CHORUS

Keston Ruxton
Manager, Fibre
Commerce Commission
PO Boc 2351
Wellington 6140

By email: infrastructure.regulation@comcom.govt.nz

1 May 2024

Dear Keston

Chorus – Recommendation of approach to MAR smoothing for PQP2

Introduction

1. This letter recommends an in-principle approach to between-period smoothing for the price path for Chorus' second regulatory period (**PQP2**) in order to address the significant step up in Maximum Allowable Revenue (**MAR**) expected in the first year of PQP2. We signalled (in prior Commerce Commission (**Commission**) engagement[1]) our intention to put forward an approach to between-period smoothing.

2. This letter includes information about Chorus' proposed approach to between-period smoothing. Smoothing will be necessary to manage the expected step-up in MAR from the end of PQP1 (2024), to the start of PQP2 (2025). This significant step change is largely the result of an increase in Chorus' WACC, compared to the WACC applied to PQP1. Our aim is for a principled smoothing mechanism which:
    a. allows for full recovery of the RP1 wash-up;
    b. minimises price volatility over the short and long term;
    c. avoids continued under-recovery;
    d. doesn't constrain FFLAS uptake – and promotes volume growth; and
    e. provides incentives to invest.

3. The Input Methodologies currently require depreciation to be calculated according to a GAAP consistent method unless the Commission is satisfied that applying an alternative method:[2]

> *(a) better promotes the purpose of Part 6 of the Act;*
>
> *(b) where relevant, best gives, or is likely to best give, effect to s 166(2)(b) of the Act; and*

[1] MAR model submission 2023 and ongoing discussions.
[2] Input Methodologies, clause 3.3.2(5) and (6).

(c) *where relevant, is consistent with the Commission's smoothing of prices or revenue under s 197 of the Act.*

4. Part 6 of the Act requires the promotion of the long-term benefit of consumers by promoting the outcome of a competitive market, so as to deliver a range of stated outcomes, which include promoting incentives to invest, and limiting the ability for suppliers to extract excessive profits. We believe our proposed approach is consistent with the purpose of Part 6.

5. We provide this information in advance of the draft price-quality decision for PQP2 to assist the Commission in its decision making. This letter and the associated material can be published alongside the draft PQ path decision for consultation.

6. We attach an expert **report** – *Revenue smoothing for RP2* (April 2024) - by Incenta detailing our proposed approach to between period smoothing for PQP2.

7. In Incenta's view:

> *altering the depreciation method for the core fibre assets is the preferred mechanism for aligning the MAR for RP2 – as well as for other RPs where the issue persists – with the revenue that Chorus expects to receive given the constraints to its pricing. This mechanism is:*
>
> *a. consistent with the standard objective for depreciation in a regulatory context, namely to determine the longer-term time path of cost recovery*
>
> *b. transparent, in that the deferral of costs can be targeted to those assets whose costs can in fact be deferred (i.e., where the risk of asset stranding is minimised), and is consistent with the deregulation adjustment mechanism in the IMs*
>
> *c. can be done without any changes to the existing regulatory regime, and*
>
> *d. promotes the most certainty that deferred costs will be recoverable in the future.*[3]

8. We also attach a testbed **model** to demonstrate our recommended MAR smoothing approach. We have used a testbed model as the Analysys Mason MAR model does not have the functionality to change depreciation profiles between different regulatory periods. This testbed model reflects our expenditure proposal after adjusting for the Commission's draft decision to reduce capital expenditure and operating expenditure allowances relative to our PQP2 proposal. We will provide an updated version of this model to reflect CY23 Information Disclosure information when that is available.

9. Our recommended approach is principles-based. It does not provide a view on the specific inputs that should be applied through methodology (i.e. the tilt factors), as these will need to be determined once key inputs for the PQP2 decision – such as the WACC, forecast CPI and final expenditure allowance decisions – are in place.

[3] Incenta, *Smoothing of revenue for RP2*, April 2024, paragraph 61.

