Cross-submission: PQ RAB & IM amendments draft decisions

30 September 2021

CHORUS

Introduction

Transitional PQ RAB can be finalised in 2021

1. The submissions by Spark and Vocus do not raise anything new – there is no new material being presented that would justify a change in approach.

2. In the RAB draft decision paper, the Commission said its aim is to resolve all possible matters prior to the final PQP1 decision, in order to provide certainty to Chorus and other stakeholders as soon as practically feasible. The Commission also said this approach was dependent on the responses it received in submissions – where matters are raised that cannot be resolved in the time available, they and some elements of the final decision could be deferred.[1]

3. As discussed in our previous submission, Chorus does not agree that matters being raised in submissions is a sufficient reason to delay the determination of the PQ RAB.[2] However, having now seen the submissions, the Commission should have comfort that no new material issues have been raised. All matters on the table can be resolved by December 2021.[3] We support the certainty this would promote for all parties. We note this certainty is particularly important because the decision to amend the input methodologies (**IMs**) relating to capital expenditure[4] effectively reduces certainty by delaying decisions on Chorus' expenditure allowance by 3 months.

Scope of submission

4. This is Chorus' cross-submission in response to submissions received on the consultation papers:

    4.1 *Chorus' initial regulatory asset base as at 1 January 2022 – draft decisions*, 19 August 2021 (**PQ RAB draft decision**); and

    4.2 *Proposed Additional Amendments to Fibre Input Methodologies: draft decisions*, 31 August 2021 (**additional IM amendments draft decision**).

5. This submission is part of the record for the IM process relating to the IM amendments that are discussed in these consultation papers.

6. This submission is not confidential.

7. Chorus' responses to points made in other parties' submissions are in the Table below.

[1] PQ RAB draft decision, paragraphs 1.21-1.24.
[2] Chorus, Submission on initial PQ RAB and additional IM amendments draft decisions, 16 September 2021, paragraphs 18-21.
[3] Other than a true-up for actual 2020/21 values.
[4] Commerce Commission, Amendments to Fibre Input Methodologies: Capex IM final decision, 29 September 2021.

Response to submission points

No.	Submitter	Position/statement	Chorus response
Overall outcomes			
1	Spark	**Paragraph 4:** Commission's proposed approach leaves very few Chorus assets and services outside Part 6 regulation and its guaranteed RAB returns. (Claims the draft decision allocates $5.1b of assets to FFLAS, when total assets are $5.3b including $300m of copper assets)	Chorus operates a single network that provides FFLAS and non-FFLAS, with dynamic asset allocation – this is why the unallocated RAB (which Spark refers to) captures a large proportion of shared assets. Chorus has made efficient choices to reuse existing assets during the UFB build, rather than build a more expensive duplicate network. This promotes the long-term benefit of end-users. The cost allocation process is designed to allocate a proportion of shared assets to non-FFLAS (i.e. are not allocated to the RAB, or are subject to Part 6 regulation), where they provide out of scope services. Spark is also entirely wrong to assert that Part 6 regulation guarantees a return. The regulation provides an opportunity for a normal return, but outcomes are not guaranteed – particularly in the face of competition.
2	Spark	**Paragraph 5:** The Commission's methodology inevitably overstates the fibre RAB value, resulting in assumed BBM fibre assets per connection significantly higher than any other fibre provider.	Simply comparing Chorus' headline costs to other fibre providers is not robust analysis, given the mix of candidate areas for each LFC. Chorus built UFB in higher cost areas, including Auckland CBD, as well as extending UFB2 to a large number of more remote locations where the cost of deployment is higher.
3	Vocus	**Paragraph 4:** Commission should quantitatively test the impact of alternative cost and asset allocator options on price and against	Vocus appears to have misunderstood the intent of the cost allocation process. The aim is not to identify each allocator and then choose one based on their expected impact (where Vocus seems to be suggesting that any allocator that would result in a lower allocation of shared costs

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		the financial capital maintenance (FCM) principle.	to FFLAS should be preferred). The aim is to find the causal or, if needed, proxy allocator that best meets the test of being "objectively justifiable and demonstrably reasonable" and promotes the purpose of Part 6.[5]
4	Vocus	**Paragraph 32:** No evidence has been provided that a RAB as high as the draft determination is required to meet reasonable investor expectations that Chorus be able to recover the prudent and efficient cost of its investments.	Submissions made to this process by Chorus, Chorus' investors and investment analysts provide a strong counter-view that in fact the PQ RAB valuation is too low and does not meet reasonable investor expectations. Declines in Chorus' share price this year – which have not been recouped since the draft RAB decision – also point to investor expectations not being met. Conversely, we have not seen any evidence presented by Vocus to demonstrate the PQ RAB is higher than is needed to meet investor expectations.
5	New Street Research	**Page 1:** The value derived through the application of the Input Methodologies of $5.4bn is grossly inadequate and does not reflect the objectives of s162 of the legislation.	The New Street Research submission shows the ongoing level of concern in the investment community about the cumulative impact of decisions through this process, which have generally under-compensated Chorus and our investors for the risks and costs of the UFB roll-out. It makes similar points to the submissions made by L1 Capital, Global Listed Infrastructure Organisation and Telstra Super on the PQ draft decision consultation.
6	New Street Research	**Page 1:** The draft decision does not meet the assurances given by the New Zealand Government on 13 October 2011, two weeks before Telecom equity investors	

[5] PQ RAB draft decision, paragraphs 2.61-2.62.

