



PQ RAB draft decision and  
Draft IM amendments

Submission | Commerce Commission  
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## Executive Summary

Thank you for the opportunity to provide feedback on the draft Price-Quality (**PQ**) RAB draft decision (**the draft**) and proposed IM amendments (**proposed amendments**).

The Commission was expected to apply a Part 4 BBM approach to the Chorus UFB fibre network, this is what Chorus asked for and policy makers sought to ensure. What wasn't expected was that approach would be applied across competitive and legacy services, and assets well beyond the UFB network in a way that will distort competition.

The draft identifies \$5.1B of assets employed in the provision of FFLAS services<sup>1</sup>, whereas Chorus – which operates nationwide copper and legacy fibre networks as well as its UFB network - reports total assets of only \$5.3B<sup>2</sup> including \$300M of copper cable assets. The Commission's proposed approach leaves very few Chorus assets and services outside Part 6 regulation and its guaranteed RAB returns.

In earlier submissions we noted that the Commission's methodology likely overstates the fibre RAB value<sup>3</sup>, resulting in assumed BBM fibre assets per connection significantly higher than any other wholesale fibre provider. This approach ensures that end users will face higher fibre prices over time than are necessary to allow Chorus a fair return on its UFB investments. As importantly, implementing Part 6 in a way that captures competitive services and assets undermines competition and distorts investment incentives. Over time, no firm can compete against BBM assured returns.

### Defining FFLAS and fibre assets to preserve and promote competition

Accordingly, we remain concerned that the draft identifies retired, legacy and competitive services such as Chorus HSNS, ATM and SDH services and Chorus' competitive regional transport services, as FFLAS services (**additional services**).

We agree that the UFB Reference Offer services are FFLAS and that Chorus' residential gateway service is not an FFLAS. However, the draft applies the principle that any service that uses a fibre input is FFLAS. This extends FFLAS to the additional services and means that any future Chorus services that access the fibre network would - in principle - be considered FFLAS irrespective of whether this promotes competition or is in end user interests. This outcome would be inconsistent with the Telecommunications Act 2001 (**Act**)'s legislative purpose, meaning any Commission application of the proposed FFLAS definition would be subject to challenge.

There are further practical difficulties in that the approach draws a different boundary between monopoly UFB networks and competitive and downstream markets than that anticipated by the Fibre Deeds, blurring the boundary between monopoly and competitive services and potentially undermining the Government open access UFB network objectives. We are already seeing signs this approach will artificially affect and inflate the prices of these legacy services. That is because services that were never subject to a geographic averaging requirement will need to be repriced to meet the FFLAS geographic averaging requirement. This repricing will increase costs for end-users for no benefit at all.

We agree that services that access the fibre network must either be FFLAS or use a FFLAS input service. However, we believe the Commission has flexibility in how it applies this principle in light of

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<sup>1</sup> Unallocated initial RAB value. These are assets used fully or in part to provide FFLAS services. The Commission's proposed methodology means that these assets will ultimately be fully incorporated into fibre prices as Chorus transitions to a fibre first business. The FLA is an additional \$1.45B.

<sup>2</sup> Reported assets excluding WIP and there are differences in reporting and reporting dates. Nonetheless, it highlights that few assets fall outcome Part 6 regulatory decisions.

<sup>3</sup> Spark submission on Chorus expenditure proposal (12 March 2021) from para 17.

the purposes of the Act. For example, legacy or potentially competitive services that rely on an existing FFLAS should not be FFLAS services themselves, rather they should be treated as accessing the fibre network through existing DFAS and ICAB services, which are FFLAS services. We believe this should be the case for the additional services set out in draft. This is consistent with the Fibre Open Access Deeds. Where it is not possible to identify the underlying FFLAS input, then the fibre network cost allocation to these services should be made transparent.

This alternative approach is unlikely to shift the RAB materially, but the additional transparency and positive incentives will have material competition and end-user benefits. The Commission can set incentives to promote competition and wider end user benefits. For example, 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.

