Submission on the Commerce Commission's fibre input methodologies – draft decision reasons paper (regulatory processes and rules) dated 2 April 2020

29 May 2020

OVERVIEW

1. We welcome the Commerce Commission's consultation on its *Fibre input methodologies: draft decision – reasons paper (regulatory processes and rules),* published on 2 April 2020 (**Reasons Paper**). This consultation represents an important step towards providing clarity on the rules and processes for price-quality regulation (**PQR**), and key operational components of the new fibre regime.

2. Our objective is to support the Commission's development of an incentives-based regime, and ensure the transition provides for fair returns for investors with no shocks to consumers, and sufficient predictability to support ongoing investment, innovation and growth of fibre services. Key to this is ensuring the right balance between certainty and flexibility, where we expect an appropriate level of certainty to be delivered through the input methodologies – which for the purposes of this consultation are the regulatory process and rules input methodologies (**RPR IMs**).

3. As outlined in our submission on the RPR topic paper,[1] we seek certainty where the legislation specifies requirements, but the Commission is yet to confirm its interpretation on key framework issues. In the context of the RPR IMs, the key issue is how the wash-up mechanism will work, and how this might interplay with other key aspects of the regime such as the incentives naturally embedded in a Building Block Model (**BBM**) regime.

4. The purpose of IMs is to promote certainty in relation to the rules, requirements and processes applying to the regulation of FFLAS.[2] The Commission's Reasons Paper provides upfront certainty in a few areas, such as confirming that maximum revenues will be in the form of a revenue cap with a wash-up, industry levies will be a recoverable pass-through cost and that there will not be an expenditure incentive mechanism for the first regulatory period (**RP1**).

5. However, the Commission either defers the development of key operational details to the PQR stage or avoids further explanation or detail. Ultimately, the IMs will result in the Commission's view of an appropriate balance of certainty and risk. For instance, if the characteristics of the wash-up mechanism are determined at the PQ stage, our understanding of the regime's ongoing incentives, and thereby innovation and investment signals will be unclear until each PQ determination is set.

6. The level of certainty proposed in Reasons Paper creates challenges and makes it difficult for us to properly assess the impacts on Chorus ahead of implementation. Our overall objective is a clear line-of-sight to a fair return on and of our investment. This allows us to continue to invest to meet the growing demands of end-users.

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[1] Chorus, *Submission in response to Commerce Commission's Fibre input methodologies – Regulatory processes and rules topic paper*, (19 August 2019), at [2].

[2] Section 174, Telecommunications Act 2001.

7. The level of certainty currently proposed could reflect the constrained timetable the Commission is operating under. However, flexibility and certainty could be provided under a principles-based approach to setting IMs (where appropriate), with the details specified in PQR.[3]

8. To this end, and consistent with Chorus' overall position on the IMs, our submission draws on key principles which support the Commission's task under Part 6 of the Telecommunications Amendment Act 2001 (**Act**). These principles guide our response to the Commission's draft decision:

    8.1. **Regulatory certainty and predictability** – the purpose of the IMs is to provide predictability for regulated suppliers, investors and consumers. This includes allowing for change that is reasonably foreseeable and within expectations.

    8.2. **Ability to earn a fair return via real FCM** – the Commission intends to allow the delivery of real FCM across all Part 6 decisions but it's not clear how this will work when key processes are pushed to the PQR stage, and not signalled in IMs.

    8.3. **Departure from Part 4 of the Commerce Act 1986 (Part 4) where appropriate and justified** – our network and commercial circumstances differ from others under a BBM regime. This should be reflected in the IMs under Part 6, diverging from Part 4 where it is justifiable.

    8.4. **Incentives based regime** – the underlying policy intent is to provide for regulatory stability while also providing incentives to invest and innovate, as well as flexibility to meet consumer demands and the rapidly changing technology landscape.

9. With the above in mind, we **agree** with the following draft decisions:

    9.1. That the IM for price specification will specify maximum revenues in the form of a revenue cap with a wash-up;

    9.2. To include telecommunication levies (**levies**) as pass-through costs and to clarify their treatment in the pre-implementation period as operating expenditure;

    9.3. The circumstances under which a PQ determination can be reopened or reconsidered (however we do not support the proposed 1% revenue threshold);

    9.4. Applying a regime with natural incentives for RP1; and

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[3] Chorus, *Submission in response to Commerce Commission's Fibre input methodologies – Regulatory processes and rules topic paper*, (19 August 2019), at [3]; 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 [151]-[153] and page 61, Q14 response.

