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Fibre input methodologies - Out of scope material received as part of submissions on the 2021 IM amendments

We received submission points that were outside the scope of our fibre IMs amendment notices of intention (**NOIs**) in 2021 and therefore outside of the scope of the final decisions in *Fibre Input Methodologies main 2021 amendments: final decisions – Final reasons paper*.[1]

Table A1 lists the submissions received throughout the fibre IMs amendment consultation process of 2021 that contain material that was outside the scope of our fibre IMs amendment NOIs and that was therefore not taken into account in making the decisions in *Fibre Input Methodologies main 2021 amendments: final decisions – Final reasons paper*.

The out of scope material is highlighted in the submissions in Table A.2.

Table A.1: Out of scope submission points

Submitter	Name of submission	Out of scope submission point references
Chorus	"Amendments to the Input Methodologies for Fibre: August 2021 amendments" (24 June 2021).	• Page 2 - the bullet reading "We think it would enhance certainty and better promote the purposes of Part 6 if the IMs were amended to include wash-ups for … The difference between forecast and actual opening RAB values for commissioned assets (for PQP2 and later)". • Page 3 - the text under the heading "Correct calculation of present value benefit of Crown financing". • Pages 3-4 - the text under the heading "Correct default approach to FLA asset life". • Page 4 - the text under the heading "Correct treatment of incentive payments". • Paragraphs 24.2, 33-35, 46-65. • Pages 19-20 - the row for clause "2.2.13 (1)(a)(i) B1.1.13(1)(a)(i)". • Page 23 - the suggestions for clause 3.1.1(9)(g). • Page 26 - the suggestions under the heading "Correct calculation of present value benefit of Crown financing. • Pages 26-27 - the suggestions under the heading "Correct default approach to financial loss asset life". • Page 27 - the suggestions under the heading "Correct treatment of incentive payments".

[1] Commerce Commission "Fibre Input Methodologies main 2021 amendments: final decisions – Final reasons paper" (29 November 2021).

Submitter	Name of submission	Out of scope submission point references
Chorus	"Amendments to the Input Methodologies for Fibre: November 2021 amendments" (8 July 2021).	• Page 2 - the text under the heading ""Changes to the definition of "notional deductible interest"". • Page 2 - the text under the heading "Reopener for individual capex allowances". • Pages 2-3 - the text reading "We have identified a further issue with the timing of calculations in this IM in relation Crown financing. The IMs as currently drafted will result in an inaccurate Crown financing adjustment being calculated for LFCs in respect of the 2022 disclosure year, and an overstatement of Chorus' avoided costs of Crown financing in the PQ determination. We propose a correction to prevent this and ensure the PQ determination reflects the actual financing costs incurred by Chorus as required by the Act." • Pages 3-4 - the text under the heading "Amendments to enhance certainty". • Paragraphs 3.1-3.3, 7-19, 21-47. • Paragraph 6 - the text reading ", but ask that the Commission also takes this opportunity to address an inconsistency in the leverage assumptions used to calculate notional deductible interest in clause 2.3.1(7)." • Paragraph 20 - the text reading "We have identified a further issue with the timing of calculations in the Cost of capital IM which needs to be corrected both to account for the different timing of disclosure years for the LFCs, and to ensure the adjustment for Crown financing in the PQ determination reflects the actual financing costs incurred by Chorus as required by the Act." • Page 15 - the row for clause "2.2.13(3)(a) B1.1.3 (2)(a)". • Page 16 - the suggestions under the heading "Definition of notional deductible interest". • Pages 16-17 - the suggestions under the heading "Re-opener for individual capex allowances". • Pages 17-19 - the suggestions under the heading "Annual benefit of Crown financing building block". • Page 19 - the suggestions under the heading "Depreciation in year of commissioning". • Page 19 - the suggestions under the heading "Clarifying definition of connection capex". • Page 20 - the suggestions under the heading "Addressing stranding risk".
2degrees	“Proposed Amendments to Fibre Input Methodologies: draft decisions Reasons Paper - Commerce Commission Consultation” (8 July 2021).	• Page 1 - the bullet reading "We consider the consideration of a Pricing Input Methodology, which may apply from PQP2, would meet the criteria to be considered outside the statutory IM process (i.e. it would help both promote competition and improve certainty". • Pages 5-6 - the text under the heading "The Commission is able to re-open other elements of the IMs outside of the IM review".
Spark	"Proposed amendments to the IM for fibre - Cross-	• Paragraphs 25-28.

Submitter	Name of submission	Out of scope submission point references
	submission" (9 July 2021).	
Vocus	"Consultation on proposed amendments to fibre input methodologies: Draft decisions – Submission/cross-submission to the Commerce Commission" (8 July 2021).	• Paragraphs 8, 28-35.
Chorus	"Cross-submission on Amendments to the Input Methodologies for fibre" (22 July 2021).	• Paragraphs 9-12.
Spark	"Fibre ID and PQ draft decisions – cross-submission" (22 July).	• Page 3 - the full paragraph reading "In any case…" • Page 3 - the full paragraph reading "Conversely, proposals to…" • Paragraph 8a - the text reading "Proposed amendments to the wash-up IM would also need to consider…our IM proposals to apply similar wash-up limits to those applying to part 4 regulated firms, and WACC. The current WACC would be further disconnected from comparator firms that face risks which - in New Zealand - are pushed on to end-users through the wash-up. • Paragraphs 8b, 11-14 • Table 1: high level view on proposals - rows a, c-i.
L1 Capital	"Cross-submission on Fibre PQ/ID Initial RAB draft decisions" (30 September 2021).	• Paragraphs 5-6.
Chorus	"Proposed amendments to fibre IMs: wash-up mechanism revised draft" (21 October 2021).	• Paragraphs 6-7, 23-26.