### **Proposed IM amendment to compensate Chorus for holding tax loss credits**

We do not support draft proposals to amend the IMs to fund the holding costs of notional fibre tax loss credits. At the time of the IMs, there were differing views relating to whether fibre tax loss credits should be recognised as a benefit at the time they are incurred – i.e., because a multi-product firm would have immediately offset these losses against profits elsewhere - or against future fibre BBM profits. While the tax benefit is taken in both instances, there is a time value benefit in offsetting revenues immediately rather than at a future date.

At the time, the Commission considered that while deferring the immediate offset would increase end-user prices, mapping notional fibre credits against Chorus' actual tax paid would likely be complex when tax losses were not expected to be material. We now know that the tax credit holding costs are material (adding over \$80M to the RAB) 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.

### **Mitigating double recovery**

The draft proposes not to apply the TERA cross-check against double recovery. However, this leaves the Commission potentially determining the RAB and expenditure path without any consideration of double recovery. The Commission no longer expects to apply the IMs anticipated protections against double recovery such as the bottom-up identification of direct costs, proportionate cost allocations and an allocation cap, nor apply a cross-check to assure material double recovery is not occurring. We agree that it would be impractical to fully ensure there is no double or over-recovery between the FLA and copper services, but it is equally not in end user interests for the BBM to be blind to the potential.

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 cross-check. Chorus has remained highly profitably through the UFB programme, and the Commission proposes to add \$1.4B of returns to Chorus. Under these circumstances, double recovery remains a significant concern – and the Commission should be validating BBM outcomes to ensure this hasn't occurred. The Commission committed to managing this risk actively and must follow through on that commitment.

## Introduction

1. Thank you for the opportunity to provide feedback on the draft Price-Quality (**PQ**) RAB draft decision (**the draft**) and proposed IM amendments (**proposed amendments**).
2. The Commission has multiple consultations over the remainder of the year in order to make a PQ decision. In this consultation it has requested feedback on its draft approach relating to:
  - a. Chorus' initial PQ RAB.
  - b. The cost and asset allocations we have applied in determining Chorus' PQP1 capex and opex allowances.
  - c. The interpretation of the definition of FFLAS, and
  - d. The implementation of the Regulations to determine which of Chorus' FFLAS are exempt from PQ regulation.
3. The Commission was expected to apply a Part 4 BBM approach to the Chorus UFB fibre network, this is what Chorus asked for and policy makers sought to ensure. What wasn't expected was that approach would be applied across competitive and legacy services, and assets well beyond the UFB network in a way that will distort competition.
4. The draft identifies \$5.1B of assets employed in the provision of FFLAS services<sup>4</sup>, whereas Chorus – which operates nationwide copper and legacy fibre networks as well as its UFB network - reports total assets of only \$5.3B<sup>5</sup> including \$300M of copper cable assets. The Commission's proposed approach leaves very few Chorus assets and services outside Part 6 regulation and its guaranteed RAB returns
5. In earlier submissions we noted that the Commission's methodology inevitably overstates the fibre RAB value<sup>6</sup>, resulting in assumed BBM fibre assets per connection significantly higher than any other fibre provider. The draft makes only minor amendments to earlier proposals and, accordingly, will result in a significantly higher RAB value per connection than any other fibre provider. We should not expect any regulatory framework that bakes in this sort of anomaly to be durable.
6. As importantly, an unnecessary broad Part 6 implementation that brings in competitive markets undermines competition and distorts Chorus and competing investors incentives. Over time, no firm can compete against BBM underpinned returns. This approach risks undermining innovation and driving out competition and competing investment and is unlikely to best support the purposes of the Act or be in end-user interests. We believe there should be more focus, in the initial BBM implementation, on preserving and promoting competition.

