our draft decision of setting the regulatory period for the upcoming regulatory period to four years?

1.13.2 Do you consider the Commission should set a default duration for regulatory periods after PQP2 and what information should we consider in making that decision?

1.13.3 When should each regulatory year start and end ie, March year-end, June year-end, September year-end or December year-end?

Process and timeline for making submissions

1.14 We invite submissions by 5pm on 20 January 2023 and cross-submissions by 5pm on 30 January 2023.

1.15 Submissions can be made to the Infrastructure Regulation mailbox (infrastructure.regulation@comcom.govt.nz). Please include "Fibre regulatory period duration" in the subject line.

Confidentiality

1.16 The protection of confidential information is something the Commission takes seriously. The process requires you to provide (if necessary) both a confidential and non-confidential/public version of your submission and to clearly identify the confidential and non-confidential/public versions.

1.17 When including commercially sensitive or confidential information in your submission, we offer the following guidance:

[9] Telecommunications Act 2001, s 207(3).

1.17.1 Please provide a clearly labelled confidential version and public version. We intend to publish all public versions on our website.

1.17.2 The responsibility for ensuring that confidential information is not included in a public version of a submission rests entirely with the party making the submission.

1.17.3 Please note that all submissions we receive, including any parts that we do not publish, can be requested under the Official Information Act 1982. This means we would be required to release material that we do not publish unless good reason existed under the Official Information Act 1982 to withhold it. We would normally consult with the party that provided the information before any disclosure is made.

Chapter 2 Framework for our draft decision

Purpose of this chapter

2.1 This chapter summarises the legal framework we have applied in reaching our draft decision on the duration of the regulatory period for Chorus' upcoming price-quality path.

Purpose statements of Part 6 of the Act

2.2 The duration of PQP2 must be determined by us and must be between 3 and 5 years.[10] When making this determination, under s 166(2) we must make the determination that we consider best gives, or is likely to best give, effect:[11]

2.2.1 to the purpose in s 162; and

2.2.2 to the extent that we consider it relevant, to the promotion of workable competition in telecommunications markets for the long-term benefit of end-users of telecommunications services.

2.3 The purpose of Part 6 of the Act, as specified in s 162, reads:

"**162 Purpose**

The purpose of this Part is to promote the long-term benefit of end-users in markets for fibre fixed line access services by promoting outcomes that are consistent with outcomes produced in workably competitive markets so that regulated fibre service providers—

(a) have incentives to innovate and to invest, including in replacement, upgraded, and new assets; and

(b) have incentives to improve efficiency and supply fibre fixed line access services of a quality that reflects end-user demands; and

(c) allow end-users to share the benefits of efficiency gains in the supply of fibre fixed line access services, including through lower prices; and

(d) are limited in their ability to extract excessive profits."

[10] Telecommunications Act 2001, s 207(2).

[11] Telecommunications Act 2001, s 166(2).

2.4 We do not expect changing the regulatory period to four years will affect the promotion of workable competition in telecommunications markets for the long-term benefit of end-users of telecommunications services. Therefore, we do not consider 166(2)(b) is relevant in reaching our draft decision.

2.5 In the following chapter, we explain within our reasons for our draft decision on the duration of PQP2, how our draft decision would be likely to best give effect to the purpose in section 162.

Status of the draft determination accompanying this draft decision

2.6 The draft determination that we have published alongside this draft decision specifies an aspect of how PQ regulation applies to Chorus under s 170(1)(b).[12] This draft determination proposes, as a new s 170 determination,[13] the duration of the regulatory period for PQP2 under s 194(2)(a) and s 207(2).[14]

2.7 Consistent with s 203(2), we are now inviting views on the duration of the regulatory period for PQP2, as specified in the draft determination.[15]

2.8 The draft determination also proposes the duration of the regulatory period for PQP2, to be notified consistent with s 207(3).[16]

2.9 Consistent with s 170(3), we intend to address other aspects of PQP2 in a separate new s 170 determination that we will consult on when making our draft decisions for the other aspects of PQP2.[17] In that separate new s 170 determination, we intend to:

2.9.1 specify the other aspects of PQP2 that will apply for Chorus, including the maximum revenues that it may recover and the quality standards that must be met by it;[18] and

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12 Telecommunications Act 2001, s 170(1)(b).