Table A.2: Submissions that contain out of scope material

Amendments to the Input Methodologies for Fibre

August 2021 amendments

CHORUS

Executive summary

Proposed amendments to process for determining initial RAB are unjustified, reduce certainty, and are inconsistent with the Act

- We accept that some form of transitional initial regulatory asset base (**RAB**) is unavoidable. But the true-up between transitional and final RAB should be limited to differences between forecast and actual costs in disclosure years prior to the implementation date as noted during the input methodologies (**IMs**) development process. The Commission's proposed amendments effectively allow it to defer completion of an exercise Parliament required the Commission to complete prior to the implementation date.
- The Commission's proposed amendments:
  - Are contrary to the requirements of the Telecommunications Act 2001 (**Act**) – They would facilitate a transitional initial RAB that doesn't meet the valuation requirements set in the Act and are contrary to the principle that Chorus' allowable revenue should be based on a particular valuation approach;
  - Reduce rather than promote the certainty that is the purpose of IMs – At no point in the lengthy IMs consultation did the Commission signal a RAB that would be revised during the first regulatory period (**PQP1**). A change of this magnitude at this late stage seriously undermines certainty; and
  - Are unjustified – The Commission has essentially given no reasons for the process change beyond stating it would like more time.
- These proposed amendments are clearly "fundamental" and fail the Commission's own test for making out of cycle amendments. We have engaged in an IMs development process lasting years to arrive at a set of rules for PQP1 and the fact the Commission has, at the eleventh hour, decided it would like more time to do its work does not present a compelling and urgent rationale for amendment.

Specification of wash-up requirements

- The Commission has proposed amendments to add more specification to the wash-up component of allowable revenue. In principle we would welcome the additional certainty such specification would bring. However, there are additional kinds of wash-ups Chorus believes should be included for PQP1. If the Commission is adding more specification to the wash-up mechanism in the IMs we think it is important these additional wash-ups be included.
- We think it would enhance certainty and better promote the purposes of Part 6 if the IMs were amended to include wash-ups for:
  - The difference between actual and forecast cost allocator metrics;
  - The difference between forecast and actual opening RAB values for commissioned assets (for PQP2 and later); and

- The difference between forecast and actual CPI for the revenue path.

- In addition, we have proposed a number of changes to clarify and improve the workability of the wash-up mechanism.

There are several errors in the IMs it is important to correct for determining the initial RAB

- We welcome the Commission's decision to consider amending the IMs to correct technical errors. In addition to the changes proposed by the Commission, there are several other errors it is important to correct for prior to determining Chorus' initial RAB.

Correcting for use of post-tax WACC

- The Commission indicated in its financial loss asset (**FLA**) IM final decision that its use of a post-tax WACC rather than a vanilla WACC to discount pre-implementation date cash flows would give rise to an error in the event of substantial tax losses. The Commission acknowledged that this would require a correction to account for the difference in the time value of money and that this correction could take place via IMs amendment.

- As set out in our submission on the initial RAB, our estimated regulatory tax losses at the start of the first regulatory period total approximately $800m and the estimated amount of the consequential adjustment to regulated revenues could exceed $40m in present value terms. This is clearly material and requires addressing urgently for it to be included in the final pricing decision for the first revenue path.

Correct calculation of present value benefit of Crown financing

- The Commission indicated in its August notice of intent (**NOI**) it was considering amendments which would correct for technical errors in the formulas for determining the 'present value benefit of Crown financing'. The Commission now says it has not identified any errors in those formulas and does not propose any amendments. However, there are errors in the formulas.

- The Commission's current approach applies the notional financing rate relating to Crown Infrastructure Partners (**CIP**) equity securities in vanilla terms and to CIP debt securities in post-tax terms. Essentially, the benefits of Crown financing are determined using a mix of vanilla and post-tax terms. This is inconsistent with the Commission's decision to use a post-tax WACC in calculating the value of the FLA and is an error which needs to be corrected.

Correct default approach to FLA asset life

- The current wording of the IMs can lead to an erroneous approach to determining the asset life of the FLA. The IMs set the default approach for calculating the asset life of the FLA as the weighted average life of the fibre assets in the RAB. The Commission has interpreted 'weighted average' as requiring an arithmetic mean whereas a harmonic mean is the correct approach in this context.

- We acknowledge the IMs permit an alternative asset life for the FLA to be adopted and that this has been proposed by the Commission in its draft price-quality

determination. However, we still believe an IM amendment is desirable to prevent this error if the Commission's views regarding applying an alternative asset life change prior to finalising the price-quality determination for PQP1, or it becomes a relevant factor in decisions for future regulatory periods.

Correct treatment of incentive payments

- Under the IMs as currently drafted, incentive payment spend appears to fall between the definitions of core fibre assets and opex. We cannot treat incentive payment spend as opex under the IMs because the expenditure is treated as capex under GAAP (i.e. NZ IFRS 15). Accordingly, in the initial asset valuation (**IAV**), incentive payments are treated as a financial asset.

- We believe the inconsistency between the IMs and GAAP contributes to the proposed exclusion of expenditure on incentives in the draft price-quality determination. Therefore the IMs should be amended to confirm that incentive payments should be treated as core fibre assets and to correctly align the IMs with GAAP.

Framework for IM amendments

1. In setting out its approach to making changes to the IMs we believe the Commission has:

   1.1 Incorrectly described the relationship between s 166 and s 174 and mischaracterised the High Court's discussion of the equivalent provisions under Part 4 of the Commerce Act. The purpose of IMs in s 174 is subordinate to s 166 only insofar as amendments should not be made solely to enhance certainty if that would conflict with s 166. But it does not follow that the IMs should only promote certainty to the extent that doing so does not detract from the promotion of outcomes in workably competitive markets. The Commission's task is to give effect to both; and

   1.2 Set out a test for out-of-cycle IMs amendments which its proposed amendments for determining the initial RAB fail to meet.

Relationship between section 166 and section 174

2. As the Commission has noted, the purpose of IMs, as set out in s 174 of the Act, is to promote certainty for regulated fibre service providers and others in relation to the rules, requirements and processes applying to the regulation, or proposed regulation, of fibre fixed-line access services (**FFLAS**).