Recommendations

10. **Between period smoothing mechanism**

a. Applying tilted annuity depreciation to a subset of the core assets that are at least risk of stranding[4] yields the following outcomes:

i. Over the short-term this allows for a reduction in the significant forecast step-up in PQP2 MAR (the level of which will be determined once key inputs have settled) and has the effect of backloading the recovery of these assets. This also allows for the drawdown of the RP1 wash-up.

ii. Over the longer term, this smooths recovery to the outer years across multiple periods (i.e. is not just limited to smoothing between PQP1 and PQP2) and creates a more stable and predictable price path, which protects end-users from volatility.

iii. Backloading recovery of assets creates risk of asset stranding. To mitigate against this, we propose applying our proposed tilted annuity depreciation profile to assets that are expected to be at least risk of stranding, including predominantly communal layer 1 network assets, which have a low (0.5%) likelihood of stranding.[5] This makes up around 53% of the RAB (including the FLA).

b. Chorus is not guaranteed to be able to price to its MAR due to competition constraints, anchor service pricing and other constraints that reduce our ability to meet customer demands (for example GCP) so this smoothing option seeks to match the amount of depreciation we can recover to the prices the market can accommodate (leaving sufficient headroom to incentivise Chorus to seek further growth opportunities). Our best estimate of this is our business forecast PQ FFLAS revenue with an additional allowance for growth, which we will assess further. The application of the tilted annuity depreciation profile is therefore:

i. **Outcomes-based** – Fitting the depreciation profile to deliver a sensible profile that promotes cost recovery and price stability.

ii. **Realistic** – Needs to be a function of what Chorus can charge, with sufficient headroom to allow for growth.

iii. **Flexible** – Needs to be specified and set for PQP2 only, and then flexible / re-determined for future regulatory periods to account for the dynamic and rapidly changing market we operate in.

c. We considered alternative approaches, including adjusting the tilt of the Financial Loss Asset (**FLA**) to effectively reverse part of the tilt of the FLA that was applied for PQP2:

[4] See **Appendix 1** to this letter. *Assets titled annuity profile to be applied to*, April 2024.

[5] NERA, *Assessment of Type II asymmetric risk for Chorus' fibre network*, 22 January 2020, table 5.1.

i. This would have the effect of slowing down the accelerated depreciation of the FLA, reducing the MAR for PQP2, and could deliver an equivalent outcome to the approach we are recommending.

ii. However, we agree with the Commission's analysis in its PQP1 decision in support of bringing forward depreciation of the FLA (e.g. that the FLA may be more prone to stranding risk, so earlier recovery mitigates that risk and promotes incentives to invest, and there may be benefits to end-users from recovering the FLA quickly as end-users may pay more if it is compounded over time).[6]

iii. On balance we see value in applying adjusted depreciation to asset categories based on the extent to which stranding risk applies to assets in those categories, where such adjustments are needed to avoid material price shock or maintain price stability.

11. **Intra-period smoothing mechanism**

a. Applying the same approach as adopted in PQP1, where revenue over PQP2 allows Chorus to maintain prices at current real levels, with room for growth where demand exceeds forecasts.

b. This involves determining building blocks revenue such that it increases by:

i. Forecasts of demand growth consistent with our RP2 expenditure proposal connections; and

ii. Forecast CPI.

c. While inter-period smoothing will have some effect in terms of smoothing the MAR in-period, intra-period smoothing within PQP2 is still needed to remove MAR volatility.

12. Thank you for considering this letter. We look forward to engaging on this further during the PQP2 decision process. If you have any questions in relation to this letter, please do not hesitate to contact me.

Yours sincerely,

[redacted]

Head of Economic Regulation

[6] Commerce Commission, *Chorus' price-quality path from 1 January 2022 – Final decision Reasons paper*, paragraphs 6.69-6.71 and 6.89.

Appendix 1. Assets tilted annuity profile to be applied to

Selected assets include L1 communal assets: Splitters, poles, ducts, manholes, cabinets, fibre cables, and OFDF

Table: 1. Assets selected as per BBM categories.