9.5. Applying a calendar year for the regulatory balance dates and information disclosure years.

Key recommendations

10. We recommend the Commission makes the following changes to provide a more balanced IM framework that implements the principles above, and supports an enduring regime (see **Appendix A** for a summary of our proposed drafting changes):

10.1. **Pass-through and recoverable costs** – consistent with Part 4, the final IM should provide for the possibility of future unforeseen costs to be passed through; pass-through costs should include local authority rates (**rates**) and disputes resolution schemes; and recoverable costs should provide for auditor / verification and self-insurance costs. The Reasons Paper doesn't explain why the Commission has departed from Part 4. We have no more control over these costs than other regulated industries;

10.2. **Wash-up mechanism** – the final IMs should provide certainty and clarify how the wash-up will be applied to ensure suppliers can earn a fair return. This could be achieved through principles to preserve flexibility at the PQR stage. That is, principles regarding which of the inputs to the Maximum Allowable Revenue (**MAR**) (i.e. building blocks, allocations, foreign exchange rates and CPI) will wash-up, and over what periods our revenue wash-ups will be recovered. This is important for ensuring a clear line-of-sight to FCM, and to provide for a regime that incentivises investment and innovation in the long-term interests of consumers;

10.3. **Revenue smoothing** – the final IMs should provide for revenue smoothing between regulatory periods and between years (within a regulatory period). This will help ease price shocks, which is beneficial for consumers and is also required for cost recovery. Additionally, revenue smoothing via altered depreciation is for us to propose in our expenditure proposal. This means we need to know the upfront rules of how these decisions (smoothing and depreciation) will work together;

10.4. **Reconsideration circumstances** – where relevant, the thresholds used should be cost-based as follows: 5% of opex and 20% of capex (individually), or 10% of total expenditure, if that is lower; rather than an aggregate maximum revenue threshold of 1%. This would achieve the same materiality outcome as the revenue threshold but improve the consistency, clarity and predictability;

10.5. **Incentives** – we recommend the Commission consults on a balanced efficiency incentive regime for RP2. We note the link between the wash-up mechanism and a regime with natural incentives. In the absence of certainty around the operation of the wash-up, we cannot properly assess the impacts on our ability to plan and maintain line-of-sight to FCM; and

10.6. **Amend the definition of "total FFLAS revenue"** – we think the Commission intends this to mean "forecast total FFLAS revenue" and should amend the IMs accordingly for clarity. We also recommend clarifying the definition to adjust

forecast total FFLAS revenue in accordance with accounting standards for discounts and rebates taken up by consumers.

PRICE SPECIFICATION AND REVENUE IM

Overview

11. The Price Specification and Revenue IM will help determine how the Commission embeds key principles to govern an enduring regulatory framework, including how costs are treated over time to enable the recovery of a fair return via real FCM and investment in services, for the long-term benefit of consumers. The level of upfront certainty provided via this IM will set the balance of risks and opportunities. For instance, if the characteristics of the wash-up mechanism are determined at the PQR stage, our understanding of the regime's ongoing incentives, and thereby innovation and investment signals will be unclear until each PQ determination is set.

12. Early clarification, where appropriate, is paramount for Chorus. Unlike other regulated suppliers, anchor products and other constraints will limit our ability and flexibility to manage the risk of under-recovery. A clear understanding of the risk, even at a principled level, in the final IMs will help Chorus and stakeholders understand how this risk will be managed across regulatory periods to support a stable regime. This is particularly relevant in the face of the economy-wide uncertainties we face transitioning into a new regime.

13. With this in mind, we request the Commission reconsiders the proposed trade-offs between upfront certainty and flexibility. This is because consumers benefit from a supplier who has a clear line-of-sight of investment opportunities and their ability to earn a fair return. This includes certainty and consistency in the treatment of costs across industries, where any divergence from relevant precedent should be appropriately justified.

14. For these reasons we support the following Commission decisions:

    14.1. To specify maximum revenues in the form of a revenue cap with a wash-up amount; and

    14.2. To include levies as pass-through costs and to treat pre-implementation period levies as opex, which will include them in the calculation of the financial loss asset.