3. We accept that certainty is a relative rather than an absolute value and note the High Court's observation, in the context of Part 4 of the Commerce Act, that the purpose of IMs in s 52R is "conceptually subordinate" to the purpose of Part 4 in s 52A. However it does not follow:

   3.1 that the Commission must *only* give effect to s 174 to the extent that doing so does not detract from promotion of the purposes set out in s 166(2);[1] or

   3.2 that s 174 does not constrain an amendment that the Commission considers is required to give effect to s 162.[2]

4. The Commission has mischaracterised the High Court's discussion of the purpose statements in Part 4 of the Commerce Act. The Court's statement that s 52R was conceptually subordinate to s 52A is in the context of a discussion about the appellate standard of "materially better". The Court observed that an amended IM advanced by an appellant might be said to be materially better with reference to the overall purpose of Part 4 or to the purpose of IMs in s 52R. That is to say, the amended IM might be said to be materially better because it better promoted outcomes that are consistent with outcomes in workably competitive markets or was more certain. However, because of the conceptual primacy of s 52A, the Court would be unlikely to prefer an amended IM solely on the grounds of greater certainty if it did not achieve the s 52A purpose statement.

5. Applied to the present context, the Court would say the Commission should not amend an IM solely in order to enhance certainty if that would *conflict* with the purposes

[1] Commission, *Proposed Amendments to Fibre Input Methodologies draft decisions - Reasons Paper*, 27 May 2021, para 2.6
[2] Ibid, para 2.4

described in s 162. But it does not follow that the Commission or the Court should only give effect to s 174 to the extent that doing so does not detract from the promotion of outcomes in workably competitive markets. Rather, the Commission's task is to give effect to both purpose statements and to implement only those amendments to the IMs that are consistent with the achievement of both. Similarly, s 174 may constrain an amendment that the Commission considers would better give effect to s 162. If that were not the case, then s 174 would be redundant and that cannot have been intended by Parliament.

6. Promoting certainty in relation to the IMs has two aspects. IMs promote certainty by clearly articulating the rules with sufficient specificity that regulated providers can understand how price-quality paths will be set. But IMs also promote certainty by requiring the Commission to demonstrate a degree of ex-ante commitment to the rule book that governs the setting of price-quality paths. The Commission's formulation is that IMs "constrain [the Commission's] evaluative judgements in subsequent regulatory decisions and increase predictability".[3] We agree. Certainty, in that sense, is undermined if the rules are constantly subject to change, or if the Commission changes the rules in a significant way at a late stage to accommodate its desired approach to setting price-quality paths. Section 174 was intended to constrain the Commission's ability to make ad hoc changes to the IMs, particularly where that would undermine settled expectations as to how a price-quality path would be set. This is of particular relevance to the Commission's proposed changes to the process for setting the initial RAB, as we go on to explain later in this submission.

Proper scope of IMs amendments outside the review cycle

7. The Commission has expressed a view that it will generally not be appropriate to consider "fundamental" changes outside the regular IM review cycle. The Commission says that the rules and processes IMs and the quality and capex IMs are not fundamental.

8. Without expressing a definitive view on the appropriate scope of IMs amendments outside of the regular review cycle, we note that – on the Commission's approach – amendments to the asset valuation IM would appear to be fundamental. That notwithstanding, the Commission has proposed an amendment to the asset valuation IM to give effect to its revised approach to the transitional RAB. Our view is that the Commission's proposed change to the process for determining the initial RAB is fundamental; indeed, it is difficult to imagine a more fundamental component of the regulatory framework. On the Commission's reasoning, then, an "especially compelling and urgent rationale" is required to justify making this change at this time. No such compelling and urgent rationale has been offered.

[3] Ibid, para 2.2

Amendments for determining the initial RAB

9. The Commission is proposing amendments to the process for determining the pre-implementation date transitional RAB. 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 limited to differences between forecast and actual values in disclosure years prior to the implementation date. The Commission's proposed amendment to replace references to "actual" values with "estimates of historic values" effectively allows the Commission to defer completion of an exercise Parliament required the Commission to complete prior to the implementation date. The Commission's proposed amendments are:

    9.1 contrary to the requirements of the Telecommunications Act;

    9.2 unjustified; and

    9.3 inconsistent with the promotion of certainty per s 174 of the Act.

Requirements of the Act

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

11. However, the Commission 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. The Commission's proposal is contrary to the requirements of the Act because it effectively defers a determination the Commission is required to make prior to the implementation date.

12. The Commission is required to make a s 170 determination before 1 January 2022 specifying how price-quality regulation applies to Chorus. In making that determination, the Commission must apply the relevant IMs. 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. 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.

13. What the Commission is instead proposing to do is to determine a provisional RAB based on "estimates" of actual values and then finally determine the initial RAB only after the implementation date. This is contrary to the requirements of the Act in three ways:

    13.1 First, the transitional initial RAB will not comply with the requirements of s 177 of the Act because it will not reflect: (i) the cost incurred by Chorus in constructing or acquiring fibre assets (for pre-2011 assets), or (ii) the cost recorded by Chorus in its financial accounts (for post-2011 assets) because it

will instead reflect a provisional estimate of those values. A proper application of s 177 requires the Commission to actually determine the relevant values. It is not permitted to determine provisional values and then subsequently amend those values after the implementation date.

13.2 Second, there is no basis in the Act to effectively revise the RAB after the implementation date. The relevant s 170 determination implementing price-quality regulation must be made prior to the implementation date. That determination must apply the relevant asset valuation IM and that IM must be in accordance with s 177. Section 177 contemplates that actual asset values are used to determine the initial value of fibre assets. The scheme of Part 6 assumes that the Commission completes the work required by s 177 before the date on which price-quality regulation is implemented. There is no basis to subsequently redetermine the initial value of fibre assets after that date. The Commission's proposal therefore exposes Chorus to an unacceptable risk that the Commission will be unable to carry out its proposed revision of the initial RAB in 2022.

13.3 Finally, Parliament intended that Chorus' allowable revenue under price-quality regulation would be determined in accordance with the asset valuation methodology it specified in s 177. Allowable revenue in the first regulatory control period will not be based on a proper application of s 177 because the true-up of the initial RAB will not be reflected in revenue until the second regulatory control period. The fact that any revenue differences from the first period will be washed-up in the second does not cure the fact that regulated revenue from 2022 to 2025 will be based on a provisional RAB rather than a properly determined RAB.