Pre2012_L1 Duct - RBI_L1 D&M_Lost	Post2012Actual_L1 Fibre Cable - RBI_L1 FO_Non	Post2012Forecast_L1 Duct - UFB A-D_L1 D&M_Non	PostRABActual_L1 OFDF - UFB A-D_L1 FO_Lost
Pre2012_L1 Duct_L1 D&M_Lost	Post2012Actual_L1 Fibre Cable_L1 FO_Non	Post2012Forecast_L1 Duct - UFB E_L1 D&M_Non	PostRABActual_L1 OFDF - UFB E_L1 FO_Lost
Pre2012_L1 Fibre Cable - RBI_L1 FO_Lost	Post2012Actual_L1 Manholes - RBI_L1 D&M_Non	Post2012Forecast_L1 Duct_L1 D&M_Non	PostRABActual_L1 OFDF_L1 FO_Lost
Pre2012_L1 Fibre Cable_L1 FO_Lost	Post2012Actual_L1 Manholes - UFB E_L1 D&M_Non	Post2012Forecast_L1 Fibre Cable - UFB A-D_L1 FO_Non	PostRABActual_L1 Poles_L1 Cu_Lost
Pre2012_L1 Manholes - RBI_L1 D&M_Lost	Post2012Actual_L1 Manholes_L1 D&M_Non	Post2012Forecast_L1 Fibre Cable - UFB E_L1 FO_Non	PostRABActual_L1 Splitter - UFB A-D_L1 FO_Lost
Pre2012_L1 Manholes_L1 D&M_Lost	Post2012Actual_L1 OFDF - RBI_L1 FO_Non	Post2012Forecast_L1 Fibre Cable_L1 FO_Non	PostRABActual_L1 Cabinets - RBI_L1 Cab_Non
Pre2012_L1 Poles_L1 Cu_Lost	Post2012Actual_L1 OFDF - UFB A-D_L1 FO_Non	Post2012Forecast_L1 Manholes - UFB E_L1 D&M_Non	PostRABActual_L1 Cabinets - UFB A-D_L1 Cab_Non
Pre2012_L1 Duct - RBI_L1 D&M_Non	Post2012Actual_L1 Poles_L1 Cu_Non	Post2012Forecast_L1 Manholes_L1 D&M_Non	PostRABActual_L1 Duct - UFB A-D_L1 D&M_Non
Pre2012_L1 Duct_L1 D&M_Non	Post2012Actual_L1 Cabinets - UFB A-D_L1 Cab_Won	Post2012Forecast_L1 OFDF - UFB A-D_L1 FO_Non	PostRABActual_L1 Duct - UFB E_L1 D&M_Non
Pre2012_L1 Fibre Cable - RBI_L1 FO_Non	Post2012Actual_L1 Duct - RBI_L1 D&M_Won	Post2012Forecast_L1 Poles_L1 Cu_Non	PostRABActual_L1 Duct_L1 D&M_Non

