

F



CONSULTATION ON CHORUS' INITIAL REGULATORY ASSET BASE AS AT 1
JANUARY 2022 – DRAFT DECISIONS

Submission to the Commerce Commission

PUBLIC VERSION

16 September 2021

EXECUTIVE SUMMARY

1. Vocus agrees with the Commission that *“the alternative allocators that have been proposed by Chorus in its alternative model submitted on 28 May 2021 and which result in an initial RAB value of approximately \$6 billion are not objectively justifiable or demonstrably reasonable”*.
2. We also agree with the Commission that *“Chorus’ alternative cost allocation approach does not comply with the IMs or s 177 of the Act, nor does it best give effect to the purpose of Part 6.”*
3. However, Vocus is concerned the Commission has been too accepting of Chorus’ proposals. We are concerned the Commission may have been too permissive in its assessment of whether Chorus’ proposed cost and asset allocators are *“objectively justifiable and demonstrably reasonable”*.
4. There are a range of potential cost and asset allocators that could be adopted. The Commission should quantitatively test the impact of alternative cost and asset allocator options on price and against the financial capital maintenance (FCM) principle. 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.
5. The adjustments the Commission has made are accumulatively minor particularly given it appears evident Chorus has adopted allocators which would result in an artificially high asset value.
6. For example, we do not consider the draft decision to allow a future benefits allocator based on an 8-year time horizon to be well-founded. The Commission’s discussion from paragraph 5.80 onwards 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”*. It should be axiomatic that if there are *“concerns over the reliability of allocator values”*, they should not be used.
7. If the asset value is inflated it will lock-in/capitalise excess returns for a period that will span multiple regulatory periods, contrary to the section 162 purpose to promote the long-term interests of end-users, and specifically (section 162(d)) to ensure Chorus is limited in its ability to extract excessive profits.
8. Any decisions that artificially inflate the Regulatory Asset Base (RAB), including Financial Loss Asset (FLA), and fibre prices will also have section 166(2)(b) implications, as the higher the fibre prices the greater the incentive for fixed-wireless substitution and/or to remain on copper services. Artificially high fibre prices will translate to artificially higher uptake and competition from fixed-wireless.
9. The decisions on allocation of shared assets will also have potential implications and precedent value for broader cost allocation decisions (if excess allocation of assets is allowed into the RAB, it will likely mean excess costs will be allocated to the fibre

business as well) and potentially for the approach to allocation between regulated and unregulated businesses adopted by regulated suppliers under Part 4 Commerce Act.

INTRODUCTION

10. Vocus welcomes the opportunity to submit in relation to the determination of the transitional Regulatory Asset Base (RAB) for Chorus' fibre business.
11. If you would like any further information or have any queries about this submission, please contact:

Emily Acland
General Counsel and GM Regulatory
Vocus Group (NZ)
Emily.Acland@vocusgroup.co.nz

OPENING REMARKS

12. Vocus recognises the challenges the Commission faces in developing and implementing the new fibre Part 6 Telecommunications Act regime within a substantially condensed period of time.
13. Vocus agrees with the Commission that it should *"make final decisions on matters that ultimately reveal Chorus' total initial PQ RAB value in 2022"* and *"This time period is necessary because some parameters are currently forecasts and actual values will not be known until 2022. In addition, the total initial PQ RAB value may be different to the transitional initial PQ RAB where there is insufficient time to scrutinise and assure the total initial PQ RAB value before our final PQP1 decision"*.
14. Vocus reiterates *"The time available to implement the new Part 6 Telecommunications Act fibre price control regime has meant it is not reasonably practicable to determine a final Regulatory Asset Base (RAB) for the PQP determination that does not risk substantial capitalisation of excess returns"* and our support for a transitional RAB. We also reiterate *"The risks that the RAB is inflated is reflected in the concerns the Commission and RSPs have raised, both before and after Chorus' submission of its RAB proposal"*.¹
15. Chorus' estimate of its RAB value reinforces the concerns that we and other RSPs have raised that Chorus RAB and Financial Loss Asset (FLA) estimates are substantially inflated.
16. Vocus is concerned the Commission has been too accepting of Chorus' proposals and hasn't done enough to test the impact of alternative cost and asset allocator options on asset values. The adjustments the Commission has made are accumulatively minor (a reduction of \$80m or about 1.5% compared to Chorus' proposal) particularly given it appears evident Chorus has adopted allocators which would result in an artificially high asset value. For example, we are concerned the Commission may have been too permissive in its assessment of whether cost and asset allocators are *"objectively justifiable and demonstrably reasonable"*.