Proposal is unjustified

14. The Commission has acknowledged in its discussion of the framework for amending the IMs that changes to "fundamental" elements of the IMs will only be justified outside of the regular IMs review cycle if there is an especially compelling and urgent rationale for doing so.

15. The only justification the Commission has offered for this change is that it has run out of time to complete the exercise that Parliament originally intended it should complete by 1 January 2020 and then extended for a further two years to 1 January 2022.

16. The Commission has not explained why it has only now realised that it has insufficient time to complete the process. We emphasised to the Commission as far back as December 2018 that the process of determining the initial RAB would be complex and was critically important to Chorus and its shareholders and therefore should commence immediately. We explained that there was no barrier to progressing that work in parallel with the determination of the IMs given the methodology was essentially specified in the Act. The Commission declined to expedite the process of determining the initial RAB.

17. It is further not clear to us why the Commission has only now determined that it has insufficient time to complete the process of scrutinising modelling undertaken to determine the RAB. The Commission has recent experience with complex economic models having worked to construct the model for the copper final price over a number of years. The size and complexity of the exercise of determining the initial RAB could

not have been a surprise. The Commission's reasons paper explains that "the 'actual values' that currently exist are simply asset values within Chorus' financial systems" and that the relevant RAB asset values "can only be determined once we have carried out appropriate scrutiny". That is not a new or unanticipated state of affairs and therefore does not justify the change in approach.

Promotion of certainty

18. As discussed above, the promotion of certainty requires not only that the rules are clear but that they are durable. Part of the rationale of IMs was to require the Commission to commit to a rule-book in advance of making the evaluative judgements required to implement price-quality regulation. If the rules are subject to constant change, or are changed at a late stage, then certainty is undermined.

19. The Commission ran a lengthy and comprehensive IMs consultation process between 2018 and 2020. The result of that process was a determination that the transitional RAB would reflect a combination of actual historic and forecast values, reflecting the fact that commissioned assets, as well as costs for the FLA calculation, in the final disclosure year prior to implementation could not be known at the point the Commission was required to make its price-quality determination. The Commission gave no indication at any point in the process that it expected to determine a transitional RAB that would include only estimates of historic values. The determination of the relevant IMs in late 2020 created a reasonable expectation of the rules that would apply for the purposes of determining this price-quality determination. Chorus was entitled to rely – and did rely – on its expectation that the Commission would in fact determine the initial RAB in accordance with the process it had outlined in the IMs.

20. Changing such a fundamental component of the price-quality path at such a late stage in the process undermines the certainty that s 174 intends the IMs deliver. Not only does it represent a highly significant shift in the approach to determining the initial RAB, which itself undermines certainty, it also means that Chorus can have no certainty – as of the implementation date – as to what the value of the initial RAB actually is or what additional scrutiny is required to finalise it. The extent of the uncertainty this produces is such that the proposed amendment cannot reasonably be said to comply with s 174 of the Act.

Specification of wash-up requirements

21. The Commission has proposed amendments to the specification of price and revenues IM to address the mechanics of the wash-up, which includes five specific wash-ups alongside the general wash-up required by s 196 of the Act: connection capex variable adjustment;[4] any individual capex projects approved in the regulatory period; the difference between the transitional and final initial RABs; forecast and actual pass-through costs; and forecast and actual Crown financing payments.

22. Chorus supports the use of a wash-up mechanism as part of the revenue path. Any regulated provider will face a combination of controllable and uncontrollable costs. Regulated providers should not be subject to windfall gains or losses for material costs they cannot control and it is reasonable for these costs to be washed up.

23. We propose:

    23.1 a number of technical amendments to improve the operation of the wash-up mechanism; and

    23.2 additional wash-ups which meet the Commission's criteria for an explicit wash-up.

24. The additional wash-ups we propose address differences between:

    24.1 forecast and actual cost allocator values (i.e. cost allocator metrics);

    24.2 forecast and actual values of commissioned assets included in the opening RAB used to calculate building blocks revenue for the next period (equivalent to the capex wash-up adjustment in the EDB IMs); and

    24.3 forecast and actual CPI for the revenue path (not other uses of CPI) – this relates to a recommendation we intend to make in our submission on the draft price-quality determination about the revenue path formula.

25. Our proposed amendments are set out in Appendix B.

Technical amendments to improve the operation of the wash-up mechanism

26. We have proposed a number of amendments that are intended to clarify the meaning of the IMs while preserving the Commission's original intent:[5]

    26.1 sub-clause (2): clarifying that forecast pass-through costs are as forecast by the regulated provider at the outset of each regulatory year (as opposed to forecast building blocks revenue which is forecast by the Commission);

    26.2 subclause (4): clarifying that wash-up amounts "comprise" the amounts determined by the Commission rather than "including" those amounts (which

[4] The Commission's proposal for a wash-up to include the revenue impact of the connection capex variable adjustment raises two timing issues that we consider need to be addressed. We have discussed this further in Appendix B
[5] Subclause references are to the numbering that appears in the amended clause 3.1.1 in Appendix B

would imply additional amounts might be included in wash-up amounts), and clarifying that wash-up amounts may be positive or negative;

26.3 subclause (5): clarifying that actual wash-up accruals are used where available and the relevant value is the present value as at the end of the current period; and forecast wash-up accruals are used for any year for which an actual wash-up accrual has not been recorded in the wash-up account;

26.4 subclause (6): moving what was previously subclause (9) up in the order of the clause to aid understanding;

26.5 subclauses (7) and (8): substituting "actual allowable revenue" for "actual revenue allowance" to align with "forecast allowable revenue"; and

26.6 subclause (9): clarifying that actual allowable revenue comprises a recalculation of forecast allowable revenue subject to the wash-ups listed in paragraphs (a) to (h). As previously drafted, it was not clear that actual allowable revenue comprised the sum of building blocks revenue, pass-through costs and the wash-up amount.