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		committed to support the UFB project and structurally separate Chorus.	The New Street Research submission emphasises how critical it is that the final PQ and RAB decisions are robust and reflect Chorus' actual commercial context.
7	New Street Research	**Page 3:** Not honouring previous commitments is not consistent with promoting certainty	
8	New Street Research	**Page 3-4:** A pattern of behaviour in not honouring commitments represents an appropriation of equity value.	
9	New Street Research	**Page 4-6:** Asset beta should reflect the period of equity commitment rather than the short term equity trading benchmarks relied on by the Commission	
Cost allocators			
10	Vocus	**Paragraph 6:** Do not support the draft decision to allow a future benefits allocator based on an 8-year time horizon. The Commission's discussion indicates that if a future benefit allocator is used it should be somewhere between 3 and 5 years. The time horizon should not extend to any period where Chorus has "concerns over the reliability of allocator values".	We disagree with a time horizon below 12 years being used for the future benefit allocator. In our submission on the draft decision, we have provided evidence that 12 years is objectively justifiable and demonstrably reasonable.[6]

[6] Chorus, Submission on initial PQ RAB and additional IM amendments draft decisions (16 September 2021), paragraphs 61-71.

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11	Vocus	**Paragraph 30:** It appears to be clear Chorus has adopted a strategy of selecting cost and asset allocators that will maximise the allocation of shared assets to the fibre business and inflate the RAB	We disagree. As required by the IMs we have chosen causal allocators where possible and proxy allocators otherwise. Our allocators are supported by evidence and have been certified. We note that the draft value of the initial PQ RAB ($5.4b) is already lower than the conservative model we submitted ($5.5b), considerably lower than our alternative allocation ($6b) and significantly lower than some market estimates (for example New Street Research's $7.7b value[7]).
12	Vocus	**Paragraph 31:** It would be useful to test the sensitivity of Chorus' asset value 'estimate' against different allocator options	We disagree. Allocators must meet the IM requirements for allocation; they cannot be selected based on the sole intention of lowering the initial PQ RAB.
13	Vocus	**Paragraph 44:** The Commission is proposing to lower the allocation of UFB A-D ducts by 5% even though the Network Strategies report has a wider range.	We disagree with the draft decision to limit the direct attribution of ducts constructed as part of the UFB initiative.[8] If the Commission does want to reduce the direct attribution of these assets then Network Strategies' estimate should not be used since it appears to rely on the efficiencies that would apply to a hypothetical efficient operator – not Chorus' actual network. We have submitted evidence from our network records that demonstrates 5% sharing immediately after ducts are employed is too high. Our network design rules suggest that this would be less than 1% (and only reach that level after a considerable period, not immediately on deployment).

[7] New Street Research, Submission on Chorus' initial regulatory base Draft Decision, page 1.
[8] See discussion in Chorus, Submission on initial PQ RAB and additional IM amendments draft decisions (16 September 2021), paragraphs 39-52.

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14	Vocus	**Paragraph 58.1:** Do not support the use of NBV as an allocator, as it biases the allocation towards newer assets because of inflation and depreciation, i.e. fibre, even though the expenditure items are not inversely related to age. If NBV is used it should be non-depreciated Book Value (still biased in favour of new assets due to inflation, but less so) outcomes or Replacement Cost. The use of TOTEX has similar impact biasing the allocation from mature parts of Chorus' network business to new developing parts of the business i.e. fibre.	We disagree. These statements fail to recognise that: • NBV is a causal driver of insurance costs and therefore is representative of which services drive cost;[9] and • Totex is a demonstrably reasonable driver of costs. No alternative evidence has been provided to address the evidence we and the Commission have used. Further, the aim of the cost allocation exercise is to identify causal and proxy allocators that meet the standard of being "objectively justifiable and demonstrably reasonable", not to seek allocators just to lower the allocation to fibre, which appears to be Vocus' intention.
15	Spark	**Paragraph 32c:** Proportionate cost allocation would provide some protection against over-recovery.	We disagree. Connections must only be used for allocation where that is justifiable. Also, Incenta has demonstrated that using connections as an allocator for shared operating costs and assets could result in an *under-recovery* of costs across copper and fibre services when shared cost or asset values increase due to providing multiple services.[10]
16	Spark	**Paragraph 32c:**	This is a mischaracterisation of the Commission's analysis. In applying the cap, the Commission agrees with Incenta's expert report which

[9] Incenta, Certain cost allocation issues relevant to the IAV (March 2021), paragraph 4.2.1.
[10] Incenta (March 2021) Certain cost allocation issues relevant to the IAV, section 3.2.