¹ Vocus, Consultation on proposed amendments to fibre Input Methodologies: draft decisions, 8 July 2021.

17. Vocus is also concerned that the ability of stakeholders other than Chorus to engage in the consultation has been limited by the extensive use of confidentiality, including, for example, treating some cost and asset allocator values as confidential.
18. The use of confidentiality seems to have reached a nadir where Chorus advocates that a particular allocator be used but argues it should be treated as confidential on the basis “Chorus itself has expressed some concerns over the reliability of allocator values”. It should be axiomatic that if there are “concerns over the reliability of allocator values” then they cannot be “objectively justifiable and demonstrably reasonable” and should not be used.

EXPENDITURE COST ALLOCATION ISSUES EXACERBATE OUR CONCERNS ABOUT THE RAB

19. In our submission in response to Chorus’ RAB proposal, we raised concern about the “Risk that Chorus’ RAB proposal is substantially inflated”. We noted “The experience with Chorus’ grossly over-estimating its copper TSLRIC and TSO net cost has been raised a number of times in submissions”.²
20. We raised issues about the risk of relying on Chorus’ proposals from the outset of the development of the new regulatory framework for fibre in 2018.³ By way of example, InternetNZ similarly commented “Chorus’ incentives are to seek the highest possible cost figures ... Any data provided by Chorus should be thoroughly audited ...”⁴
21. Our submission on the RAB proposal noted the allocation method used by Chorus to determine the RAB appeared to be closer to the avoidable cost allocation methodology (ACAM), than the required accounting-based allocation approach (ABAA). We also raised, for example, that “The issues Spark raised about excessive cost allocation to FFLAS in Chorus’ expenditure proposal appear to manifest in the allocation of shared assets, and the estimate of the Financial Loss Asset (FLA) value”.
22. The submissions the Commission has received on Chorus’ RAB and expenditure proposal, as well as the Commission’s consultation material, highlight issues with cost allocation and potential inflated expenditure.
23. For example, Chorus’ statement “the Commission should apply a proxy allocator that allocates 100% of the relevant shared costs”⁵ to FFLAS would result in an ACAM type approach. Likewise, Chorus’ statement “We have used a proxy allocator to allocate a subset of the IT assets that are shared between FFLAS and non-FFLAS; this subset is the IT assets associated with standing up Chorus immediately post-demerger. Our allocator apportions 100% of the value of these assets to FFLAS, which reflects: (i)

² https://comcom.govt.nz/_data/assets/pdf_file/0019/226711/Vocus-Submission-on-PQID-process-and-approach-paper-14-October-2020.pdf

³ https://comcom.govt.nz/_data/assets/pdf_file/0024/111984/Vocus-Group-Submission-on-new-regulatory-framework-for-fibre-21-December-2018.PDF

⁴ InternetNZ, InternetNZ Cross Submission: Further Consultation on issues relating to determining a price for Chorus’ UCLL and UBA services under the Final Pricing Principle, 30 April 2014, page 7.

⁵ Chorus, Submission on Commission’s consultation on Chorus’ initial PQ RAB, 28 May 2021.

*limitations with our data which means it's difficult to identify utilisation; (ii) the driver of the investment – the need to establish Chorus as a standalone business to undertake the UFB initiative; and (iii) the service which is intended to benefit from the assets over their useful life – FFLAS. We could not find a suitable causal allocator which accounts for these factors”.*⁶

24. The Commission needs to ensure the 100% cost allocation/ACAM type approach is expunged from the RAB and expenditure allowances Chorus has proposed.
25. A lot of the elements of the expenditure allowances and forecasts are treated as confidential which has limited the extent to which we could review the draft decision internally.

