

20 May 2021

Mr Andrew Riseley
General Counsel
Commerce Commission
BY EMAIL

Dear Andrew

DETERMINING CHORUS' FIRST FIBRE PRICE-QUALITY PATH: PROCESS UPDATE

I am writing in relation to the process update paper published by the Commission on 30 April 2021, and particularly the proposal to base PQP1 allowable revenue on a 'draft initial PQ RAB'. As discussed with you when we met on 11 May 2021 Chorus has significant concerns regarding the Commission's proposals. We are concerned that this approach may be unlawful and exposes Chorus, its shareholders and investors to an unacceptable level of commercial uncertainty.

While we accept that some form of transitional initial RAB is unavoidable (as we acknowledged in our submissions in the course of the IMs process), the true-up between transitional and final RAB should be narrowly confined, and meaningful consultation on the draft initial PQ RAB is essential before it is incorporated into the PQP1 determination.

We acknowledge the positive engagement with Commission staff on 19 May. This engagement goes some way to addressing the concerns that we set out in this letter. However, given the informal nature of the engagement on these matters to date, and the significance of these issues for Chorus, we consider it important that Chorus set out its concerns formally. Our intent is that these concerns can be better understood by the Commission, so we can continue to work constructively towards resolving them. We suggest the Commission engage urgently with Chorus and other stakeholders on a short list of matters that will be subject to the true-up of the transitional initial RAB so that Chorus can move into PQP1 with a greater level of certainty than the Commission is proposing.

The significance of the initial RAB decision

At our meeting on 18 May 2021 the Commission expressed surprise that a final RAB was so critical for Chorus. From Chorus' perspective, this late into the implementation of the regime, and noting the extensive submissions we have made on this point, it is disappointing to us that the Commission does not seem to appreciate the impact of key aspects of the regime on Chorus.

We have, since the outset of the IMs process, emphasised: (a) the importance to Chorus, investors and other market participants of gaining certainty as early as possible regarding the value of the initial RAB, and (b) the level of challenge involved in setting the initial

RAB. For those reasons, as far back as December 2018 we asked the Commission to prioritise the initial RAB and set out a clear process and timetable to achieve this¹.

We summarise the points made in our meeting of 18 May 2021 on the significance of the initial RAB:

- From a shareholder perspective, the initial RAB is one of the key drivers of the valuation (share price) of Chorus. Regulated entities are frequently valued on the basis of a 'RAB multiple', whereby the total value of the company is calculated by reference to a multiple of the RAB. The logic for this is that the RAB represents an independent, regulated value of the business over the life of the asset. The absence of a final value requires investors to speculate on what the RAB might be, which adds uncertainty and volatility.
- Investment markets dislike uncertainty. Any extension in the determination of the initial RAB and its implications for future revenues means Chorus' shareholders will be affected by uncertainty for longer. This has a direct impact on the value of their investment. Direct feedback from market participants, including international infrastructure funds that are not current shareholders, is that Chorus is currently "not investible" and that they are "staggered" there is still uncertainty.

This sentiment is reflected in the following analyst commentary:

Even at this late stage in the regulatory process, the outcome of CNU's UFB RAB and MAR remains uncertain. And given CNU is a long-dated business with substantial operating and financial leverage, any assessment of the company's fundamental value, cash flow and dividends can still vary with seemingly modest variances in the outcome.

A final initial RAB also provides certainty to financiers and credit rating agencies, which promotes cheaper and more flexible funding structures. This could be important for being able to achieve the cost of capital set for PQP1.

The Commission's proposed approach may be unlawful and results in unacceptable level of commercial uncertainty

The IMs contemplate a transitional initial RAB to account for the fact that the initial RAB is established as of 1 January 2022, and the Commission is required to determine PQP1 prior to that date. The IMs oblige the Commission to determine the initial RAB based on:²

- *actual* asset-related values prepared in accordance with GAAP and s 177 of the Act, where those actual values are available; and
- *forecast* values where actual values are not available in respect of any disclosure year or part thereof.

In responding to the Commission's IMs consultation, we were comfortable that the Commission would have to forecast asset-related information in 2020/21, and that any

¹ Chorus, *Submission in response to the Commerce Commission's invitation to comment on its proposed approach to the new regulatory framework for fibre dated 9 November 2018* (21 December 2018) at paragraphs 23, 61 and following.

² Clause 3.3.1(8).

differences between forecast and actual values would be washed-up in the course of either the first or second regulatory period. We had understood that would be the extent of the transitional process.

However, the Commission's process update states it is now proposing a more extensive exercise that includes "updating" its determination of historic asset-related values following further scrutiny in the course of 2022. Furthermore, the Commission is proposing to use its draft initial PQ RAB as the opening RAB input for the PQP determination without any consultation on that input³. The result is that Chorus' allowable revenue for PQP1 will be based on an initial RAB that: (a) is entirely provisional, and (b) has not been subject to consultation.

The Commission has recognised that IM amendments are required to give effect to this proposal. While we note that the Commission flagged the possibility of "updating" actual asset values in its September 2020 process and approach paper,⁴ our view is the IMs currently do not permit that. The Commission evidently shares that view as it is proposing to amend clause 3.3.1(8) to replace references to "actual" values with "estimates of historic values". But, given the Commission only proposes to make a decision on IM amendments in August 2021, the Commission appears to be presenting this revised approach as a *fait accompli*.