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		The Commission proposes not to apply the cap, except in the limited exchange space situation.	concluded that it is "unlikely that the avoided cost cap would bind, and less likely again in a material way".[11]
17	Spark	**Paragraph 32c and Figure 1:** the allocators applied in practice has not led to a proportionate transition of operating costs. For example, … the draft proposes to allocate significantly higher proportion of costs to FFLAS than supported by a proportionate allocation (based on revenue or connection share).	Spark fails to recognise that, during the time where Chorus was building ahead of demand, allocators based on revenue or connections would not reflect the distribution of business effort between FFLAS and non-FFLAS. Today, Chorus' FFLAS revenues are a higher proportion of total revenues than FFLAS expenditure is as a proportion of total expenditure (i.e. FFLAS revenue is 59% of total, while FFLAS expenditure is 53% of total).[12]
18	Spark	**Paragraph 32d:** The proposed allocators move further away from delivering proportionate cost allocation and no longer fully relate to how an asset is employed at each stage of its life	We disagree. We have chosen asset allocators that reflect how assets are employed. Through our s221 responses, RFI responses, submissions and interactions with the Commission we have provided evidence to support our allocators. Allocating using connections should be done where justified, not as a starting point for all assets. Spark has not provided specific evidence for any asset to show that connections better meet the criteria set out in the draft decision.[13]

[11] PQ RAB Draft Decision, paragraph 5.295.
[12] Chorus, FY21 Full Year Result Presentation.
[13] PQ RAB Draft Decision, paragraph 2.62.

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Tax losses			
19	Spark	**Paragraphs 17, 18, 23 & 36:** Do not support draft proposals to amend the IMs to fund the holding costs of notional fibre tax loss credits. We now know that the tax credit holding costs are material yet the draft, rather than look to immediately take the tax benefit as discussed through the IMs, proposes to transfer further increase end-users' prices by funding a cost that Chorus never incurred in practice.	We disagree. IM amendments are required to correct the FLA and tax effect of tax losses to ensure there is no under-recovery. In the final IMs decision for the FLA the Commission had previously signalled that a change could be made to account for the difference in the time value of money of tax losses.[14] Also, the proposed IM amendments relate to the *calculation* of carry forward value of tax losses and the tax effect of tax losses, not whether the tax losses should be offset by profits from other services. The Commission already considered Spark's views on this during the IMs determination process and disagreed with Spark based on principle, not materiality.[15]
End-user benefits			
20	Spark	**Paragraph 15:** Following a Commission draft to require a separate connection incentives capex proposal, Chorus has now announced it will increase 100/20 template speeds to 300/100. This is the sort of end-user welfare enhancing response to competition that the Commission should be promoting.	We welcome Spark's agreement that the 300/100 speed product will be welfare-enhancing for end-users. For the record, however, the driver of this initiative was not related to the question of whether an individual capex proposal is necessary for incentives capex.

[14] Commerce Commission "Fibre input methodologies: Financial loss asset final decision – reasons paper (3 November 2020), paragraph 3.402.
[15] Commerce Commission "Fibre input methodologies: Main final decisions reasons paper – reasons paper (13 October 2020), paragraphs 8.90-8.110.

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Cross-checks			
21	Spark	**Paragraph 31:** We are now in a better position to apply the TERA cross-check as, in developing the BBM, the Commission now has ready access to the information and an economic model to apply the crosscheck. Double recovery remains a significant concern – and the Commission should be validating BBM outcomes to ensure this hasn't occurred.	Spark suggests that a cross-check could be conducted by applying BBM methodology across both copper and fibre costs and revenues. We disagree – while a combined BBM was considered during the legislative review, it is not relevant to this process given Part 6 regulation applies only to FFLAS.
22	Spark	**Paragraph 32:** If the Commission decides not to check whether there has been a misstatement of costs – none of the IM expected mitigations against double recovery will have been applied.	We refer to our previous submission on TERA cross-checks, which explains clearly why the TERA cross-check proposal is misconceived.[16]
IM amendments			
23	Spark	**Paragraph 37:** Do not support proposed IM amendments to codify the wash-up. The proposal is not addressing a mistake and we are not aware of any new circumstances that require an	This topic was not covered in the amended draft IM amendments of 31 August 2021. Stakeholders had their opportunity to submit on the proposal to increase the level of detail around wash-ups included in the IMs in the consultation on the draft IM amendments of 27 May 2021. We

[16] 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), paragraph 185.

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		amendment to the IMs. This is an issue the Commission should come back to prior to the second regulatory period.	refer the Commission to our views on wash-ups in our previous submission.[17] Further, it would not promote certainty for Chorus operating within PQP1 (and would create fears of arbitrary outcomes) if the wash-ups for PQP1 are only determined after the expenditure has been committed and revenues have been received.

[17] Chorus, Amendments to the Input Methodologies for Fibre - August 2021 amendments (24 June 2021), paragraphs 21 to 38.