

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

By email: [infrastructure.regulation@comcom.govt.nz](mailto:infrastructure.regulation@comcom.govt.nz)

20 December 2023

Dear Keston

## **Chorus – Recommendation of improvements to price path mechanics for PQP2**

### **Introduction**

1. The purpose of this letter is to recommend changes to the mechanics of the revenue path that applies to Chorus for PQP2, in order to address some unexpected outcomes and complexities we have experienced in PQP1. We signalled in our submission on the Process and Approach consultation that we would be providing this information.<sup>1</sup> Our aim is to ensure the revenue path is predictable and workable, allowing Chorus an ability to earn a normal return while meeting the needs of FFLAS end-users.
2. This letter includes information about Chorus' current intention to move to a 1 January pricing year from 2025. The core driver for this change is that the gap between forecast total FFLAS revenue and forecast allowable revenue in our most recent CY24 price compliance statement (**PCS**) prevents us from making our annual CPI-related price change to our core FFLAS products on 1 October 2024 despite a large positive wash-up balance from CY22 being in place. As such, we need to defer the price change until the next available date.
3. We wanted to provide information about our pricing compliance situation to you as soon as possible. However, the planned change to our pricing year has not been publicly announced and is confidential and commercially sensitive until we communicate the change to RSPs, likely by June 2024. Accordingly, this letter should not be publicly released until after that announcement – we believe this should be manageable for the Commission as the letter can still be published in a timeframe that is consistent with the draft decision on Chorus' price-quality path.
4. We also request that if the Commission intends to disclose this information or this letter to any third party under the Official Information Act 1982, that you first notify us so that we can consider our response and take any action as appropriate.

### **Recommendations**

5. In summary, we **recommend**:
  - 5.1. As previously raised with the Commission, extending the CPI-wash-up mechanism to include year 1 of a regulatory period. This could be implemented by way of an IM amendment or an amended PQ

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<sup>1</sup> Chorus Limited, *PQP2 Process and Approach*, 28 September 2023, pages 5 and 18.

determination. This would enhance certainty and incentives to invest by creating confidence that Chorus will be able to recover the costs of its investments and operating costs irrespective of variation in expected inflation during the regulatory period.

- 5.2. Adopting a lagged measure of CPI for pricing compliance purposes in PQP2 (using actual CPI for the year ending June in the calendar year in which the PCS is submitted). This addresses the current mismatch between in-market expectations of changes to fibre prices, the anchor service regulation requirements and the limits placed on prices under the PQ determination for PQP1. It adopts actual measures of CPI (avoiding reliance on forecasts) and enhances pricing predictability for Chorus and its customers.
- 5.3. Requiring an annual PCS, for all years other than the first year of a regulatory period, no later than 31 December prior to the regulatory year in question. For the first regulatory year, a pricing compliance statement should be required within 6 months of the start of that year. This better aligns compliance forecasting processes with Chorus' intended new fibre pricing cycle of January, gives sufficient time for Chorus to adjust FFLAS prices to ensure compliance, and results in more workable requirements.
- 5.4. Not requiring a mid-year PCS. This would improve the effectiveness of the current requirements and remove unnecessary compliance costs.

### **Implementing a CPI wash-up for year 1**

6. As has been acknowledged in correspondence between Chorus and the Commission during 2022 and 2023, there is no clear wash-up available for variations between actual and forecast inflation in the first year of a regulatory period. This is inconsistent with the treatment of inflation in other years of a regulatory period, and there is no policy or principled reason to allocate all inflation forecasting risk to Chorus in year 1 and to end-users in other years.
7. The IMs, PQ determination and wash-up notice should apply a consistent inflation wash-up across all years of a regulatory period.<sup>2</sup> As noted in our submission on the Commission's Process and Approach Paper, a first-year wash-up for Chorus could be implemented by way of an IM amendment, or a refinement to the PQ determination (eg by specifying the year 1 revenue cap net of CPI).<sup>3</sup>
8. We **recommend** addressing this shortcoming (which exposed Chorus to an economic loss for PQP1 that has not been resolved) to enhance certainty and incentives to invest. Addressing this issue improves confidence that Chorus will be able to recover the costs of its investments and operating costs irrespective of changes to inflation expectations during a regulatory period.<sup>4</sup>

### **Updating maximum allowable revenues in-period for inflation**

9. The unexpectedly high inflation environment for PQP1 showed that the inflation forecasts used to update maximum allowable revenue (**MAR**) in-period for pricing

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<sup>2</sup> The Commission has extended the wash-up to include the first year of a regulatory period for firms regulated under Part 4 of the Commerce Act 1986: Commerce Commission, Financing and incentivising efficient expenditure during the energy transition topic paper, Part 4 Input Methodologies Review 2023 – Final decision, 13 December 2023, Topic 4b.