15. However, we disagree with the Commission's decision to:

    15.1. Depart from Part 4 and exclude rates, disputes schemes as pass-through costs, and exclude a process for including new pass-through costs if / when they arise;

    15.2. Depart from Part 4 and exclude a separate recoverable cost category, which would preclude the classification of self-insurance, audit and verifier fees as recoverable costs; and

    15.3. Defer giving clarity on the wash-up and revenue smoothing mechanisms until the PQR process.

16. We **recommend** the Commission make the following changes to improve the balance of certainty and flexibility of the Price Specification and Revenue IM:

16.1. **Pass-through and recoverable costs** – amend the criteria for determining costs that can be passed through in light of its own Part 4 precedent, and amend the pass-through cost IM accordingly:

16.2.1 Provide for the possibility of future unforeseen costs to be passed through;

16.2.2 Pass-through costs should include rates and disputes resolution schemes; and

16.2.3 Recoverable costs should provide for auditor / verification and self-insurance costs.

16.3 **Wash-up mechanism** – the final IM should clarify how suppliers can earn a fair return by including statements of principles that guide the operation of a symmetric and unconstrained wash-up mechanism.

16.3.1 We seek clarity around certain MAR inputs, i.e. building blocks, allocations, CPI and foreign exchange rates, and over what period(s) the revenue wash-up will be recovered.

16.3.2 This would provide the certainty Chorus and stakeholders require ahead of the transition to PQR and support forward-planning, while also preserving flexibility for further details to be determined at the PQR stage.

16.4 **Building blocks and revenue smoothing** – the final IM should provide for revenue smoothing between regulatory periods and between years (within a regulatory period).

16.4.1 This will help ease price shocks, which is beneficial for consumers and is also required for cost recovery.

16.4.2 Revenue smoothing via altered depreciation is for us to propose in our expenditure proposal. This means we need to know the upfront rules of how these decisions (smoothing and depreciation) will work together.

16.5 **Amend the total FFLAS revenue definition** – we think the Commission intended clause 3.1.1(1) definition to mean ***forecast* total FFLAS revenue** and should amend the IM accordingly. We also recommend clarifying the definition to adjust forecast total FFLAS revenue in accordance with accounting standards with respect to rebates and discounts taken up by consumers.

Pass-through and recoverable costs – criteria and divergence from Part 4

17 We recommend the Commission adopt an approach to IMs consistent with Part 4 unless there is a good reason to depart. There's no difference in the level of control we have over levies, rates and certain disputes resolution costs compared to other regulated suppliers, and therefore we don't see any reason to depart from Part 4.

18 The Commission has departed from its previous approach in other industries and applied a different distinction between pass-through and recoverable cost categories which means:

18.2 Pass-through costs are those which are outside the control of the regulated supplier; whereas

18.3 Recoverable costs permit the pass-through of costs that are not entirely outside of the supplier's control (subject to discretionary approval by the Commission).

19 The Commission, in its draft decision, has concluded that a recoverable cost category isn't required because the only cost it has decided to pass-through is levies. However, the Commission has reached this conclusion by excluding rates, disputes resolution schemes, self-insurance, audit and verifier fees on the basis that they are somewhat controllable by the supplier. In doing so, it has assessed these costs solely against the criterion for pass-through and has consequently excluded them, rather than asking: (i) should these costs be directly passed through; and (ii) if not, should they be recoverable costs subject to the same approval process.

20 The experience under Part 4 has demonstrated the value of the recoverable cost category. Where costs are largely outside of the supplier's control (albeit somewhat controllable) and challenging to forecast at the outset of a regulatory period, the appropriate approach is to allow the supplier to pass those costs through to prices. The alternative is to expose the supplier to risk that it is not well placed to manage.

Pass-through costs

An enduring regime

21 We support the Commission's decision to include levies as a pass-through cost and welcome clarification on their pre-implementation treatment as operating expenditure, where they will be included in the calculation of the financial loss asset. The regime should also include a process to enable us to add future pass-through costs in order to provide regulatory certainty and predictability.

22 In principle we agree with the Commission's framework for determining pass-through costs. However, the criteria applied by the Commission in assessing pass-through costs go further than the approach taken under Part 4 – in particular, the third criterion requiring the driver of the cost to be foreseeable when the IMs are determined. It is reasonable to assume that costs can arise between determining the IMs and PQ determination, and between IM reviews, that meet the principal criteria for

pass-through and the Commission should be able to deal with this, as it does under Part 4.