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<sup>4</sup> Unallocated initial RAB value. These are assets used fully or in part to provide FFLAS services. The Commission's proposed methodology means that these assets will ultimately be fully incorporated into fibre prices as Chorus transitions to a fibre first business. The FLA is an additional \$1.45B.

<sup>5</sup> Reported assets excluding WIP and there are differences in reporting and reporting dates. Nonetheless, it highlights that few assets fall outside Part 6 regulatory decisions.

<sup>6</sup> This is because the starting point is Chorus' current complex business and - without any real consideration of a FFLAS provider cap - this inevitably brings through the complex and high-cost copper operating model, legacy assets and unnecessary sunk costs. Where a legacy service is classified as FFLAS, legacy non-fibre assets are brought in to the RAB. For example, Spark submission on Chorus expenditure proposal (12 March 2021) from para 17.

## Interpretation of the definition of FFLAS

7. We set out our concerns in earlier submission<sup>7</sup> that the expenditure proposal includes funding to potentially overlay infrastructure that Spark and other parties have invested in. For example, the expenditure proposal seeks funding for projects to potentially overlay already competitive fibre routes and risks undermining the current collaborative industry model to new fibre deployments. We asked that the Commission either take a “hands on” role to proposed investment – ensuring that specific BBM funded projects avoided undermining existing investment – or make transparent BBM funded projects and cost allocations applied so that non-discriminatory access by other users of the fibre route can be ensured.
8. The draft raises similar competition and incentive concerns in that the proposed approach to identifying FFLAS services appears to capture competitive and legacy services. The draft proposes to identify FFLAS services on the basis of whether the service uses an access or inter-exchange UFB fibre. However, that approach does not consider whether these are competitive service that can be provided using an existing UFB reference offer input service, and accordingly casts the BBM net widely. This extends FFLAS to the additional services and means that any future Chorus services that access the fibre network would - in principle - be considered FFLAS irrespective of whether this promotes competition or is in end user interests. This outcome would be inconsistent with the Telecommunications Act 2001 (**Act**)’s legislative purpose, meaning any Commission application of the proposed FFLAS definition would be subject to challenge.
9. We agree that FFLAS includes a range of fibre access services and connectivity between fibre network aggregation points or exchanges, and that the Commission has discretion to determine individual or classes of (service types) FFLAS<sup>8</sup>. The Commission should use current UFB Reference Offer services and variants as the starting point for identifying FFLAS services<sup>9</sup>. We further agree that Chorus’ residential gateway service is not an FFLAS.
10. However, as set out in Table 1, the draft also proposes to classify additional services such as HSNS, ATM, STM and CNS as FFLAS when they have been and tail extension as FFLAS (**additional services**). However, these are services that we understand to have been decommissioned, subject to competition, legacy or readily identifiable as being based on DFAS and ICAB inputs.

Table 1 based on Table A1 of the Draft

| Category                | IM Description  | Additional FFLAS   | Comment  |
|-------------------------|---|--|--|
| Point-to-point services | Single, multi-class or layer 1 point-to-point fibre access services (including, [...]). | HSNS Lite<br>HSNS Premium<br>STM1, STM4<br>ATM<br>CNS Ethernet,<br>CNS SDH/PDH | We understand that the ATM equipment has been decommissioned. This should be omitted.<br><br>Chorus offers better bitstream alternatives in the UFB footprint, i.e., our preference is to purchase cheaper Bitstream 2, 3 and 4 over HSNS. HSNS should be omitted.<br><br>CNS ethernet is a competitive service – RSPs have deployed similar platforms. Should be omitted. |

<sup>7</sup> Spark submission on Chorus expenditure proposal (12 March 2021) at para 30 and 59

<sup>8</sup> The IMs Reasons paper notes that a decision on the individual services that come within the definition of FFLAS would be made in the PQ and ID decisions at 2.107.