27. In addition to the technical amendments listed above, we note the following:

27.1 Our understanding of the concept of "forecast wash-up accruals" is that, while the forecast accrual will be used to determine the amounts drawn down in the next period, Chorus will also record an actual wash-up accrual for that year in the wash-up account. This will effectively result in a true-up of the forecast accrual when the draw-down for the next period is next calculated. We consider it is important that any forecast wash-up accrual is ultimately trued-up to the actual accrual for that year. If our understanding is not correct, amendments should be made to ensure this true-up to the actual accrual takes place.

27.2 For the purposes of calculating the balance of the wash-up account, the Commission will need to specify in the s 221 notice requesting the necessary information that: (i) the opening balance for PQP1 is nil; (ii) the time value of money adjustment is calculated against the opening balance; and (iii) whether accruals enter the account at mid-year or year-end. We expect further engagement with the Commission on these issues before the s 221 notice is finalised.

Additional wash-ups proposed

28. The Commission has explained that it will include an explicit wash-up where:[6]

28.1 Chorus not bearing the risk that outcomes differ from forecast best promotes the purpose of Part 6 or workable competition (often in terms of the economic principles and incentive framework); and

28.2 there is no existing mechanism which provides for that.

29. We propose that the following items are washed-up (and these wash-ups are added to the list in clause 3.1.1.(8) of the IMs):

[6] Commission, *Chorus' Price-quality path from 1 January 2022 - Draft decision*, 27 May 2021, para A 136

The difference between actual and forecast cost allocator metrics

30. Chorus's FFLAS business is still growing and the rates of demand, expenditure and other relative utilisation indicators over time are particularly hard to forecast. There is a material risk that some forecast allocator metrics turn out to not reflect the actual utilisation of expenditure or assets that are shared between PQ-FFLAS and other services. In particular, given the forecast uncertainty, Chorus has set allocators for PQP1 based on past actuals which in light of a growing fibre business could lead to actual utilisation (between PQ-FFLAS and other services) varying materially over PQP1.

31. To manage this risk, and to mitigate the need for extensive debate on cost allocator metrics at the time revenues are set, it is reasonable to wash-up for the revenue impact of differences between forecast and actual allocator metrics i.e. that this risk is not borne by Chorus. This is especially important given the transitional nature of PQP1. We note that this wash-up incentivises accurate forecasting of allocator metrics.

32. This will promote the long-term benefit of end-users by preserving the expectation of an NPV=0 outcome and reducing the risk of windfall gains or losses. It will promote competition by ensuring the allocation of costs between FFLAS and non-FFLAS services is correct over time.

The difference between forecast and actual opening RAB values for RP2 and later

33. The primary purpose of the wash-up between the transitional and final initial PQ RAB is to ensure there is a correct opening RAB value for PQP1. There is a similar wash-up (recoverable cost) for the energy firms regulated under Part 4 with respect to the value of commissioned assets forecast to be included in the opening RAB for the forthcoming regulatory period. We consider that this wash-up should also apply to Chorus such that the opening RAB for each regulatory period is corrected for this variance.

34. This will promote investment incentives, and hence the long-term benefit of end-users, by ensuring that Chorus is able to recover the actual cost of its new investments in future periods and minimises excessive profits by ensuring that prices reflect actual opening RAB values for these investments over time.

35. While this wash-up will not affect revenues set for PQP1, it is desirable that it be specified now to promote regulatory certainty and minimise future consultations on IM amendments.

Forecast v actual CPI for revenue path.

36. As we will discuss in our submission on the draft price-quality determination, the draft determination requires forecast building blocks revenue (**FBBR**) to be rolled forward using the term $(1+\Delta CPI_{t-1})$. However, this is inconsistent with the formula for in-period revenue smoothing which means the ex-ante expectation of real FCM will not hold. Failure to correct this will result in error due to variability in inflation. We expect this means Chorus will under-recover the PV of its maximum allowable revenue (**MAR**) by approximately $4m for PQP1.

37. A better approach is to roll-forward FBBR using forecast CPI for the current regulatory year $(1+\Delta CPI_{t})$. This will give Chorus an ex-ante expectation it will be able to recover

its MAR, but would then require a wash-up for the difference between forecast and actual CPI for year t.

38. This will promote the long-term benefit of end-users as it would preserve investment incentives by ensuring Chorus can recover its MAR (as will be explained in our price-quality submission) and ensuring that prices are consistent with actual rather than forecast CPI over time.

Amendments to correct technical errors

39. The Commission has proposed amendments to the fibre IMs to correct technical errors. Below we describe some errors in the fibre IMs which it is important for the Commission to correct prior to determining the initial PQ RAB in order to best meet the purpose of Part 6.

40. We have also noted further technical errors, and commented on the detail of some of the Commission's proposal, in the table at Appendix A.

Correcting for use of post-tax WACC

41. The Commission indicated in its FLA final decision that its use of a post-tax WACC to discount pre-implementation date cash flows would give rise to an error in the event of substantial tax losses. The Commission acknowledged that this would require a correction to account for the difference in the time value of money.[7]

42. We submitted during the IMs consultation on the need to make this change and proposed a method for doing so. When we provided our MAR model to the Commission we also indicated that Chorus had incurred substantial tax losses in the pre-implementation period. Further, in our submission on the initial RAB, we set out that our estimated regulatory tax losses at the start of the first regulatory period total approximately $800m and the estimated amount of the consequential adjustment to regulated revenues could exceed $40m in present value terms. This is clearly material and requires addressing urgently for it to be included in the final pricing decision for the first revenue path.[8]

43. It is important the Commission make the amendments to the IMs prior to the calculation of the transitional initial RAB because:

    43.1 The Commission acknowledged when determining the FLA IMs that a correction would be required in the event of substantial tax losses. Chorus therefore had a reasonable expectation that the Commission would address this issue in the event that tax losses did exist and, on that basis, Chorus chose not to take any further action at the time the IMs were determined.

    43.2 The Commission's own reasoning supports correcting for this issue. The Commission stated in its FLA IMs reasons paper that using a post-tax WACC to discount pre-implementation cash flows implies that the tax deduction benefit for notional interest costs was received during the pre-implementation period. Because of Chorus' tax losses, those benefits will actually be received in future regulatory years. A correction is therefore required to ensure that the value of the FLA accords with the requirements of s 177 of the Act. If not, then the value of the FLA understates Chorus' accumulated unrecovered returns over the pre-implementation period.