VOCUS AGREES CHORUS' ALTERNATIVE ESTIMATE SHOULD BE DISREGARDED

26. We agree with the Commission, and other stakeholders, that Chorus' *“alternative”* estimate of the RAB value of \$6 billion is not IM compliant and *“the alternative allocators that have been proposed by Chorus in its alternative model submitted on 28 May 2021 and which result in an initial RAB value of approximately \$6 billion are not objectively justifiable or demonstrably reasonable”.*

DETERMINATION OF ASSET VALUE IS KEY TO LIMITING EXCESS PROFITS AND AVOIDING ARTIFICIALLY HIGH PRICES

27. The asset value used for price-quality regulation (PQR) is particularly important. If the asset value is inflated it will lock-in/capitalise excess returns for a period that will span multiple regulatory periods, contrary to the section 162 purpose to promote the long-term interests of end-users, and specifically (section 162(d)) to ensure Chorus is limited in its ability to extract excessive profits. As Chorus has warned *“Once set, the initial RAB does not change”.*⁷
28. Any decisions that artificially inflate the RAB (including FLA) and fibre prices will also have section 166(2)(b) implications, as the higher the fibre prices the greater the incentive (for consumers and access seekers with cellular networks) for fixed-wireless substitution. Artificially high fibre prices will translate to artificially higher uptake and competition from fixed-wireless. It could also slow down consumer migration from copper to fibre services.
29. The decisions on allocation of shared assets will also have potential implications and precedent value for broader cost allocation decisions (if excess allocation of assets is allowed into the RAB, it will likely mean excess costs will be allocated to the fibre

⁶ Chorus, Submission on Commission's consultation on Chorus' initial PQ RAB, 28 May 2021.

⁷ Chorus, Submission on Commission's consultation on Chorus' initial PQ RAB, 28 May 2021.

business as well) and potentially for the approach to allocation between regulated and unregulated businesses adopted by regulated suppliers under Part 4 Commerce Act.

THE APPROACH TAKEN TO ALLOCATION OF SHARED ASSETS IS RESULTING IN AN EXCESSIVE RAB

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.
31. Vocus considers that it would be useful to test the sensitivity of Chorus' asset value 'estimate' against different allocator options (similar to the analysis in Figures 3.1 and 3.2). We expect this would highlight: (i) Chorus' asset value 'estimate' is at the top of (or above) the range of potential asset values under different cost allocation options; and (ii) there are alternative reasonable allocators which would result in a substantially lower RAB but satisfy the full capital maintenance (FCM) principle.
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.

ISSUES WITH CHORUS' CONSTRUCTION OF ITS RAB MODEL

33. Vocus is uncomfortable Chorus has not put in place appropriate accounting/documentation processes for constructing its RAB model and identifying the purpose of its capital expenditure and producing an estimate of the directly attributable capex.
34. We are concerned Chorus has not produced "*a definitive number*" and "*has had to apply a considerable degree of judgement when estimating the capex that is directly attributable*".
35. This undermines Chorus' claims about the validity of its RAB estimates and whether Chorus is able to fully recover its costs. If Chorus does not have a clear documentation of its asset value, it isn't in a position to comment on whether the Commission's asset value/price-quality path determinations are sufficient or not to enable it to recover its costs (including cost of capital).
36. We agree "*We are therefore not satisfied that Chorus' direct attribution of certain assets to UFB FFLAS over the entire pre-implementation period meets the IMs definition of "directly attributable" requiring an asset to be "wholly and solely employed...in the provision of a particular service*".
37. We also agree "*Given the effort and judgement required, we would have expected that [at the very minimum] Chorus could provide a more detailed explanation of the rules it applied to categorise capex and why those rules are the best available*".

38. If Chorus cannot properly justify its claimed RAB estimate values, the Commission should consider whether they should be included. It is not in the long-term interests of consumers to be beholden to Chorus' judgement about what capex is directly attributable, particularly given the Commission has identified that Chorus' interpretation is non-compliant and overstates directly attributable capex (see discussion in following section).