13 Under s 203(1), before the end of each regulatory period, we must make a new s 170 determination specifying the PQ paths that will apply for the following regulatory period.

14 Under s 194(2)(a), a price-quality path must specify the regulatory period to which it applies. Under s 207(2), we must determine the duration of each regulatory period following the first regulatory period and those regulatory periods must be between 3 and 5 years.

15 Under s 203(2), in making a new s 170 determination, we must consult with interested persons in relation to the requirements listed in s 194. The requirement for a price-quality path to specify the regulatory period to which it applies is set out in s 194(2)(a).

16 Under s 207(3), we must notify the duration of each new regulatory period in a s 170 determination.

17 Under 170(3), it is not necessary for a single determination to address all matters relating to fibre fixed line access services, or to a regulated fibre service provider, and different parts of any determination may come into effect at different times.

18 Telecommunications Act 2001, s 194(2)(c) and s 195(1).

2.9.2 consistent with s 170(4), require Chorus to comply with the requirements set out in our final s 170 determination that will accompany our final decision on the matters in this paper.[19]

[19] Under s 170(4), a determination made under s 170 may require a regulated fibre service provider to comply with the requirements set out in any other determination that has been made under s 170 in respect of fibre fixed line access services.

Chapter 3 Our draft decision on the duration of the upcoming regulatory period

Purpose and structure of this chapter

3.1 This chapter outlines the reasons for our draft decision on the duration of the regulatory period for Chorus' upcoming price-quality path. It covers:

3.1.1 Summary of our draft decision;

3.1.2 How our draft decision is likely to best give effect to the purpose in s 162 of the Act; and

3.1.3 Other matters related to our draft decision.

Summary of our draft decision

3.2 Our draft decision is to determine the duration of the next regulatory period as four years. This would mean the regulatory period would start on 1 January 2025 and end on 31 December 2028. We have considered the following options for the duration of PQP2:

3.2.1 Retain the three-year regulatory period used for PQP1;

3.2.2 Four and five-year regulatory period durations;

3.2.3 Regulatory period lengths with different year-end dates including years ending 31 March, 30 June, 30 September and 31 December. This would have the effect of creating a partial year for the first or last year of PQP2 eg, 3 ¾ for a 30 September 2028 year end.

3.3 Our view is that a four-year regulatory period for PQP2 is in the long-term benefit of end-users and would be likely to best give effect to the purpose in s 162.[20] A four-year regulatory period balances the benefits from frequently resetting Chorus' revenues based on current and updated forecasts of expenditure and quality standards while allowing sufficient time for Chorus to find efficiencies as well as spreading the costs of a reset over a longer time period.

3.4 We consider the regulatory regime has the tools to address the potential uncertainty from increasing the duration of the regulatory period from three to four years. However, we do not consider a five-year regulatory period prudent at this stage of the regulatory regime.

[20] Telecommunications Act 2001, s 166(2).

3.5 PQP1 was the first time Chorus put together a long-term expenditure forecast for regulatory approval. We expect Chorus' forecasting capability to improve over time including greater use of bottom-up forecasting models and asset models in combination of top-down forecasts.[21] Developments in Chorus' forecasting and asset management capabilities may give us confidence to move to a 5-year regulatory period for future price-quality paths.

3.6 Our draft decision is to not determine a long-term default for the duration of future regulatory periods at this stage. We do see some potential benefits of setting a default duration in the future. A default duration could give greater certainty to Chorus and stakeholders on future revenue stability and potentially remove the necessity to consult on the duration of the regulatory period before each reset.

3.7 In our view, the decision to move to a default regulatory period duration would depend on developments Chorus makes to its forecasting methodologies, asset management system and the level of confidence we have in the regulatory regime to address greater uncertainty with longer regulatory periods.