<sup>9</sup> Draft at A18

| Category           | IM Description  | Additional FFLAS   | Comment  |
|--------------------|---|--|--|
|                    |   |  | CNS SDH/PDH supports legacy PSTN services and is progressively being decommissioned. Associated STM1 and STM4 are legacy services in decline. These services should be omitted.  |
| Transport services | Layer 1 or managed throughput fibre services provided over the fibre network, to transport voice and data traffic between central offices, including central offices that are also POIs (including, [...]). | HSNS Tail Extension (where it is not POI-to-POI)<br>Chorus Regional Transport (where it is not POI-to-POI) <sup>10</sup> | CRT is for between POIs, and ICAB is between exchanges within a UFB area. CRT between POIs is typically competitive. As noted in the draft, CRT is not provided within UFB candidate areas. It should be removed.<br>Chorus proposes to amend HSNS prices so that, in effect, there are no HSNS Tail Extension charges within a UFB candidate area (the extension is bundled in with access price). Accordingly, Tail extension should be removed. |

11. None of the additional services should be considered FFLAS and, to the degree they use the UFB fibre network, demand should be reflected in DFAS and ICAB volumes and revenue.
12. It is to see the benefits in identifying these services as FFLAS where there is no obvious competition concern, and a layer 1 FFLAS input service should already be applied. Any approach that brings in otherwise contestable services and assets undermines competition and distorts Chorus - and other investors' incentives - to invest in fixed infrastructure. Further the proposed approach may raise practical issues:
- a. The proposed approach draws a different demarcation between FFLAS and non-FFLAS services than that set out in the Fibre Deeds. For example, the Fibre Deed requires that Chorus use the same DFAS input service for any point-to-point Layer 2 fibre service<sup>11</sup>, whereas the draft BBM approach will see an implied demarcation based on causal cost allocations.  
  
Accordingly, the proposed approach blurs the boundary between the UFB fibre network, and competitive adjacent and downstream markets, and is likely to undermine the Government open access UFB network objectives. Interested parties have little if any visibility of how costs are allocated between regulated and competitive services and revenues are attributed to the RAB.  
  
While the BBM approach need not be identical to the Fibre Deeds, aligning the approaches where possible would promote transparency and competition, and reduce compliance costs.
  - b. The s201 uniform pricing obligation applies to all FFLAS services, and prices for legacy services may need to be amended to comply with this obligation. In practice, s201 compliance likely requires a single price across the fibre network from the end-user premises to the first access point or switch.  
  
Chorus is currently consulting on proposals to rebalance HSNA prices to comply with the uniform pricing obligation (in effect, by reducing access prices to the single

<sup>10</sup> It is unclear whether CRT is FFLAS or not. CRT is included in Table A1, but the draft acknowledges at A36 that CRT in UFB areas is in practice the ICABs service (and is therefore not FFLAS).

<sup>11</sup> Chorus Deed of Open Access at 5.1 and Schedule 1

price, while increasing tail extension prices). This consultation has not been completed, but there may be implications for other additional services.

13. Therefore, we recommend that the Commission consider further how it will identify FFLAS services.
14. We agree that services that access the fibre network must be either FFLAS or use a FFLAS input service. However, we believe the Commission has flexibility in how it applies this principle in light of the purposes of the Act. For example, a better approach would be:
  - a. legacy or potentially competitive services that rely on an existing FFLAS should not be FFLAS services themselves, rather they should be treated as accessing the fibre network through existing DFAS and ICAB services, which are FFLAS services.

We believe this should be the case for the additional services set out in draft. For example, HSNS, ATM, SDH and CNS services are not FFLAS, and their demand would be reflected in the BBM DFAS and ICAB volumes and revenues. This is consistent with the Fibre Open Access Deeds. .

- b. Where it is not possible to identify the underlying FFLAS input, then the fibre network cost allocation to these services should be made transparent.

This is similar to our expenditure proposal suggestion that there be transparency of capex allocations for new shared assets (i.e., between FFLAS and non-FFLAS services that will be supported by the new investment).