23 Under the Part 4 IMs, the Commission has a process for including new costs by allowing additional pass-through costs to be included as part of the PQ determination process.[4] This ensures the Price Specification and Revenue IM is both enduring and provides certainty that processes are in place to deal with changes when they arise.

24 It's unclear why the Commission considers this irrelevant for the Part 6 IMs. In our view the principle equally applies. That is, an enduring fibre regime should allow for future unforeseen costs to be passed through when they arise (that meet the criteria). It seems inefficient to require an IM be amended rather than providing for this circumstance from the outset.

Rates are sufficiently outside our control

25 We do not agree with the Commission that rates do not meet their pass-through criteria and instead, should be included in opex. This is also inconsistent with the treatment of rates under Part 4.

26 In the Commission's 2010 electricity distribution IM reasons paper,[5] the Commission explicitly accepted that rates were sufficiently outside the regulated supplier's control and that pass-through was warranted. However, the Commission's view under Part 6 is that they are sufficiently within Chorus' control and do not qualify as either a pass-through or recoverable cost.

27 The Commission also notes the basis for treating rates as opex rather than a pass-through is to incentivise Chorus to make efficient decisions regarding: (i) whether to rent rather than buy; or (ii) choosing where to locate facilities. However, in practice those incentives don't exist for Chorus because:

27.2 Our network and properties will largely be in place at implementation date and reflect designs agreed through our contracts with the Crown;

27.3 We have no control over the cost of rates going forward as this is solely at the discretion of the city councils;

27.4 In the event these incentives did exist, they would only apply to new assets; whereas the vast majority of Chorus' rates in any given year will be on existing assets (with the majority of our rates cost relating to the network rather than properties). Additionally, Chorus cannot choose year-on-year to convert freehold to leasehold, re-locate or remove network to minimise our rates bill (for example); and

[4] See clause 3.1.2(1)(b).

[5] https://comcom.govt.nz/__data/assets/pdf_file/0019/62704/EDB-GPB-Input-Methodologies-Reasons-Paper-Dec-2010.pdf.

27.5 At an individual asset level rates don't impact our decision making because rate costs are likely to be so small relative to other costs. However, these aggregate to a material cost.

28 Local authority decisions that govern rates are unpredictable and material in nature, and Chorus has no control over how these might change over time. It is therefore appropriate to treat rates as a pass-through cost.

Disputes schemes – participation in BSPAD is sufficiently outside our control

29 Our view is that costs related to participation in disputes resolution schemes (such as Utilities Disputes) should be included as a pass-through cost, because these are beyond the control of network operators.

30 Chorus and other network operators are required to sign up to BSPAD[6] if they wish to exercise property access rights in relation to certain fibre services, under the Act.[7] Scheme membership is compulsory until at least 2026. We recommend the IMs allow for this cost to be passed through which is also consistent with the Part 4 approach.

31 In addition, these property access rights provisions benefit consumers by allowing for a shorter timeframe for the provision of certain fibre services. We cannot see how network operators would avoid exercising these rights.

Recoverable costs

32 As mentioned above, we recommend the Commission adopts an approach consistent with Part 4, by including recoverable costs as a category that can be passed through.

33 We're unsure why the Commission has departed from both its previous position in its 2019 RPR Topic Paper[8] and Part 4. We're particularly interested in the Commission's justification for no longer including audit and verifier fees, and why Chorus' proposed inclusion of self-insurance is disallowed.[9] Consistent with our previous submission:[10]

33.2 **Audit and verifier fees** – are likely to be significantly higher if we are required to undertake an audit twice within a year, given the Commission's

[6] Utility Disputes is the Approved Scheme for Broadband Shared Property Access Disputes (BSPAD) under the Telecommunications (Property Access and Other Matters) Amendment Act 2017. Section 4 of the Utilities Disputes Scheme Document for BSPAD sets out network operators' requirements.

[7] Subpart 3—Access to property, involving rights of multiple parties, to deploy fibre optic media and other technology.

[8] Commerce Commission, *Fibre input methodologies – Regulatory processes and rules topic paper* (19 August 2019), at [31].

[9] The RPR Topic Paper expressly identified audit/verifier fees as likely recoverable costs (paragraph 31). This is not addressed anywhere in the Commission's draft decisions reasons paper.

[10] Chorus, *Fibre Regulatory Process and Rules submission* (9 September 2019), at [42]-[46].

decision on balance dates. While Chorus has some control over the cost (through a tender process) we do not have the choice whether to undertake the audit / verification.