How our draft decision best promotes s 162

3.8 We consider that a four-year regulatory period for PQP2 is likely to best give effect to the purpose in s 162.

3.9 In particular, a four-year regulatory period will ensure Chorus:

3.9.1 have incentives to improve efficiency and supply fibre fixed line access services (FFLAS) of a quality that reflects end-user demands (s 162(b));

3.9.2 allow end-users to share the benefits of efficiency gains in the supply of FFLAS, including through lower prices (s 162(c)); and

3.9.3 are limited in their ability to extract excessive profits (s 162(d)).

3.10 In determining how our draft decision is likely to best give effect to the purpose in s 162, we have considered the following factors. These factors are discussed below in the context of s 162 of the Act.

3.10.1 Impact of the duration of the regulatory period on efficiency incentives;

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[21] Bottom-up forecast models typically mean models that have been built using more granular data relating to the asset class or expenditure category. For example, models forecasting expenditure for asset replacement categories may use a price X quantity formula, where price equals the unit cost of a certain asset and quantity refers to the number of assets that are forecast to be replaced. Top-down forecast models are often based on high level data such as macroeconomic data, managerial driven revenue targets or benchmarking forecasts.

3.10.2 Assessment of risk and uncertainty from different regulatory period durations;

3.10.3 Regulatory and price certainty; and

3.10.4 Regulatory and administrative cost burdens.

How our draft decision best promotes s 162(b) and 162(c)

3.11 We consider the principal way a four-year regulatory period would give effect to the s 162 purpose is by helping ensure that Chorus "improve efficiency and supply FFLAS of a quality that reflects end-user demands (s 162(b))" as set out in s 162(b).

3.12 We consider a longer regulatory period provides greater incentives on Chorus to find further efficiencies. Under the current PQ settings for Chorus, maximum revenues and expenditure allowances are determined before the start of a regulatory period (ex-ante). Chorus can outperform an ex-ante capex allowance during a regulatory period by improving efficiency and delivering capex at a lower value than its forecasts.

3.13 Longer regulatory periods typically create stronger incentives on regulated fibre service providers (**regulated providers**) to find efficiencies over the regulatory period. A longer regulatory period means Chorus would have more time to find efficiencies and hold on to any efficiency gains before a reset.

3.14 Note that without regulatory interventions to balance incentives over time, there is a bias towards finding efficiencies at the start of the regulatory period. This may create further incentives on Chorus to defer efficiencies until revenues have been reset. Other regulatory regimes have included expenditure incentive mechanisms to impose a standard annual incentive rate. The typical aim of this type of mechanism would be to remove an incentive on Chorus to make efficiency gains early on in the period as well as set a standard rate for sharing efficiency gains between Chorus and end-users. Note that we are not proposing to introduce an expenditure incentive mechanism as part of this consultation.

3.15 We note that price-quality resets can impose significant costs onto Chorus, the Commission and stakeholders. Costs include staff resources as well as consultancy costs, to develop and evaluate a price-quality path, and opportunity costs from deferring other work. Ultimately, these costs are borne by end-users through levies and regulated operational expenditure.

3.16 Reducing the frequency of resetting the price-quality path by increasing the duration of the regulatory period would reduce the regulatory and administrative burden of the regime. Increasing the duration of the regulatory period from three years to four or five years would reduce the per year cost and free up resources at Chorus and the Commission to focus on other value-add activities. In practical terms, a three-year regulatory period means that there is only little over one year between the final determination coming into effect and commencing a new reset process.

How our draft decision best promotes s 162(d)

3.17 We have considered whether moving to a four-year regulatory period increases the risk that Chorus may be able to extract excessive profits (s 162(d)). This could occur from a potential increase in over-forecasting risk from increasing the regulatory period. However, while it is difficult to quantify this risk, we consider we have tools to mitigate the increased risk such as scrutiny of Chorus' expenditure proposals, information disclosure and expenditure reopeners.