Pre2012_L1 Fibre Cable_L1 FO_Non	Post2012Actual_L1 Duct - UFB A-D_L1 D&M_Won	Post2012Forecast_L1 Splitter - UFB A-D_L1 FO_Non	PostRABActual_L1 Fibre Cable - UFB A-D_L1 FO_Non
Pre2012_L1 Manholes - RBI_L1 D&M_Non	Post2012Actual_L1 Duct - UFB E_L1 D&M_Won	Post2012Forecast_L1 Cabinets - Legacy_L1 Cab_Won	PostRABActual_L1 Fibre Cable - UFB E_L1 FO_Non
Pre2012_L1 Manholes_L1 D&M_Non	Post2012Actual_L1 Duct_L1 D&M_Won	Post2012Forecast_L1 Cabinets - UFB A-D_L1 Cab_Won	PostRABActual_L1 Fibre Cable_L1 FO_Non
Pre2012_L1 Poles_L1 Cu_Non	Post2012Actual_L1 Fibre Cable - RBI_L1 FO_Won	Post2012Forecast_L1 Duct - UFB A-D_L1 D&M_Won	PostRABActual_L1 Manholes - UFB A-D_L1 D&M_Non
Pre2012_L1 Duct - RBI_L1 D&M_Won	Post2012Actual_L1 Fibre Cable - UFB A-D_L1 FO_Won	Post2012Forecast_L1 Duct - UFB E_L1 D&M_Won	PostRABActual_L1 OFDF - UFB A-D_L1 FO_Non
Pre2012_L1 Duct_L1 D&M_Won	Post2012Actual_L1 Fibre Cable - UFB E_L1 FO_Won	Post2012Forecast_L1 Duct_L1 D&M_Won	PostRABActual_L1 OFDF - UFB E_L1 FO_Non
Pre2012_L1 Fibre Cable - RBI_L1 FO_Won	Post2012Actual_L1 Fibre Cable_L1 FO_Won	Post2012Forecast_L1 Fibre Cable - UFB A-D_L1 FO_Won	PostRABActual_L1 Poles_L1 Cu_Non
Pre2012_L1 Fibre Cable_L1 FO_Won	Post2012Actual_L1 Manholes - RBI_L1 D&M_Won	Post2012Forecast_L1 Fibre Cable - UFB E_L1 FO_Won	PostRABActual_L1 Splitter - UFB A-D_L1 FO_Non
Pre2012_L1 Manholes - RBI_L1 D&M_Won	Post2012Actual_L1 Manholes - UFB A-D_L1 D&M_Won	Post2012Forecast_L1 Fibre Cable_L1 FO_Won	PostRABActual_L1 Splitter - UFB A-D_L2 Eq_Non
Pre2012_L1 Manholes_L1 D&M_Won	Post2012Actual_L1 Manholes - UFB E_L1 D&M_Won	Post2012Forecast_L1 Manholes - UFB A-D_L1 D&M_Won	PostRABActual_L1 Cabinets - RBI_L1 Cab_Won
Pre2012_L1 OFDF_L1 FO_Won	Post2012Actual_L1 Manholes_L1 D&M_Won	Post2012Forecast_L1 Manholes - UFB E_L1 D&M_Won	PostRABActual_L1 Cabinets - UFB A-D_L1 Cab_Won
Pre2012_L1 Poles_L1 Cu_Won	Post2012Actual_L1 OFDF - RBI_L1 FO_Won	Post2012Forecast_L1 Manholes_L1 D&M_Won	PostRABActual_L1 Duct - UFB A-D_L1 D&M_Won
Pre2012_L1 Duct_L1 D&M_National	Post2012Actual_L1 OFDF - UFB A-D_L1 FO_Won	Post2012Forecast_L1 OFDF - UFB A-D_L1 FO_Won	PostRABActual_L1 Duct - UFB E_L1 D&M_Won
Pre2012_L1 Manholes_L1 D&M_National	Post2012Actual_L1 Poles_L1 Cu_Won	Post2012Forecast_L1 OFDF_L1 FO_Won	PostRABActual_L1 Duct_L1 D&M_Won
Pre2012_L1 Poles_L1 Cu_National	Post2012Actual_L1 Splitter - UFB A-D_L1 FO_Won	Post2012Forecast_L1 Poles_L1 Cu_Won	PostRABActual_L1 Fibre Cable - UFB A-D_L1 FO_Won
Post2012Actual_L1 Cabinets - Legacy_L1 Cab_Lost	Post2012Actual_L1 Cabinets - Legacy_L1 Cab_National	Post2012Forecast_L1 Splitter - UFB A-D_L1 FO_Won	PostRABActual_L1 Fibre Cable - UFB E_L1 FO_Won