15. This alternative approach is unlikely to shift the RAB materially, but the additional transparency and positive incentives will have material competition and end-user benefits. The Commission can set incentives to promote competition and wider end user benefits. For example, 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.

## The Financial Loss Asset

### Tax losses

16. The Commission proposes to amend the IMs in order to compensate Chorus for holding notional fibre “tax loss” credits from when they are incurred until when they are offset against future fibre network profits (this concern is driving proposed WACC amendments). The Commission reports that the proposed amendment would add \$80.5 million to the FLA.
17. We do not support the proposal.
18. The treatment of notional fibre tax losses was considered at length through the IMs process. Submitters had differing views relating to whether notional fibre “tax losses” should be recognised as a benefit at the time they are incurred - because Chorus would have used the notional losses against other profitable services - or offset against future profits of a standalone fibre network. The difference between the scenarios is the time value of taking the tax benefit immediately or at a future date.
19. We submitted that the tax benefit of losses should be immediately set against Chorus’ group position at the time the loss is identified<sup>12</sup>. Chorus, as a highly profitable multi-product firm,

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<sup>12</sup> Summarised in the IMs Reasons Paper at 8.99

would have offset the implied tax losses from a “loss making” services (FFLAS) against profits from other established product lines (copper and transport). For example, Chorus financial reports incurring a tax liability of ~\$40 million per year through the pre-implementation period, and if not for notional fibre losses the tax paid would have been higher. This offsetting is what any firm operating in a competitive market would do.

20. Vodafone also noted that assuming fibre is a standalone is inconsistent with the underlying assumptions in the regime<sup>13</sup>:

The LFCs requested that the tax benefit be carried forward until it is used to offset future tax costs of fibre services. This assumes that fibre is a stand-alone business, which is inconsistent with many other assumptions in the regime. If the tax benefit was able to be absorbed by another part of the LFCs business, it must be applied as such in the regime, and treated as a revenue item in the year incurred.

21. Nonetheless, the Commission:

- a. Did not see a clear case for considering the tax position in the context the wider Chorus business – it not being obvious that an issue of allocative or dynamic efficiency is at stake<sup>14</sup>, and
- b. While end-users would be slightly worse off to the extent of the time value of money for the period for which taking the credits was deferred, this was not considered to be material.

8.94 By notionally carrying forward tax losses, end-users will be worse off than if the tax losses were immediately recognised (ie, they would experience higher prices) to the extent of the time value of money relating to the tax effect of any of the tax losses for the deferral period. We do not consider this is likely to be material. In respect of losses carried forward to the post-implementation period (1 January 2022), based on the provisional nature of the information that we have at this point, and the need to make potentially arbitrary group loss-offset assumptions, we do not know and cannot know for sure to what extent regulated providers may have enjoyed the time value of money benefit of losses and whether the benefit is material.

22. The Commission further noted that considering the effect of notional fibre losses in the context of Chorus’ overall tax position would require it to map these losses to the historic loss position of the group, and this would potentially require making assumptions about the tax situation of Chorus’ other activities<sup>15</sup>. It’s unclear why there would be more than minor differences in phasing of the tax benefit, or why this allocation would be any more complex or arbitrary than the many other allocation decisions that Commission must make in applying the BBM.

23. We now know that this is a material issue. However, rather than considering how it might offset fibre losses against Chorus’ overall tax position as discussed in the IMs, the draft proposes to recover from holding costs of the tax credits from end users. This means that end-users not only face of the costs deferred tax credits anticipated by the original IM decision – a recognised downside of the IM approach, albeit deemed not material - but now face the additional costs of Chorus holding these deferred benefits. These are not a cost that Chorus has faced in practice and it is unclear what the end-user purpose the funding of these credits could be.