Chorus and the Commission have a shared interest in ensuring that the initial PQ RAB determination has a firm legal basis. The initial RAB is a critical input for all future price-quality determinations and will therefore be the subject of close scrutiny from all market participants. Any uncertainty regarding the legal basis for the initial RAB is of great concern to Chorus.

The Commission's proposed approach is potentially unlawful for at least three reasons:

1. *It effectively defers a determination the Commission is required to make prior to the implementation date.* The Commission is required to make a s 170 determination before 1 January 2022 specifying how price-quality regulation applies to Chorus.⁵ In making that determination, the Commission must apply the relevant IMs.⁶ The asset valuation IM must be determined in accordance with s 177, which in turn specifies a valuation methodology that requires the Commission to determine the actual costs of fibre assets.⁷ Read together, the effect of these provisions is that the Commission must determine an initial RAB based on actual asset-related values, applying s 177, before the implementation date. Determining a transitional initial RAB based on estimated values, with further scrutiny to follow after 2022, either amounts to: (a) determining an IM that fails to comply with s 177, or (b) deferring an exercise that Parliament expected the Commission to complete prior to the implementation date.
2. *The Commission is required to consult on the key inputs to its PQP1 determination.* It is a fundamental requirement of administrative law that the Commerce Commission consult with interested parties before making a determination that affects their rights or interests. To be meaningful, that consultation must provide an opportunity to comment on the key inputs into the Commission's PQP determination.

⁴ Para 5.137.

⁵ Section 172.

⁶ Section 175.

⁷ Sections 176 and 177.

Of those inputs, few are more critical than the initial RAB. The Commission's process update indicates that the Commission is proposing not to consult on its draft initial PQ RAB before finalising the PQP1 determination. We have separately been told informally (at the staff level meeting yesterday) that the Commission will consult in August and take that into account in making the PQP1 determination, albeit it won't reach any final views until 2022. The informal indication we have received does not describe a meaningful consultation exercise. The Commission will doubtless respond that any differences will be washed up in the second regulatory period. However, this ignores Chorus' (and other stakeholders') legitimate interest in the prices that will apply for the next three years, and also the competitive constraints on fibre prices, which mean that if the final initial RAB is higher than the transitional initial RAB, we may not be able to recover the washed-up values in future regulatory periods.

3. *Consultation on IMs amendments does not appear to allow for the Commission to change its mind.* The Commission has indicated that it will make a decision on IMs amendments in August 2021. While in principle the Commission could determine not to proceed with the IMs amendments and instead consult on a final initial RAB value in 2021 or revert to an approach where only forecast values are subject to a subsequent 'updating', its process does not afford a realistic period for the Commission to consult on the final initial RAB this year or to revert to its prior approach with adequate consultation if the Commission decides to do this.

The Commission's proposed approach also results in an unacceptable level of commercial uncertainty. As the Commission knows, and as reiterated above, the initial RAB is a key driver of Chorus' allowable revenue across multiple regulatory periods, and therefore of the value of the business. This is of critical importance to shareholders and investors, and in turn influences Chorus' ability to plan and invest in its network. Chorus has emphasised the importance of gaining certainty of the RAB since the outset of the IM process, and highlighted the challenge of setting the RAB and the need for this to be prioritised by the Commission, with a clear process and timeline to achieve this.⁸

The Commission chose not to expedite the process of determining the initial RAB and, as a consequence, now finds that it is pressed for time. That is disappointing, particularly given the Minister has already, at the Commission's request, extended the implementation date by the two-year maximum period permitted by the Act.

The transition to a building blocks model of regulation was decided by Cabinet in April 2016. The consequence is that Chorus, its shareholders and investors have now spent five years waiting for certainty regarding the critical driver of the business' long-term value. We had expected that, at the latest, we would have certainty regarding the majority of this key input by late 2021. The Commission's proposal means that we will have to wait another year for certainty on the value of the initial RAB. Furthermore, our revenues in the first regulatory period will be contingent on a wash-up of the initial RAB in the next period. For the first regulatory period, we will have to run our business on the basis that the Commission will apply an ex post adjustment to revenue of unknown magnitude. That is an unacceptable level of uncertainty against which to operate the business.

⁸ Chorus, *Submission in response to the Commerce Commission's invitation to comment on its proposed approach to the new regulatory framework for fibre dated 9 November 2018* (21 December 2018) at paragraphs 23, 61 and following.

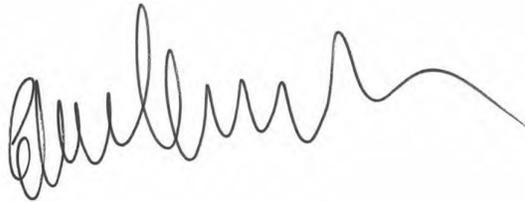
Next steps

Proceeding with the proposed course of action exposes the PQP1 determination to a risk of legal challenge, and results in an unacceptable level of commercial uncertainty. To mitigate this risk, we ask the Commission to:

- confine narrowly the matters that may be revisited between the transitional and final initial PQ RABs. In our view, those matters should be limited to differences between forecast and actual asset-related values required to calculate the initial RAB; and
- conduct a meaningful consultation on the draft initial PQ RAB before incorporating it into the PQP1 determination.

We suggest the Commission urgently engage with Chorus and other stakeholders on a short list of matters that will be subject to the true-up of the transitional initial RAB. We are available at your convenience to discuss this further.

Yours sincerely



Elaine Campbell | Chief Corporate Officer and General Counsel

C H ● R U S | T +6499752983 | M +6421940329