CHORUS' MISAPPLICATION OF "DIRECTLY ATTRIBUTABLE" AS "DIRECT RESULT"

39. Chorus' use of "direct result" criteria has resulted in allocations that would breach 'stand-alone cost'/ACAM. Even if ACAM was a permitted allocation methodology Chorus would need to take into account that a stand-alone fibre business would optimise costs/assets for the requirements of a fibre-only business i.e. ACAM does not translate to 100% allocation of all shared costs and assets to the fibre business.
40. We reiterate, *"We ... find it extraordinary Chorus' would submit that "To best give effect to s 177, the Commission should apply a proxy allocator that allocates 100% of the relevant shared costs that were incurred as a direct result of taking on the UFB initiative" given the clear requirement to apply ABAA not ACAM, but it appears consistent with the intent of the cost and asset value allocations Chorus has 'proposed'".*⁸
41. We also reiterate *"The argument "Chorus was established to build the UFB network and this was the business' primary reason for existence"⁹ was not one Chorus ran in relation to allocation of shared costs in the copper TSLRIC determination. The approach of allocating 100% of shared costs to Chorus would result in realisation of the fibre-copper double-recovery concerns we have previously raised".*¹⁰
42. The Commission is correct that *"If Chorus' proposed approach to post-2011 UFB assets (to fully allocate the assets to the services that motivated their investment) were to be applied consistently to pre-2011 assets, this would suggest that those pre-2011 assets should be fully allocated to the non-FFLAS (eg copper) services that those assets were originally installed to supply".*
43. Chorus' "direct result" approach highlights the internal inconsistencies with its allocation proposals. If Chorus was consistent in its arguments and its proposals it would propose that 0% of pre-2011 assets and costs be allocated to the RAB (including the determination of the FLA) as: (i) no pre-2011 assets are a "direct result" of carrying out the UFB initiative, and instead (ii) pre-2011 assets are a "direct result" of other business activities such as its copper network business operation. We are not aware of Chorus making any suggestion that pre-existing assets that have been repurposed for use in

⁸ Vocus, Consultation on proposed amendments to fibre Input Methodologies: draft decisions, 8 July 2021.

⁹ Chorus, Submission on Commission's consultation on Chorus' initial PQ RAB, 28 May 2021.

¹⁰ Vocus, CONSULTATION ON CHORUS' PRICE-QUALITY PATH FROM 1 JANUARY 2022 – DRAFT DECISION, 8 July 2021.

providing FFLAS be excluded from the RAB and FLA, but that is the clear and logical consequence of their “*direct result*” position.

44. We are concerned the Commission has only partially remedied this e.g. Chorus proposed 100% allocation of UFB ducts etc, and the Commission is only proposing to lower the allocation by 5%. The Commission noted “*Based on expert advice from consultants Network Strategies, we consider at a minimum 5% of these ducts would be capable of sharing and have reduced the directly attributable portion accordingly*” but did not explain why it considered adopting the minimum change was more appropriate than the 10% allocation at the top of Network Strategies’ range.

A FUTURE BENEFITS ALLOCATOR BASED ON AN 8- OR 12-YEAR TIME HORIZON SHOULD NOT BE USED

45. The Commission has treated most of the relevant information in relation to the future benefits allocator as confidential, but it is clear, given the draft decision to reduce the allocator from a 12-year time horizon to an 8-year time horizon reduced the value of the PQ RAB by \$27 million, use of this allocator has a material impact on the RAB.
46. We do not support use of the future benefits allocator to allocate certain joint marketing expenses. We do not support use of any allocator that needs to be treated as confidential.
47. At the minimum, the future benefits allocator should reflect the time value of money (lower weighting given to future years).
48. We consider lagged actual revenue would be a more appropriate allocator reflecting the immediate impact of any joint marketing activities.
49. While the Commission’s “*draft decision is that, in principle, Chorus’ proposal to allocate certain marketing expenses using an allocator type that reflects expected revenues is reasonable*”, none of the reasoning the Commission has provided would justify use of an 8-year time horizon.
50. It would be unusual for marketing to have a longer 8- or 12-year focus or pay-back. Incenta submitted, on behalf of Chorus, an average customer life is four years.
51. The Commission commented that “*Incenta observes that a 12-year horizon reflects three cycles of an average customer life of four years, although no rationale is given as to why one cycle is four years or why three cycles might be appropriate*”. Similarly, the Commission also hasn’t provided rationale why adoption of 8-years or 2 cycles might be appropriate.
52. We agree with the Commission that “*any attempt to forecast revenues over a 12-year period is likely to be subject to considerable uncertainty*” and “*Chorus’ corporate planning appears to be based on a five-year planning horizon, which is updated annually. This suggests that a period shorter than 12 years is likely to be appropriate when determining*

the value of a cost allocator" [footnote removed]. Again, this suggests a period shorter than 8 years is likely to be appropriate.

