CHORUS

Keston Ruxton
Manager, Fibre
Commerce Commission
Wellington

24 September 2024

Dear Keston

Chorus – Revenue path and alternative depreciation for PQP2

Introduction

1. This letter confirms the preferred revenue path, to be delivered through alternative depreciation, for Chorus in our second regulatory period (**PQP2**). It also recommends the principles on which the alternative depreciation profile should be selected.

2. This letter contains confidential and market sensitive information, which is marked as **[ ] CCI**. We request the Commission provide us with advance notice of any plan to release the confidential and market sensitive information, so we can consider our disclosure obligations prior to publication.

3. As the Commerce Commission (**Commission**) is aware, the Maximum Allowable Revenue (**MAR**) for our second regulatory period is likely to be significantly higher than for PQP1, driven primarily by the higher cost of capital and inflation environment. Competition will likely constrain our ability to recover the full un-adjusted MAR during PQP2.

4. We therefore proposed[1] a mechanism to smooth the MAR over future regulatory periods, by applying an alternative depreciation profile to selected core fibre assets, in order to avoid building up an excessively large wash-up balance in PQP2. This is valuable to end-users because a large wash-up balance:

    a. would undermine investor confidence in the regime and thus impact investment incentives; and

[1] Chorus-Letter-on-approach-to-MAR-smoothing-1-May-2024.pdf (comcom.govt.nz)

b. may create concern about large step-ups in fibre pricing, even though Chorus would not be able to increase our prices to recover all of the unsmoothed MAR during PQP2.

5. The Commission's draft decision on the price-quality path for PQP2 accepted this proposal. We support the Commission's views that:[2]

> *"Chorus' estimate of achievable revenue is the best estimate available to us…*
> *Chorus knows its business best and are in the best position to forecast future demand and the associated revenue it can achieve. We consider Chorus has incentives to provide us an unbiased best estimate"*

6. The draft decision was based on an in-principle test bed model demonstrating how the alternative depreciation method could be applied. This was subject to review following updates for key inputs, including the confirmed PQP2 cost of capital and CPI forecast, the final expenditure allowances, the final wash-up balance for PQP1 and CY23 Information Disclosure inputs.[3] Chorus undertook to provide an updated version of the model once the final inputs for the PQ decision were available. In our submission on the draft PQ decision, we noted that the tilt rate of the model may need to be reviewed.[4]

7. Chorus has now reviewed the alternative depreciation approach, taking account of updated information and our latest fibre revenue forecast.

8. We recommend an alternative depreciation profile is selected to deliver a revenue path for PQP2 that achieves the following principles:

   a. provides sufficient allowed revenues to incentivise growth and connections;
   b. does not constrain revenue upside opportunities for Chorus – as it would not be desirable for Chorus to be prevented from pursuing new revenue opportunities during PQP2 where the revenues would still be less than the unsmoothed PQP2 MAR; and
   c. avoids the build-up of an excessive wash-up balance that would call the credibility of the regulatory settings into question.

9. To meet these principles, we recommend the alternative depreciation profile is set to deliver a PQP2 MAR within a range that is $40m to $70m above the draft decision each year. **[**[redacted]**] CCI**

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[2] Commerce Commission, *Chorus' price-quality path for the second regulatory period (2025 – 2028) – draft decision*, p. 147.
[3] Chorus – Recommendation of approach to MAR smoothing for PQP2, letter to Commission, 1 May 2024, para 8 & 9.
[4] Also, the draft PQP2 determination stated that the tilt rate was 3.5% real. However, the test bed model, used to support the draft decision, applied a 3.5% <u>nominal</u> tilt rate.

10. The recommended revenue path to deliver this outcome is in the table and chart below. We will confirm the tilt rate necessary to achieve this outcome alongside the final PQP2 MAR model by 27 September.[5]

Scenario (nominal, includes PQP1 wash-up)	2025	2026	2027	2028	Total PQP2	Gap v no tilt
	$m	$m	$m	$m	$m	$m
Recommended MAR	**[[redacted]] CCI**	**[[redacted]] CCI**	**[[redacted]] CCI**	**[[redacted]] CCI**	**[[redacted]] CCI**	**[[redacted]] CCI**
Draft decision MAR	908	947	983	1,018	3,856	546
No tilt MAR[6]	1,036	1,081	1,123	1,163	4,403	-
Chorus revenue forecast	**[[redacted]] CCI**	**[[redacted]] CCI**	**[[redacted]] CCI**	**[[redacted]] CCI**	**[[redacted]] CCI**	**[[redacted]] CCI**
Headroom	**[[redacted]] CCI**	**[[redacted]] CCI**	**[[redacted]] CCI**	**[[redacted]] CCI**		

MAR and revenue for PQP2

[redacted] **CCI**

11. A MAR that is higher than the draft decision is necessary and justified for the following reasons:

   a. Based on updated information since the time of the draft decision, the revenue path produced in the draft decision was too low and would unduly restrict our pricing and our ability to recover our costs in PQP2.

   b. **[**[redacted] **CCI** The revenue path needs to be set at a level that gives confidence to investors that growth opportunities will not be unnecessarily curtailed in

[5] Note that due to final modelling adjustments, the recommended revenue path may change slightly from that stated here, but we do not expect any material shift.

[6] These totals assume the PQP1 wash-up is drawn down in equal amounts in each year of PQP2.

the later years of PQP2 in particular (noting that Chorus is entitled to recover our revenue requirement).

c. The increase in MAR reflects the effect of the final decision on the expenditure allowances and the use of CY23 ID inputs. We note the benefit for end-users (in terms of the allowable revenues that are deferred to beyond PQP2) is somewhat greater than in the draft decision.

12. **[**[redacted]**] CCI** To apply a consistent gap in all years would require further changes to the PQP2 model, such as adjusting the growth rates that are applied. That would create additional complexity which we do not consider desirable at this stage of the process.

13. Importantly, **[**[redacted]**] CCI** For CY25 the FFLAS prices (to take effect on 1 January) have been consulted on and are due to be confirmed on 25 September, well before the final PQ decision will be published. The CY25 price increase that was consulted on was also lower than draft decision MAR for that year. We are contractually prevented from increasing prices more than once every 12 months.

14. Thank you for considering this letter. If you have any questions in relation to this letter, please contact me.

Yours sincerely,

[redacted]

Ian Ferguson
Head of Economic Regulation