<sup>3</sup> Chorus Limited, *PQP2 Process and Approach*, 28 September 2023, page 45.

<sup>4</sup> As noted in our submission, the solution we propose applies for PQP2 onwards, and does not resolve the failure to compensate Chorus for the inflation spike in the first year of PQP1, which continues to have the effect that we will never be able to make a normal return on our investments that were in the regulatory asset base at that time.

compliance purposes can become materially out of step with pricing expectations established with our fibre customers and by the market.

- 9.1. The mismatch arises from MAR being updated each regulatory year in the PQ pricing compliance statement using the most recent Reserve Bank forecasts of annual CPI (January - December of the following year),<sup>5</sup> whereas commercial fibre prices are generally expected to increase by lagged actual CPI (July – June of the year prior), consistent with the anchor service price cap.<sup>6</sup>
- 9.2. Differences between forecast and actual CPI on MAR are eventually washed-up, however the in-period MAR changes that rely on Reserve Bank forecasts can be insufficient to accommodate commercial fibre price adjustments calculated using actual lagged CPI – leading to the situation described in paragraph 2 of this letter where price increases expected by the market have been deferred. This makes fibre pricing less predictable for Chorus and its customers. The inconsistency between a forecast CPI used for updating the MAR in-period, and a lagged CPI used for updating the anchor service price cap, also creates practical difficulties and unexpected outcomes.
10. We **recommend** that in-period updating of the MAR for pricing compliance purposes for Chorus is instead achieved by applying actual lagged CPI (ie, year ending June in the year in which the pricing compliance statement is submitted). This aligns with market expectations of fibre pricing and the anchor service price cap and eliminates reliance on forecasts of CPI for pricing compliance purposes. There is regulatory precedent for this approach as lagged CPI for pricing compliance purposes has been applied to EDBs/GPBs and the Commission originally suggested a lagged CPI be applied for Chorus for PQP1.
11. For the avoidance of doubt, we are proposing that the inflation forecasts implicitly or explicitly used initially in setting initial building blocks allowable revenues, and for any in-period smoothing of the MAR, would remain unaffected by this change.
12. Alternatively, if the Commission does not agree with the above recommendation, we would seek a mechanism where an in-period draw-down of the wash-up balance can be achieved to avoid unnecessary pricing constraints caused by CPI forecasting and to help avoid price shocks (up or down) at the following reset if a large wash-up balance is developed. This would need to be carefully designed to avoid creating pricing volatility that would be difficult for Chorus to manage given competitive constraints – an automatic draw-down mechanism like the one that applies to EDBs would not be practicable.
13. A further alternative we considered was the new method to apply to the regulated electricity sector, where in-period updates to MAR for pricing compliance purposes would revise prior MARs for that regulatory period using the most recent CPI information from the Reserve Bank (including actual CPI where available).<sup>7</sup> For these businesses, the in-period estimation of current year MARs should better align with actual inflation out-turn. If applied to Chorus, however, it would not eliminate the mismatch with actual lagged CPI used to calculate Chorus’s customer revenues and cap anchor prices. It would therefore not be sufficient to eliminate the problem experienced in PQP1 (which could be recurring through PQP2 and beyond).

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<sup>5</sup> Fibre Price-Quality Path Determination 2021, Schedule 1.

<sup>6</sup> An annual price increase based on a July – June measure of actual inflation is consistent with maximum prices specified for the broadband anchor service, voice anchor service and large-user direct fibre access service under the Telecommunications (Regulated Fibre Services) Regulations 2021.

<sup>7</sup> Commerce Commission, Financing and incentivising efficient expenditure during the energy transition topic paper, Part 4 Input Methodologies Review 2023 – Final decision, 13 December 2023, Topic 4b.