33.3 **Self-insurance** – Chorus does not have a captive insurer and it is not clear how self-insurance costs (including costs below policy deductibles or outside policy scopes) will be treated under PQR. These costs are not likely to be of significant magnitude to warrant a re-opener. If the Commission rejects these as recoverable costs, we recommend they be recognised in a separate opex allowance category.

34 In addition, we understand that Transpower is only able to include self-insurance in its regulatory opex allowance because it has a captive insurer. For Chorus, this would require us to set up a body with a separate Board and governance processes along with additional financial reporting and auditing, resulting in extremely inefficient recovery of these costs. Alternatively, we would need to expand the scope of our external insurance (including reducing deductibles) beyond what we have previously found to be cost-effective. The more efficient approach to self-insurance is to allow for recovery through a recoverable cost category in order to ensure FCM.

Wash-up mechanism

The Commission's approach makes our line-of-sight to FCM uncertain

35 As the requirement for a wash-up mechanism is specified in the Act, we are strongly of the view it is more appropriate to address wash-up principles in the IMs. The purpose of the IMs is to provide regulated suppliers with long-term certainty and predictability, which would be considerably undermined if left to the PQR process. This also makes our line-of-sight to FCM uncertain, reducing confidence and potentially affecting investment, which will ultimately come at a cost to consumers.

36 Section 196 of the Act requires that the Commission apply a wash-up for "any over-recovery or under-recovery" without qualification. Our interpretation of the wash-up mechanism specified in the Act, remains that:[11]

36.2 The wash-up account is symmetric; and

36.3 The wash-up account will be unconstrained (i.e. no caps or collars applied) and wash-up all variations between allowed and actual revenue.

37 This is to align with policy recognition that Chorus has invested ahead of demand, by allowing us to wash-up differences between our MAR and actual revenues for recovery in future periods.

38 A symmetric and unconstrained wash-up mechanism is particularly important in this regime given the range of additional constraints carried over in contrast to other regimes (e.g. anchor and mandatory services), which will constrain Chorus' revenue

[11] Chorus, *Fibre Regulatory Processes and Rules submission* (9 September 2019), at [9]-[13].

and may lead to periods of under-recovery of allowed revenues. Without an ability to carry under-recovery into future periods, real FCM will not be realised.

39 Unlike other regulated suppliers that have flexibility to adjust prices in order to recover their MAR (which means the risk of under-recovery sits with the regulated supplier), Chorus will be subject to price-capped anchor services and other constraints which may prevent us from adjusting prices to meet our MAR. Therefore, there is a greater need for the wash-up to work effectively.

A more balanced approach can be achieved through principles in IMs

40 We seek greater certainty and clarification as to how wash-up related risks will be addressed in the regime as this impacts our forecast of cashflows over the medium term. Certainty could be achieved via principles in the IMs detailing how a symmetric and unconstrained wash-up will be recovered, and over what periods. Our secondary preference would be through some form of guidance or explanatory paper (as the Commission has done in Part 4) ahead of the PQR stage. We agree flexibility of how principles are applied is needed and should be addressed in each PQ process.

41 As presently drafted, the Commission is proposing to address recovery of wash-up amounts only in the PQ determination at the commencement of each regulatory period. The Commission has also not provided any detail as to how wash-up amounts will be applied in each disclosure year, or over regulatory periods. This means that Chorus will have no certainty about how these amounts will be recovered over multiple periods. Period-to-period decisions (through PQ process) on fundamental characteristics, such as timing of wash-up recovery, will have a detrimental impact on our business management. For example, uncertainty regarding the timing of future cashflows affects funding (debt and equity), which in turn has implications for investment decisions.

42 Additionally, certainty on whether and how risks will be mitigated via ex-post allowable revenue will ensure Chorus can appropriately manage risk exposure given economy-wide uncertainties. If these characteristics are left to the PQ process to determine, we'll have insufficient time to properly assess the transitional impacts on us ahead of implementation. We therefore seek clarity on the following, and anticipate the Commission will consult on these in due course:

42.2 Whether the wash-up is the difference between the total FFLAS revenue received and forecast allowable revenue, or some type of *ex-post* allowable revenue;

42.3 If ex-post allowable revenue, then whether that would use ex-post building blocks; allocator metrics; foreign exchange rates and CPI; and

42.4 Whether the difference between forecast and actual value of commissioned assets will be washed up.

43 The wash-up also affects how the regime's natural incentives will operate, and therefore affect the opportunities for Chorus absent an expenditure incentive.