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<sup>13</sup> Vodafone cross submission Cross-Submission on Fibre Regulation Emerging Views (31 July 2019) at page 7

<sup>14</sup> IMs Draft Decision Reasons paper 19 November 2019 at 3.1952 - 3.1953

<sup>15</sup> IM Reasons Paper at 8.104

24. This has material consequences for end users and, accordingly, the Commission should consider notional fibre losses in light of Chorus' overall tax position. This would be consistent with Chorus' actual costs to provide FFLAS and, as Vodafone notes, with the principles that underly the Commission's BBM approach. Adjusting for any differences in phasing between years in which the notional loss is incurred and actual tax paid is unlikely to be onerous, and certainly no more difficult than many other BBM decisions faced by the Commission.

### The TERA cross check

25. The Commission proposes not to apply the TERA cross-check to the BBM outcomes on the basis that it impractical<sup>16</sup>. The Commission reports seeing a number of practical difficulties with such a highly prescriptive approach, and it would come at a cost, which we consider does not match the benefits it would deliver<sup>17</sup>.

26. We recommend that the Commission consider how it might assure the FLA against material double and over-recovery of costs.

27. It is unclear from the draft what the underlying concern with the TERA cross-check against double recovery is. The draft refers to Reasons Paper concerns with TERA's recommendation relating to the granularity at which assets would be specified for the purposes of the RAB. TERA had recommended – amongst other things – that the Commission should seek a level of granularity similar to that used for the TSLRIC modelling exercise. This would help to identify inconsistent allocations between the BBM and TSLRIC models that is the underlying cause of double recovery. The Reasons Paper noted that requiring granular asset information would come at a cost that does not match the benefits it would deliver<sup>18</sup>.

28. However, this was but one of a number of TERA recommendations<sup>19</sup>, and we were referring in our submission to the TERA recommended cross check that augmented these recommendations<sup>20</sup>.

As a crosscheck to augment the more detailed cost category reporting, the absence or existence of double recovery can also be tested by calculating the total cost recovered from copper and fibre regulated activities. This methodology, which does not depend on the cost category information, will be an important cross-check for the Commission.

29. As TERA note, the cross-check does not rely on detailed cost category reporting that concerns the Commission. TERA set out in this report that this can be done by applying the BBM model across aggregate copper and fibre costs and revenues. The calculation would be possible in practice because it is based on the same methodology, cost categories, allocations and accounting data starting point as the BBM<sup>21</sup>.

30. The Commission set out in the IMs its reservations relating to the TERA cross-check: the TSLRIC and BBM methodologies are seen as fundamentally different, may appear to revisit FPP prices by clawing back some of the revenues and may exclude pre-2011 assets such as ducts<sup>22</sup>. However, while the methodologies are different, TSLRIC and BBM both seek to provide the

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<sup>16</sup> Draft at 3.7

<sup>17</sup> Draft at 3.61

<sup>18</sup> Reasons paper at 3.417

<sup>19</sup> TERA at 3.1. TERA made a number of recommendations in its report relating to: the granularity of asset data (referred to by the Commission), controlling for double recovery through the BBM rather than retrospectively applied to copper, a prescriptive BBM approach, the necessity for a prescriptive approach, adjusting RAB values where deregulation occurs, and the importance of monitoring and ensuring consistency of overall cost recovery

<sup>20</sup> TERA Study on potential cost over-recovery in the BBM model for fibre services (31 July 2019) at page 27

<sup>21</sup> TERA at page 28

<sup>22</sup> IMs Reasons Paper at 3.366

same normal return over time and the cross-check is based on actual costs and revenues in the context of a BBM model.