    43.3 The amount at issue is significant. We set out our calculation of the revenue impact of the Commission's use of a post-tax WACC when we provided the

[7] Commission, *Fibre Input Methodologies – Financial Loss Asset Final Decision – Reasons paper*, 3 November 2020, para 3.402
[8] Chorus, *Submission on Commission's consultation on Chorus' initial PQ RAB*, 28 May 2021, paras 20-22

Commission with our MAR model. The magnitude of the issue is such that it requires a change to the IMs.

44. There are broadly two options for how this can be implemented in the IMs. The first is to use a vanilla WACC to discount cash flows to calculate the value of the FLA. However, this would likely require extensive changes to the IMs as currently drafted, and we understand that the Commission's preference is to include a correction item in the relevant formulae rather than to switch from a post-tax WACC to a vanilla WACC methodology. Accordingly, the more straightforward option is to calculate the value of the unused interest deductions in the pre-implementation period and apply a one-off adjustment to the value of the FLA and carried forward tax losses at the implementation date.

45. We describe in Appendix B the methodology we anticipate the Commission adopting. Note that Chorus' MAR model includes functionality (currently disabled) that illustrates the effect of these calculations. We can therefore use the existing MAR model to demonstrate the effect of this correction for the Commission.

Correct calculation of present value benefit of Crown financing

46. The Commission indicated its August NOI it was considering amendments which would correct for technical errors in the formulas for determining the "present value benefit of Crown financing". In the Proposed Amendments Reasons Paper the Commission then said that, having considered the matter further, it had not identified any errors in those formulas and did not propose any amendments.

47. In our view, there are errors in the formulas which need to be corrected by amendment to the IM.

48. The IMs as currently drafted fail to properly account for the tax implications of the Commission's characterisation of the nature of Crown financing in the pre-implementation period. The Commission's decision was to use the post-tax approach to calculating the financial losses, and that 25% of the CIP equity securities were effectively debt-like and should be treated as such when quantifying Chorus' financing costs.

49. The consequence of characterising this portion of the equity as debt is that the Commission ought to have specified the cost of debt for that component of Crown financing in post-tax terms and, therefore, applied a (1-Tc) term. It has not done so. This means that in calculating the notional benefit of Crown financing based on the post-tax approach, the Commission is:

    49.1 Correctly treating all of the CIP debt component as tax deductible by applying the (1-Tc) term;

    49.2 Correctly specifying the 75% of the CIP equity to which the cost of equity is applied on an equivalent post tax basis. This occurs because the cost of equity has been estimated using the simplified Brennan Lally WACC, which delivers an estimated cost of equity that is net of the benefit of imputation tax credits; but

    49.3 Incorrectly treating the 25% of the CIP equity component by applying a cost of debt in vanilla terms which assumes that this component of return (if it was

received)[9] would be neither deductible as interest for tax purposes nor give rise to imputation tax credits.

50. The IMs should apply a consistent approach to determining the annual benefits of Crown financing both in the pre- and post-implementation periods. In the post-implementation period, the IMs calculate the annual benefits of Crown financing using cost of debt and cost of equity values expressed in vanilla terms, consistent with the use of vanilla WACC in the calculation of the return on capital building block.[10] For example, the amount C in clause 3.5.11(1)(c) represents the notional financing rate relating to CIP equity securities, expressed in vanilla terms, and is calculated using the following formula:

    (0.75 × cost of equity for that regulatory period) + (0.25 × cost of debt for that regulatory period)

51. For comparison, the amount A under clause 3.5.11(1)(a) represents the notional financing rate relating to CIP debt securities, also expressed in vanilla terms, and it is calculated using the following formula:

    (proportion of 'B' that is forecast to be senior debt × cost of debt for that regulatory period) + (proportion of 'B' that is forecast to be subordinated debt × (cost of debt for that regulatory period + 0.41%))

52. In the pre-implementation period, clause B1.1.2(5) of the IMs requires us to calculate the present value of annual benefits of Crown financing using cost of debt and cost of equity values expressed in post-tax terms, consistent with the use of post-tax WACC in the calculation of the present value of the FLA. However, the cost of debt value applied in the calculation of the amount C under clause B1.1.2(5)(c), which represents the notional financing rate relating to CIP equity securities, is expressed in vanilla terms using the following formula:

    (0.75 × cost of equity for that financial loss year) + (0.25 × cost of debt for that financial loss year)

53. For comparison, the amount A under clause B1.1.2(5)(a) represents the notional financing rate relating to CIP debt securities, expressed in post-tax terms, and is calculated using the following formula:

    (proportion of 'B' that is senior debt × cost of debt for that financial loss year (1 - Tc)) + (proportion of 'B' that is subordinated debt × (cost of debt for that financial loss year + 0.41%)(1 - Tc))

54. This means that the formula for calculating the present value of annual benefits of Crown financing under clause B1.1.2(5) applies the notional financing rate relating to CIP equity securities expressed in vanilla terms and the notional financing rate relating to CIP debt securities expressed in post-tax terms. In other words, the present value of annual benefits of Crown financing is determined using notional financing rates that are based on a mix of vanilla and post-tax terms. This is inconsistent with the Commission's requirement to calculate the present value of annual benefits of Crown

[9] No tax deduction or imputation tax credits have been created in reality because the focus here is on the required return that Chorus has *avoided* as a consequence of receiving the Crown financing

[10] We intend to address in our submission on the November 2021 IM amendments the calculation of the notional deductible interest with respect to Crown financing outstanding under clause 2.3.1(7), which is currently inconsistent with the calculation of annual benefits under clause 3.5.11

financing using cost of debt and cost of equity values expressed in post-tax terms, consistent with the use of post-tax WACC in the calculation of the present value of the FLA.