Building blocks revenues

44 We support the Commission's view that the IM for price specification will prescribe a revenue cap to apply from the implementation date, and will ensure Chorus has the ability to earn a fair return and follow GAAP.[12] This is defined in nominal terms, exclusive of GST, and after deducting customer discounts and rebates. However, we seek clarification of the Commission's decision on the definition of the building block calculation, and recommend clarifying that customer discounts and rebates are in accordance with accounting standards.

Revenue smoothing and definition of building blocks calculation

45 Revenue smoothing between regulatory periods and between years (within a regulatory period) should be in scope of the IMs. This will help ease price shocks – which is beneficial for consumers - and is also required for cost recovery.

46 As the Commission notes, smoothing between periods can be accommodated within the Commission's calculation of the BBM via altered depreciation. However, altered depreciation is for Chorus to propose in its expenditure proposal, which means we need to know the upfront rules of how these decisions (smoothing and depreciation) will work together.

47 We also propose that the definition of "building blocks revenue" should provide for revenue smoothing between years. As currently drafted, it simply defines this as the sum of the building block components but does not consider the year-to-year volatility that could arise (for example, due to the Commission's treatment of inflation), which could cause unstable prices for end-users.

48 Therefore, we propose the additional wording (underlined) be added to the definition of "building blocks revenue" to read:

> 48.2 ***Building blocks revenue*** *means the sum of building blocks components (which may have positive or negative values) as determined by the Commission for a regulatory year, and, for the avoidance of doubt, includes a component or components that give effect to the smoothing of revenue under s 197 of the Act <u>and within a regulatory period where the methodology for revenue smoothing is be determined during the PQ determination.</u>*

Treatment of customer discounts and rebates

49 We agree with the Commission's proposal to apply GAAP treatment to revenue. We understand the Commission's intention is to treat customer discounts and rebates as a reduction in revenue, in line with NZ IFRS 15.

50 We recommend the Commission amend the definition of total FFLAS revenue to clarify this intended treatment, as follows:

[12] As required by section 195 of the Act for RP1.

50.1 ***[Forecast] total FFLAS revenue*** *means all revenue derived by Chorus from the provision of regulated FFLAS, in nominal terms exclusive of GST, ~~and must~~ adjusted in accordance with accounting standards to include discounts and rebates taken up by customers.*

51 We note that compliance with NZ IFRS 15 GAAP treatment results in:

51.1 Discounts and rebates are initially treated as an asset; and then

51.2 Amortised against revenue over the implicit or explicit term of the customer contract for the relevant product.

52 Other customer incentives are defined as an expense under GAAP (because they're not a discount or rebate for revenue purposes), and therefore not amortised against revenue, in line with NZ IFRS 15 GAAP treatment.

Forecast total FFLAS revenue

53 Clause 3.1.1(1) of the draft IMs, which relates to the revenue cap, currently specifies that **total FFLAS revenue** must not exceed **allowable revenue**. We think the Commission intends this to be **forecast total FFLAS revenue** and should amend it accordingly. Additionally, the definition will also require amending to reflect the addition of "forecast".

54 As currently drafted, it would require Chorus to be able to perfectly forecast demand ahead of time so that actual revenue did not exceed allowable revenue. Rather, any difference between *actual* total FFLAS revenue and allowable revenue will be washed-up and recognised in following years.

RECONSIDERATION OF A PRICE-QUALITY PATH IM

Overview

55 Overall, we agree with the Commission's draft decision on reopeners and reconsideration circumstances. The proposal achieves an appropriate balance between predictability and flexibility. In particular, we support the proposed flexibility around cyber-security threats that has been included in the definition of catastrophic events.[13]

56 We consider that the most material uncertainties highlighted in our previous submission on this subject[14] have been addressed through the Connections Capex adjustment mechanism and the Individual Capex category in the draft Capex IM.

57 It is essential that we are able to respond appropriately and rapidly to credible and specific threats and we consider there is sufficient flexibility in the proposed IM to enable this. However, we don't support an aggregate revenue threshold of 1% across several reopener and reconsideration circumstances.

58 We also recommend that the IMs should encourage major transactions, as these are likely to enhance efficiency of investment and will therefore be in the long-term interests of consumers.