3.18 The duration of the regulatory period affects the level of certainty of expenditure forecasts used to set the price-quality path. Chorus must forecast its expenditure allowances to support any ex-ante price-quality path. Longer regulatory periods mean Chorus must forecast its expenditure requirements out further. Greater uncertainty in forecast allowances means the risk of over or under-forecasting Chorus' allowance is greater.

3.19 Different sectors may have different factors that lead to greater or lesser levels of uncertainty for future investment decisions. Factors such as the rate of technological change, the potential for changes in competition in the sector and drivers of asset replacement and network change may also affect the decision on the duration of the regulatory period.

3.20 The default length of the regulatory period for electricity transmission (eg, Transpower New Zealand Limited's individual price-quality path) is five years. Current differences between FFLAS and electricity transmission networks may suggest a four-year regulatory period is more appropriate for Chorus, particularly at this stage of Chorus' price-quality regulation. However, as noted in paragraph 3.5, developments in Chorus' forecasting capabilities and the regulatory framework could mean a five-year regulatory period is appropriate for Chorus in future regulatory periods. In addition, we will have a longer time series of disclosure information to use in assessing trends and variability in different inputs to PQP decisions that may provide greater confidence to shift to a longer regulatory period.

3.21 The ability of Chorus to forecast its investment horizon effects the degree of over and under-forecasting risk. Improvements in Chorus' forecasting approaches will give us greater confidence in its longer-term forecasts. This will minimise the potential for over and under forecasting. However, greater improvements are not guaranteed, and we will still need to assess Chorus' forecasts during resets and monitor Chorus' development in asset management and forecasting reporting through our information disclosure regime.

3.22 We have mechanisms in the IMs for dealing with uncertainty in forecasting expenditure. Gaining experience with these mechanisms during the PQP1 period may give us greater confidence to manage uncertainty with longer regulatory periods. Some examples of managing this uncertainty are:

3.22.1 the individual capex mechanism in the capex IM was designed to address timing uncertainty for larger capex projects and programmes.[22] We expect to gain experience using this mechanism during PQP1;

3.22.2 volumetric allowances, such as the connection capex variable adjustment;[23] and

3.22.3 price-quality path reopeners in the IMs to deal with significant unexpected events.

3.23 Our experience with managing uncertainty in the regime with expenditure and revenue reopeners should increase over time. We do have the option to amend these reopeners over time.[24]

3.24 Longer regulatory periods may also lead to a larger wash-up balance. This could mean a larger wash-up amount will need to be spread over the following regulatory period and may cause larger price increases on end-users than from a shorter regulatory period. However, other regulatory tools such as revenue smoothing can help mitigate this risk.[25]

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[22] Commerce Commission "Fibre input methodologies: Main final decisions – reasons paper" (13 October 2020), paragraph 7.449.

[23] *Fibre Input Methodologies Determination 2020*, as amended on 29 November 2021, clause 3.7.21.

[24] Commerce Commission "Fibre Input Methodologies main 2021 amendments: final decisions – Final reasons paper" (29 November 2021), Chapter 2.

[25] Telecommunications Act 2001, s 197.

Other matters related to our draft decision

Alignment with Chorus' financial and pricing functions

3.25 We have the ability to set the duration of PQP2 to align with Chorus' pricing or financial reporting functions. This would require changing the year-end of the regulatory period for PQP2 and include part of a year, for example 3 ¾ for a September year-end. The particular functions we could consider aligning the price-quality path with are:

3.25.1 Chorus' pricing year. Chorus sets its prices for FFLAS with RSPs on a 30 September year-end;

3.25.2 Chorus financial reporting and tax reporting obligations – 30 June year-end.

3.26 The benefit of aligning the regulatory year with these functions is this would potentially simplify Chorus' regulatory obligations and introduce efficiency benefits for Chorus. However, we also acknowledge there would be a cost to Chorus from moving towards a regulatory period with a different year-end. Additionally, there would still be non-alignment between either the pricing year or financial year and tax reporting depending on which year-end was chosen.

3.27 Our view is that there are not strong enough reasons at this stage to change from a December year-end regulatory year. Therefore, our draft decision is for the PQP2 regulatory period to last for four years and to end on 31 December 2028.