## Timing of annual price compliance statement

14. As mentioned in paragraph 2 of this letter, Chorus intends to move to a 1 January date for our annual price changes, which would apply to all of our major FFLAS products (rather than 1 October). This simplifies compliance processes by better aligning forecasts of FFLAS revenue with the regulatory year of 1 January – 31 December. It also avoids the need for a mid-period PCS as price changes will be known in advance of the regulatory year and included in the annual PCS.
15. Requiring a pricing compliance statement in August (the current requirement for years in PQP1 other than the first year of a regulatory period) is only suitable for the current price change cycle and does not provide flexibility to adjust our pricing practices.
16. We **recommend** that for PQP2 a pricing compliance statement is required (for all years other than the first year of a regulatory period) no later than 31 December immediately prior to the regulatory year in question. The statement should be based on forecasts of associated quantities at the time the applicable FFLAS prices are determined.
17. For the first year of a regulatory period, we **recommend** a pricing compliance statement is required within 6 months of the start of that regulatory year to give sufficient time for Chorus to adjust FFLAS prices to ensure compliance if necessary. Alternatively, the Commission would need to make the final price-quality decision sufficiently early that Chorus has time to consult with customers and notify a price change for the start of the first regulatory year, or the Commission would need to commit to not requiring Chorus to reduce revenues in the first year of PQP2. This is because the current plan to determine the price-quality path for Chorus in late CY24 does not give Chorus enough time to adjust prices to comply with the new MAR in time for the start of PQP2.
18. These changes would better align with Chorus' commercial pricing practices, result in a more workable compliance requirements and be consistent with equivalent timing requirements for price compliance statements under Part 4 of the Commerce Act.

## No need for a mid-year price compliance statement

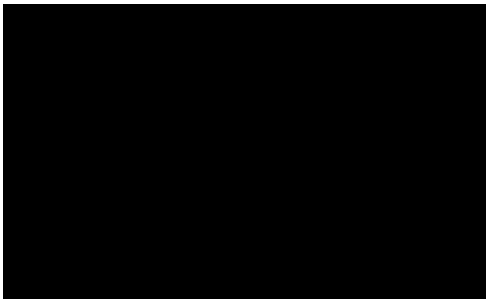
19. The PQP1 PQ determination requires a new PCS to be submitted if Chorus intends to change the price of an existing FFLAS product, or to introduce a new FFLAS product that is materially the same as an existing FFLAS product.<sup>8</sup> The intention is to demonstrate compliance with the annual revenue cap if FFLAS prices are revised for part of a regulatory year.
20. Chorus' move to a 1 January cycle for customer pricing purposes, together with the restriction in our customer contracts on increasing prices more than once in any 12-month period, means that annual price increases for PQP2 will be captured in the annual PCS. Experience during PQP1 has shown:
  - 20.1. Material price changes for any product have not occurred outside Chorus' annual pricing cycle, and any changes that have occurred have been de minimis and not included any core FFLAS products, as will be apparent from an assessment of the mid-year compliance statements Chorus has produced.

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<sup>8</sup> Fibre Price-Quality Path Determination 2021, clause 9.1; Schedule 3

- 20.2. Disclosure of prices for all products occurs in advance of prices taking effect so will be transparent to interested persons; and
- 20.3. The preparation of a new PCS involves considerable administrative effort and costs, including the re-forecasting of affected product quantities and director certification by Chorus. There are also costs incurred by the Commission in receiving the PCS.
21. Lastly, any differences between allowable revenues and the FFLAS revenues derived by Chorus (as ultimately determined under the revenue cap wash-up calculations) are publicly disclosed as part of Chorus' information disclosure regulation. They are also included in the wash-up accrual which is returned to Chorus/customers via the MAR in future regulatory periods.
22. Accordingly, we **recommend** not requiring a mid-year PCS as there are no benefits to end-users of demonstrating compliance under a mid-year PCS, but the mid-year PCS creates compliance costs. This recommendation would improve the effectiveness of the current requirements.
23. If you have any questions in relation to this letter, please do not hesitate to contact me.

Yours sincerely,



Regulatory and Policy Affairs Manager  
**Chorus**