55. This is an unjustifiable inconsistency in the Commission's approach to treating annual benefits of Crown financing in the pre-implementation period. For consistency with the use of post-tax approach to calculating the financial losses, the Commission should apply the post-tax cost of debt to the portion of CIP equity securities that the Commission considers to have the characteristics of debt.

Correcting FLA asset life

56. In its consultation on Chorus' IAV model, the Commission expressed a view that Analysys Mason's calculation of the asset life of the FLA did not comply with clause 2.2.10(1)(d)(i) because it did not use a weighted arithmetic average to determine the FLA asset life. As we explained in our submission responding to the Commission's consultation, the approach adopted by Analysys Mason complies with the IMs because clause 2.2.10(1)(d)(i) merely requires the use of a "weighted average" of the lives of the UFB-related core fibre assets to determine the asset life of the FLA. The IMs do not specify the type of weighted averaging method, or specifically that a weighted arithmetic average must be used.

57. Analysys Mason used depreciation as the weighting variable, which is a simplified and equivalent method of applying a weighted harmonic average using initial RAB values for the core fibre assets as weights. The use of a weighted harmonic average is consistent with clause 2.2.10(1)(d)(i). We provided with our submission in response to the Commission's consultation on the IAV a report from Incenta that demonstrates the equivalence of Analysys Mason's approach.[11]

58. Not only is a weighted harmonic average permitted by the IMs; we think it is more consistent with the purpose of the FLA. In our view, the main criterion for choosing a method for calculating the FLA asset life is that which most closely matches the profile of recovery if the accumulated losses had not been aggregated into a single asset and instead were recovered as part of the core fibre asset values using their individual asset lives. Our submission in response to the Commission's consultation on the IAV, and the supporting report from Incenta, outlines this in greater detail.

59. We acknowledge the IMs permit an alternative asset life for the FLA to be adopted and that this has been proposed by the Commission in its draft price-quality determination. However, an IM amendment is desirable to prevent an error arising if the Commission's views regarding applying an alternative asset life change prior to finalising the price-quality determination for PQP1, or it becomes a relevant factor in decisions for future regulatory periods. Given a weighted harmonic average would better achieve the purpose of the FLA, we propose an amendment to clause 2.2.10(1)(d) to clarify that a weighted harmonic average is the required approach.

Correct treatment of incentive payments

60. In Attachment G of the Commission's Reasons Paper accompanying its draft price-quality determination, the Commission has outlined its proposed approach to evaluating incentive payments made to retain existing, and drive new, connections to

[11] Incenta, *Remaining life for the FLA asset – report for Chorus*, May 2021

the fibre network. We will separately respond to the Commission's proposed approach in our submission on the draft price-quality determination, but the Commission's analysis demonstrates that there is a gap in the IMs in relation to incentive payments.

61. The Commission has explained that, pursuant to NZ IFRS 15, the incremental costs of obtaining a contract with a customer are recognised as an asset. The Commission also observes that incentive payments are not "operating costs" because the relevant IMs definition excludes "a cost that is treated as a cost of an asset by GAAP".[12] The Commission then goes on to comment that whether incentive payments have been incurred in the acquisition of a "core fibre asset" and whether they are employed in the provision of regulated FFLAS will be a fact-specific inquiry.

62. Our position, which is addressed in our submission responding to the price-quality determination, is that incentive payments are demonstrably incurred in the acquisition of a core fibre asset. But we note that the nature of incentive payments under NZ IFRS 15 is not clearly addressed in the definition of "core fibre asset" in the IMs as currently drafted.

63. The IMs provide that "core fibre assets" excludes intangible assets unless they are finance leases or "identifiable non-monetary assets" whose costs do not include pass-through costs. "Identifiable non-monetary asset" is defined with reference to GAAP. Our understanding, based on advice from our auditors, is that incentive payments are not identifiable non-monetary assets. Rather, they are more properly characterised as financial assets and that is how we have treated them in our MAR model.

64. The Commission has rightly acknowledged that incentive payments that are recognised as assets under NZ IFRS 15 should be eligible for inclusion in the RAB to align with the GAAP treatment. Accordingly, the definition of core fibre assets should permit that. To the extent that there is any doubt about whether the definition of core fibre asset includes incentive payments that would be recognised as an asset under NZ IFRS 15, it would be appropriate to amend the IMs to clarify that it does to avoid error.

65. If incentive payments are excluded from the definition of core fibre asset, then the result would be that the Commission would exclude expenditure directly related to the fibre business that is economically justified and in the interests of consumers because of a gap in the IMs. Given that the Commission has recognised that incentive payments are "treated as a cost of an asset by GAAP" and therefore cannot be treated as opex, it follows that they must be treated as fibre assets. Otherwise there is no mechanism to recover these costs through the IMs. This would be contrary to:

    65.1 the asset valuation requirements of the Act because it would deprive Chorus of the opportunity to recover through regulated fibre prices the costs of a relevant "fibre asset" as that term is defined in s 177(6); and

    65.2 the purpose of Part 6 as it would undermine incentives to invest in growing the fibre customer base to achieve the efficiency gains that the Commission has identified accrue to customers where incentive payments succeed in increasing connection numbers.

[12] Commission, *Chorus' Price-quality path from 1 January 2022 - Draft decision*, 27 May 2021, paras G12-G13

Appendix A - Other amendments to correct technical errors

This table sets out our view on some of the Commission's proposed changes to correct technical errors and suggests other corrections we think should be made.