Monetary thresholds should be cost-based

59 We consider that the application of a monetary threshold should be cost-based, as opposed to revenue-based, across reopener and reconsideration circumstances. We recommend cost-based thresholds of 5% for opex, 20% for capex and 10% on a total expenditure basis, if that is lower.

60 Our reasons for this are:

60.1 **For planning purposes** - we need clarity over the level of cost impacts that will give rise to a PQ reconsideration – and those that won't. There is a complex relationship between revenue and underlying costs, such that the revenue impact can vary significantly depending on whether the costs are opex or capex; and if capex, on the asset lives in question. It would be clearer and more transparent to consider the impact on costs directly; and

60.2 **For catastrophic events** - the draft decision assumes that we are exposed only to the difference between the forecast and recalculated maximum revenues "over the regulatory years of the PQ determination remaining on and after the first date at which a remediation cost is proposed to be or has been incurred".[15] However, the risk also applies to the following regulatory period.

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[13] IM 3.9.1(1).

[14] Paragraph 56 and related table in submission to the 19th August RPR Topic Paper.

[15] IM 3.9.1(1)(d)(iv).

This is because material costs could be incurred at the end of a regulatory period, after a PQ determination has set the maximum revenue for the following period. The proposed drafting also does not take into account the impact on maximum revenue in the subsequent regulatory period as a result of future efficiency incentive arrangements.

61 Rather than introducing complex drafting to cover these scenarios, and to improve clarity, we suggest the threshold is set as a percentage of approved opex and capex (individually), in the *remaining years* for which there is a PQ determination. These thresholds are designed to achieve broadly the same materiality outcome as the revenue-based threshold, but with improved consistency, clarity and predictability. This would allow a straightforward and transparent assessment of the materiality of an intervention and would allow the price path to be reopened if there is a material additional opex requirement and/or capex requirement in the relevant years.

62 Our suggested cost-based thresholds should apply to catastrophic events, legislative and regulatory change events and GAAP changes – unless the GAAP changes relate to revenue recognition rules or criteria, rather than costs incurred by the business, in which case the revenue threshold would still be appropriate.

63 Clarifying the circumstances in which a PQ determination could be reopened or reconsidered is important for understanding how risks related to future changes in circumstance or errors will be managed. It's important to strike a balance of predictability – for planning and risk appetite; and flexibility – for innovation and enduring rules.

Preserving efficiencies in major transactions

64 We also propose an amendment to clause 3.9.7(2) of the draft IMs to take account of the fact that a key rationale for future major transactions is likely to be the potential for net cost reductions. We consider that the incentive to reduce costs should not be removed when resetting the price-path.

65 Major transactions are likely to enhance efficiency and therefore benefit consumers in the long-term. The Commission should seek to encourage such transactions. We propose adding the underlined words below, to the relevant part of 3.9.7(2):

65.1 *The Commission must not amend the price path or quality standards more than is reasonably necessary to take account of the change in costs <u>(subject to, in the case of "major transactions", permitting the transacting parties to retain a reasonable share of the reduction in costs that the transaction may create)</u> net of any insurance or compensatory entitlements resulting from the relevant event or transaction.*

OTHER IM-RELATED MATTERS

Incentives

Balanced incentives for RP2

66 The Commission's draft decision is to not include specific expenditure incentives, which we take to mean specific expenditure incentive mechanisms. In the absence of any details or guidance on how the revenue wash-up will work, we are unable to properly assess the implications of this draft decision. However, we appreciate that there is now insufficient time to develop a balanced incentive regime for RP1.

67 On that basis, we accept the draft decision and recommend the Commission work with us and the industry towards developing a balanced efficiency incentive regime for RP2. This is important for ensuring a regime with incentives to invest and innovate, as well as flexibility to meet consumer demands and the rapidly changing technology landscape.

68 We understand the complexities of creating a balanced incentive, particularly in relation to an Incremental Rolling Incentive Scheme (**IRIS**) for opex,[16] but we look forward to working with the Commission to resolve these issues. It is in the long-term interests of consumers that the regime includes expenditure incentive mechanisms as it matures.