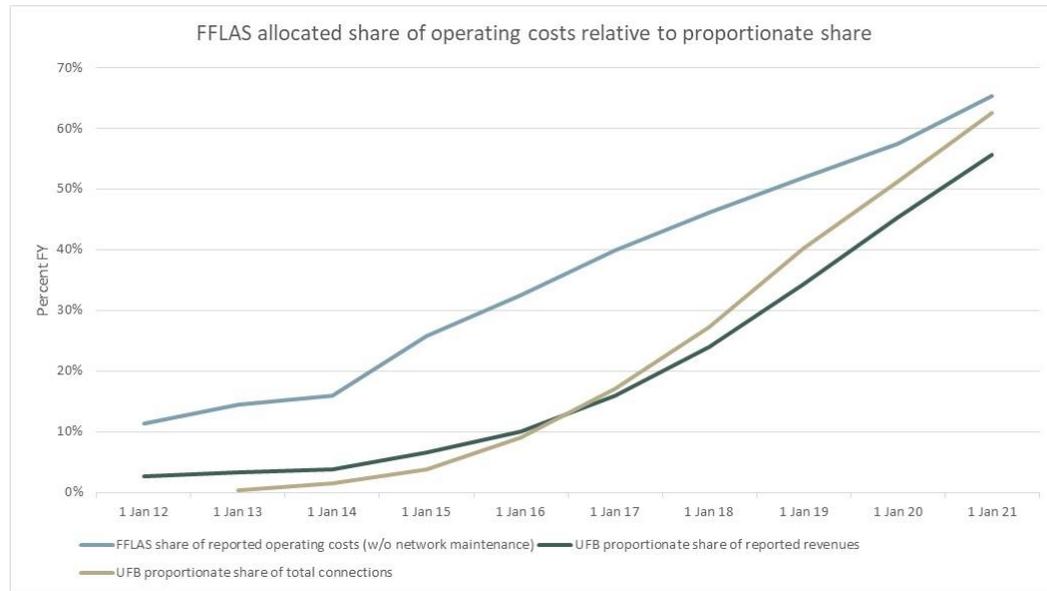
31. Of course, we are now in a better position to apply the cross-check. We now know that the RAB and expenditure proposal is based on Chorus financial reports, the proposed fully allocates Chorus' costs to services, and the Commission is using a BBM like model to estimate financial losses. The Commission has identified pre-2011 assets – which seemed to be an original concern - and these can be included in the cross-check. Accordingly, the information necessary to apply the TERA cross-check is now readily available to the Commission and can be readily applied to assure the BBM outcomes.
32. The difficulty we face in the current process is that – 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<sup>23</sup>. The Commission was conscious through the IMs process that double recovery and windfall gains were not permitted and – recognising Chorus strong incentives to maximise allocations to fibre and the risk of potential gaming – provided for a number of measures to mitigate this risk<sup>24</sup>. However, as the IMs have been implemented, the planned IM protections appear to have fallen away. For example, the IMs anticipated that:
  - a. BBM costs would be based on careful bottom-up analysis of asset values and operating costs directly attributable to FFLAS and not FFLAS services. In practice, the Commission has taken a top down and residual approach that starts with Chorus' existing business and costs, and fully allocates these costs to services.
  - b. Shared assets would only come into the FLA, and post-implementation, into the RAB, when they are employed in the provision of UFB FFLAS. Filters would be applied in identifying assets that could potentially be shared and, where there were information constraints, such costs could be excluded (or a relatively low share be allocated to the FLA). However, an allocation approach has been applied that does not rely on filtering or exclusion of assets.
  - c. Proportionate cost allocation would provide some protection against over-recovery. For example, as demand transitions from copper services to fibre services, the allocation of costs of shared pre-2011 assets will reflect this transition. However, the allocators applied in practice has not led to a proportionate transition of operating costs. For example, Figure 1 shows that the draft proposes to allocate significantly higher proportion of costs to FFLAS than supported by a proportionate allocation (based on revenue or connection share).

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<sup>23</sup> Reasons paper at 3.382 and from 3.326. The draft does propose to update cost allocation data annually.

<sup>24</sup> For example, IMs Reasons Paper at 3.307

Figure 1: comparison of actual allocations against proportionate



- d. An avoided cost cap would mitigate the risk that excessive costs are transferred into the initial value of the fibre RAB. The Commission proposes not to apply the cap, except in the limited exchange space situation.
- e. A limited number of default allocators would apply. While the Commission has the discretion to accept alternative allocators (which it proposes to do), the proposed allocators: move further away from delivering proportionate cost allocation outcomes, increase the potential for gaming allocators selected and no longer fully relate to how an asset is employed at each stage of its life<sup>25</sup>.