Post2012Actual_L1 Duct - RBI_L1 D&M_Lost	Post2012Actual_L1 Duct_L1 D&M_National	Post2012Forecast_L1 Splitter_L1 FO_Won	PostRABActual_L1 Fibre Cable_L1 FO_Won
Post2012Actual_L1 Duct - UFB A-D_L1 D&M_Lost	Post2012Actual_L1 Fibre Cable - RBI_L1 FO_National	Post2012Forecast_L1 Fibre Cable - RBI_L1 FO_National	PostRABActual_L1 Manholes - UFB A-D_L1 D&M_Won
Post2012Actual_L1 Duct - UFB E_L1 D&M_Lost	Post2012Actual_L1 Fibre Cable_L1 FO_National	Post2012Forecast_L1 Fibre Cable_L1 FO_National	PostRABActual_L1 OFDF - UFB E_L1 FO_Won
Post2012Actual_L1 Duct_L1 D&M_Lost	Post2012Actual_L1 Poles_L1 Cu_National	Post2012Forecast_L1 Manholes - RBI_L1 D&M_National	PostRABActual_L1 Poles_L1 Cu_Won
Post2012Actual_L1 Fibre Cable - RBI_L1 FO_Lost	Post2012Actual_L1 Splitter - UFB A-D_L1 FO_National	Post2012Forecast_L1 Manholes_L1 D&M_National	PostRABActual_L1 Splitter - UFB A-D_L1 FO_Won
Post2012Actual_L1 Fibre Cable - UFB A-D_L1 FO_Lost	Post2012Actual_L1 Splitter - UFB A-D_L2 Eq_National	Post2012Forecast_L1 Poles_L1 Cu_National	PostRABActual_L1 Splitter - UFB A-D_L2 Eq_Won
Post2012Actual_L1 Fibre Cable - UFB E_L1 FO_Lost	Post2012Actual_L1 Splitter_L1 FO_National	Post2012Forecast_L1 Splitter - UFB A-D_L1 FO_National	PostRABActual_L1 Cabinets - RBI_L1 Cab_National
Post2012Actual_L1 Fibre Cable_L1 FO_Lost	Post2012Actual_L1 Splitter_L2 Eq_National	Post2012Forecast_L1 Splitter_L1 FO_National	PostRABActual_L1 Cabinets - UFB A-D_L1 Cab_National
Post2012Actual_L1 Manholes - RBI_L1 D&M_Lost	Post2012Forecast_L1 Cabinets - Legacy_L1 Cab_Lost	PostRABActual_L1 Cabinets - Legacy_L1 Cab_Lost	PostRABActual_L1 Duct - UFB A-D_L1 D&M_National
Post2012Actual_L1 Manholes_L1 D&M_Lost	Post2012Forecast_L1 Duct - UFB E_L1 D&M_Lost	PostRABActual_L1 Cabinets - UFB E_L1 Cab_Lost	PostRABActual_L1 Duct - UFB E_L1 D&M_National
Post2012Actual_L1 OFDF - RBI_L1 FO_Lost	Post2012Forecast_L1 Duct_L1 D&M_Lost	PostRABActual_L1 Duct - UFB A-D_L1 D&M_Lost	PostRABActual_L1 Duct_L1 D&M_National
Post2012Actual_L1 OFDF - UFB A-D_L1 FO_Lost	Post2012Forecast_L1 Fibre Cable - UFB E_L1 FO_Lost	PostRABActual_L1 Duct - UFB E_L1 D&M_Lost	PostRABActual_L1 Fibre Cable - UFB A-D_L1 FO_National
Post2012Actual_L1 OFDF - UFB E_L1 FO_Lost	Post2012Forecast_L1 Fibre Cable_L1 FO_Lost	PostRABActual_L1 Duct_L1 D&M_Lost	PostRABActual_L1 Fibre Cable - UFB E_L1 FO_National
Post2012Actual_L1 Poles_L1 Cu_Lost	Post2012Forecast_L1 Manholes - UFB E_L1 D&M_Lost	PostRABActual_L1 Fibre Cable - UFB A-D_L1 FO_Lost	PostRABActual_L1 Fibre Cable_L1 FO_National
Post2012Actual_L1 Cabinets - UFB A-D_L1 Cab_Non	Post2012Forecast_L1 Manholes_L1 D&M_Lost	PostRABActual_L1 Fibre Cable - UFB E_L1 FO_Lost	PostRABActual_L1 Manholes - UFB A-D_L1 D&M_National

Post2012Actual_L1 Duct - RBI_L1 D&M_Non	Post2012Forecast_L1 OFDF - UFB A-D_L1 FO_Lost	PostRABActual_L1 Fibre Cable_L1 FO_Lost	PostRABActual_L1 OFDF - UFB A-D_L1 FO_National
Post2012Actual_L1 Duct - UFB A-D_L1 D&M_Non	Post2012Forecast_L1 OFDF - UFB E_L1 FO_Lost	PostRABActual_L1 Manholes - UFB A-D_L1 D&M_Lost	PostRABActual_L1 OFDF - UFB E_L1 FO_National
Post2012Actual_L1 Duct - UFB E_L1 D&M_Non	Post2012Forecast_L1 Poles_L1 Cu_Lost	PostRABActual_L1 Manholes - UFB E_L1 D&M_Lost	PostRABActual_L1 Poles_L1 Cu_National
Post2012Actual_L1 Duct_L1 D&M_Non	Post2012Forecast_L1 Cabinets - Legacy_L1 Cab_Non	PostRABActual_L1 Manholes_L1 D&M_Lost	PostRABActual_L1 Splitter - UFB A-D_L1 FO_National
		PostRABForecast_C1 Property - Buildings - Short life_L1 Other_Non	PostRABActual_L1 Splitter - UFB A-D_L2 Eq_National