There's a link between the operation of the wash-up and form of incentive

69 The form of the wash-up determines the form of the natural incentives, but we don't yet know what form the wash-up will take. There are several ways in which the wash-up and natural incentives could work in practice. For example, under Part 4, electricity distribution businesses have a natural incentive for both opex and capex while Transpower has only a natural incentive for opex, because capex washes up to ex-post actual cost.[17]

70 We have assumed that there will be a natural incentive for both opex and capex, because the Commission observes that "setting the revenue path against forecast expenditure provides for some financial incentives to operate efficiently",[18] and does not differentiate between opex and capex in doing so. We have also assumed that the natural incentives will be symmetric in respect of costs and savings, for both opex and capex.

71 Ideally, the combination of wash-up and incentive mechanisms would result in opex and capex incentives which are balanced (i.e. have similar rates or sharing ratios) and constant, regardless of when in a regulatory period costs or savings are incurred.

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[16] For example, the base year of RP2 will be at the start of RP1, making a simplified opex IRIS in that case almost impossible to implement.

[17] The base and major capex incentive mechanisms are then added to give effect to the overall capex incentives.

[18] Reasons paper paragraph 137.

Such balanced incentives allow businesses to set business rules for reducing the forecast whole-of-life costs of decisions on a total expenditure basis, in the knowledge that the business will benefit from a share of any savings on a total expenditure basis.

72 In the absence of a balanced incentive regime we will not be able to set these types of efficiency-based business rules and so there will be an impact on efficiency. It is therefore in the long-term interests of consumers that a balanced approach to incentives is developed for RP2.

Regulatory balance dates

73 We accept the Commission's draft decision that the regulatory balance date for all regulated suppliers, and for both Information Disclosure and PQ, will be 31 December. We note the Commission has accepted that there will be additional costs associated with this arrangement.

APPENDIX A: CHORUS PROPOSED AMENDMENTS TO THE RPR IMS

This table summarises Chorus' recommended drafting changes to the Commission's draft RPR IM Determination that are discussed in the body of our submission. Our proposed changes are outlined in red text below.

Draft IM Reference	Issue	Proposed change
Interpretation section - **Building block revenue**	The IMs should provide for revenue smoothing between regulatory periods and between years (within a regulatory period). This will help ease price shocks, which is beneficial for consumers and is also required for cost recovery. Additionally, revenue smoothing via altered depreciation is for us to propose in our expenditure proposal. This means we need to know the upfront rules of how these decisions (smoothing and depreciation) will work together.	**Building blocks revenue** means the sum of building blocks components (which may have positive or negative values) as determined by the **Commission** for a **regulatory year**, and, for the avoidance of doubt, includes a component or components that give effect to the smoothing of revenue under s 197 of the Act and within a regulatory period where the methodology for revenue smoothing is be determined during the PQ determination.
Interpretation section – **total FFLAS revenue**	Consistent with our proposed change (below) under clause 3.1.1(1), we recommend this defined term be amended to add "forecast". Additionally, we recommend the definition clarify that the revenue is adjusted in accordance with accounting standards to include discounts and rebates taken up by customers.	**Forecast total FFLAS revenue** means all revenue derived by Chorus from the provision of regulated FFLAS, in nominal terms exclusive of GST, adjusted in accordance with accounting standards to include discounts and rebates taken up by customers.
3.1.1(1)	The current drafting would require Chorus to be able to perfectly forecast demand ahead of time so that actual revenue did not exceed allowable revenue. Rather, any difference between *actual* total FFLAS revenue and allowable revenue will be washed-up and recognised in following years.	3.1.1(1) For the purpose of s 194(2)(b) and s 195 of the **Act**, the 'maximum revenues' that may be recovered by a **regulated provider** for a **regulatory year** in a **regulatory period** will be specified in a **PQ determination** as a revenue cap, whereby the **forecast total FFLAS revenue** derived by a **regulated provider** must not exceed **allowable revenue** specified in the **PQ determination** for **that regulatory year.**

3.9.7(2)	As discussed in our submission, the IM for major transactions should take into account that such transactions are likely to enhance efficiency and reduce costs, which is in the long-term interests of consumers. Therefore, the Commission should seek to encourage such transactions and add the proposed wording accordingly.	(2) Where the **PQ determination** is amended due to: (a) a **catastrophic event**; (b) a **change event**; or (c) a **major transaction**, the **Commission** must not amend the price path or quality standards more than is reasonably necessary to take account of the change in costs *(subject to, in the case of "major transactions", permitting the transacting parties to retain a reasonable share of the reduction in costs that the transaction may create)* net of any insurance or compensatory entitlements resulting from the relevant event or transaction.