- 33. We agree that it would be impractical to fully ensure there is no double or over-recovery between the FLA and copper services<sup>26</sup>, but it is equally not in end user interests for the BBM to be blind to the potential.
- 34. 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 cross-check. A TERA type cross-check is feasible<sup>27</sup> and, while not a trivial exercise, it is a reasonable means to validate the draft BBM results and significant \$1.4B FLA claim.
- 35. Chorus has remained highly profitably through the UFB programme, and the Commission proposes to add \$1.4B of returns to Chorus. Under these circumstances, double recovery remains a significant concern – and the Commission should be validating BBM outcomes to ensure this hasn't occurred. The Commission committed to managing this risk actively and must follow through on that commitment.

<sup>25</sup> IMs reasons paper at 4.155 to 4.160. For example, by allocating marketing on future benefits rather than current employed demand.

<sup>26</sup> Reasons Paper at 3.381

<sup>27</sup> For example, Ireland Wallace & Associates applied a not totally dissimilar economic profitability analysis framework to Meridian Energy to test outcomes achieved in electricity markets. The Commission further holds the underlying information and FLA financial model that could be applied to the issue.

## Draft decision on IM amendments

36. The Commission is also further consulting on proposed IM amendments. For completeness, as noted above, we do not support amending the IM to compensate Chorus for holding notional fibre tax loss credits (against which it could offset against future profits):

- a. This is not correcting for a mistake in the IMs<sup>28</sup> – the Commission made a conscious choice in the IMs not to apply the time value of holding the credits - and this is a material change to that approach.
- b. Chorus did not incur costs to hold tax loss credits as, in practice, they have been immediately off set against other taxed profits from other services (reducing its tax from what it would have otherwise paid). This is what any multi-service firm in a competitive market would do.
- c. The Commissions' original IM decision - which it acknowledged would increase prices for end users – assumed that tax losses would not be material. The Commission considered that aligning notional fibre tax loss credits with Chorus actual tax would be complex and outweighed any benefits of resolving for suspected immaterial losses.
- d. We now know that notional fibre tax losses are material – increasing end user costs and adding over \$80M to the RAB - and the Commission should consider its wholistic approach to tax loss credits. There are material implications for consumers and the Commission should – consistent with the approach signalled in the IMs - align with Chorus' group tax position by taking the benefit of the tax loss at the time it was incurred (or there about).
- e. The proposed amendments – which are only required to implement revised treatment of tax loss credits – introduce uncertainty in themselves and require complex and essentially arbitrary methodological choices.

37. Further, we do not support proposed IM amendments to codify the wash-up. The wash-up was considered through the IM process and decision made at that time not to detail the wash-up in the IMs, but to do this through the PQ process. Accordingly, the proposal is not addressing a mistake and we are not aware of any new circumstances that require an amendment to the IMs. We believe that this is an issue that the Commission should come back to prior to the second regulatory period when the Commission is looking to set efficient incentives for the second regulatory period. Specification of the wash-up is one of the tools by which the Commission can set these incentives and it should avoid locking in any particular approach prior to that review.

38. If the Commission anticipates amending the IM wash-up provisions, it should also consider the relevant IM submissions on this issue. For example, Vocus reiterates its concerns with an unlimited wash-up in its July submission<sup>29</sup>, and there were a number of other submissions through the IM process suggesting a bounded wash-up to better allocate risk. If the Commission does decide to specify the wash-up in the IMs, it should consider these earlier submissions in this process.

**[End]**

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<sup>28</sup> Draft IMs amendment decision at page 20

<sup>29</sup> Vocus submission on proposed IM amendments 8 July 2021 at 24