53. Similarly, the Commission's observation about its accounting treatment of retention costs supports no more than a 4 year period: *"Chorus' treatment of customer retention costs in its audited annual financial accounts also supports the use of a shorter timeframe over which to consider the benefits of marketing activities to attract and retain customers. ... 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."* Chorus reports the average connection life as up to 4 years for new connections and migrations".
54. We agree with 2degrees it is incongruent Chorus' doesn't have confidence in its expenditure and demand forecasts beyond the initial three-year regulatory period but considers it should be able to use a 12-year future benefits allocator based on forecast revenue.
55. We note the Commission's comment *"In the context of its claims around confidentiality, Chorus itself has expressed some concerns over the reliability of allocator values that are based on long-range forecasts"*. If Chorus has *"concerns over the reliability of allocator values that are based on long-range forecasts"* they should not be used. If Chorus adopted an internally consistent position, it would, at most, advocate that the future benefits allocator should be based on revenue forecast over the 3-year regulatory period from 1 January 2022 to 31 December 2025.
56. The Commission has only provided two reasons why a period as long as 8 years may be reasonable:
 - 56.1 The Commission asserts *"An eight-year timeframe also recognises that once an end-user moves on to a new FFLAS-based retail service, they may be more inclined to remain on that service (or to move to a higher-value FFLAS-based service) for a longer period of time, given the higher capability and quality of fibre compared to Chorus' legacy services. This would support a timeframe that is somewhat longer than Chorus' reported view on average customer lifetimes"*. As noted above, this argument suffers from the objections the Commission raised in relation to Incenta. The Commission has not proved any explanation why it considers Chorus' has understated average customer lifetimes.
 - 56.2 The statement *"We also note that a timeframe of eight years broadly aligns with the term of the original UFB contracts, which covered the period from 2011 to 2019. In our view, it would be reasonable to have regard to forecasts made as part of planning for this period"* is spurious. The time provided for the UFB roll-out has nothing to do with customer life-cycles. There would be stronger justification in use of the 3-year regulatory period.
57. In short, the Commission's discussion from paragraph 5.80 indicates that a shorter time-frame than either 8 or 12 years should be used if a *"future benefit"* allocator and for determining a *"value which can be relied upon and which still reflects the forward-looking*

focus of the marketing expenditure". The Commission's discussion suggests that if a future benefit allocator is used it should be somewhere between 3 and 5 years (lower depending on Chorus' view on confidentiality) outcomes.

OTHER COMMENTS

58. Vocus has the following additional comments:

58.1 Vocus does not support use of Net Book Value (NBV) or TOTEX as they bias the allocation to the fibre business. The Commission should consider whether options such as total opex or service company overhead would be a better and more reasonable allocators.

Vocus doesn't 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.

58.2 Vocus agrees with the Commission and Spark that the asset valuation needs to make allowance for unusable ducts (damaged or already in use).

58.3 We similarly agree newly vacant space at Chorus central business district (CBD) sites (and vacant space generally) needs to remain outside the allocation pool and that *"Going forward, as Chorus' copper-based equipment is retired, and as Spark vacates more space with the removal of its NEAX exchanges, it is our view that any vacated space in Chorus' larger sites should not be allocated to FFLAS"*.

We are concerned by the Commission's observation that Chorus' model used to calculate its building cost allocator *"has minimal supporting documentation and sheds no light on the details of the approach Chorus has taken" etc and "does not include an explicit calculation for vacant space, simply apportioning the total cost of the building between UFB and non-UFB"*. We agree *"This means that any consideration of vacant space will require further data collection and modelling"*.

We are also concerned by the Commission's statement: *"To the extent that the allocators applied to Chorus' central office floorspace allocate such vacant space to FFLAS, the shared cost cap may take effect"*. Any such allocators should not be permitted and the shared cost cap (which Chorus says won't bind anyway) should not be relied on to address this issue.