Reference	Issue	Recommended Solution
2.1.1 (5)-(6), (9) 3.2.1 (7)-(8), (13)	These sub-clauses have an error as they do not allow for cost/value to be allocated to services that are not regulated FFLAS (it requires costs to be allocated to **EITHER** PQ-FFLAS **OR** ID-only FFLAS). The omission of services that are not regulated FFLAS could unintentionally imply that non-FFLAS costs/values should be allocated to FFLAS. Use of the words "…to either….or…" implies one or the other, and doesn't allow allocation across 2 or more options (e.g. allocation of shared national IT assets across non-FFLAS, PQ-FFLAS and ID-only FFLAS).	Services that are not regulated FFLAS should be added to the list of service classes to which costs/values can be allocated. For example, 2.1.1(5) should be amended to: *In respect of operating costs that are not directly attributable to the provision of PQ FFLAS, ID-only FFLAS, or services that are not regulated FFLAS, cost allocators must be used to allocate those operating costs ~~to either~~ between:* *(a) PQ FFLAS; ~~or~~* *(b) ID-only FFLAS; and/or* *(c) services that are not regulated FFLAS.* Equivalent changes should be made to 2.1.1(6) and (9)(b); and 3.2.1 (7), (8) and (13)(b).
2.2.13 (1)(a)(i) B1.1.3(1)(a)(i)	Chorus records capital contributions consistent with GAAP – rather than recording asset values net of any capital contribution received. This would be problematic to rework historical data over a number of years. In Chorus' IAV model, to produce the effect equivalent to netting off capital contributions, the model has "negative" asset	Amend the IM rules to allow a proxy approach, where Chorus has not historically recorded asset values net of capital contributions received.

	classes over which capital contributions received are spread.	
2.2.13(6)(b)	The Commission has identified an error in use of the term "commissioned" and proposed to replace it with "commissioned for FFLAS". The need for the change is not clear to us since a core fibre asset should be commissioned for FFLAS anyway, but we are comfortable with the Commission's aim and agree alignment with B1.1.3(4)(b) is desirable.	We are comfortable with replacement of "commissioned" with "commissioned for FFLAS" in 2.2.13(6)(b)

Appendix B – Drafting changes to IM Determination

Amendments for determining the initial RAB

Clause 3.3.1

In sub-clause (8), replace all references to "*estimates of historic values*" with "*historic actual values*".

Specification of wash-ups

Clause 3.1.1.

Amend clause 3.1.1 as follows:

(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 in a regulatory year must not exceed forecast allowable revenue specified in the PQ determination for that regulatory year.

(2) 'Forecast allowable revenue' means the sum of the following for a regulatory year:

(a) forecast building blocks revenue;

(b) forecast pass-through costs as determined by the regulated provider in calculating forecast allowable revenue for each regulatory year; and

(c) the wash-up amount.

(3) For the purpose of this clause, subclauses (2)(b) and (c) can be positive or negative amounts.

(4) For the purpose of subclause (2), the 'wash-up amount' for each regulatory year of the second regulatory period onwards ~~includes~~ comprises amounts (which may be positive or negative) determined by the Commission for each regulatory year of that regulatory period, where the sum of those amounts equals the total closing wash-up account balance adjustment for the current regulatory period in present value terms as at the final day of the current regulatory period.

(5) 'Closing wash-up account balance adjustment' means a positive or negative amount determined by the Commission in advance of each regulatory period for the second regulatory period onwards that is drawn down from the wash-up account ~~balance~~ in the last ~~completed~~ regulatory year of the current regulatory period, and this amount must be no more than the sum ~~in absolute terms~~ of:

(a) the present value as at the end of the current regulatory period of the wash-up account balance for the last ~~completed~~ regulatory year of the current

regulatory period for which a wash-up accrual has been recorded in the wash-up account ~~as at the end of the current regulatory period~~; and

(b) a forecast wash-up accrual for ~~the final~~ any regulatory year of the current regulatory period for which a wash-up accrual has not been recorded in the wash-up account.

(~~96~~) 'Wash-up account' means a memorandum account maintained by a regulated provider to record wash-up accruals not yet returned to or recovered from access seekers, closing wash-up account balance adjustments, and to record a time value of money adjustment:

(a) using a rate equal to the mid-point estimate of post-tax WACC determined under clause 3.5.1(2); and

(b) calculated by applying a method:

(i) as specified in a PQ determination; or

(ii) as specified and obtained by the Commission.

(~~67~~) 'Wash-up accrual' means an amount for a regulatory year, being the difference between the actual ~~revenue allowance~~ allowable revenue and actual total FFLAS revenue for that regulatory year, as determined by the Commission.

(~~78~~) 'Forecast wash-up accrual' means an amount for a regulatory year, being the forecast difference between the actual ~~revenue allowance~~ allowable revenue and actual total FFLAS revenue for that regulatory year, as determined by the Commission.

(~~89~~) 'Actual ~~revenue allowance~~ allowable revenue' means the sum of forecast building blocks revenue, pass-through costs and the wash-up amount for a regulatory year, ~~an amount~~ as specified by the Commission~~,~~ for the purposes of calculating a wash-up accrual or forecast wash-up accrual, and ~~which~~ must include the revenue impacts (for a wash-up accrual) or forecast of ~~actual~~ revenue impacts (for a forecast wash-up accrual) (whichever is applicable) for that regulatory year of:

(a) subject to subclause (10), the difference between:

(i) the sum of all "opening RAB values" of all fibre assets for the PQ RAB as of the implementation date, as determined under clause 3.3.1(7)-(8); and

(ii) the sum of all initial RAB values in respect of all fibre assets in the PQ RAB as at the implementation date, as determined in accordance with clause 2.2.3(2) and 2.2.4(1); and

(b) the difference between:

(i) the 'annual benefit of Crown financing building block' for that regulatory year, as determined under clause 3.5.11; and

(ii) *the 'annual benefit of Crown financing building block' for the disclosure year that corresponds with that regulatory year, as determined under clause 2.4.10;*

(c) *the difference between:*

(i) *any capex allowance determined in respect of the current regulatory period that was determined before the current regulatory period commences; and*

(ii) *any capex allowance determined in respect of that regulatory year that is determined after the current regulatory period commences;*

(d) *the difference between:*

(i) *the forecast pass-through costs as determined by the regulated provider in calculating forecast allowable revenue for that regulatory year; and*

(ii) *the actual pass-through costs for that regulatory year; ~~and~~*

(e) *the difference between:*

(i) *forecast operating costs and forecast asset values allocated to PQ FFLAS for that regulatory year by applying forecast allocator values; and*

(ii) *forecast operating costs and forecast asset values allocated to PQ FFLAS by applying actual allocator values determined under clause 2.1.1 for the disclosure year that corresponds with that regulatory year;*

(f) *the difference between:*

(i) *the forecast of ΔCPI_t as set out in a PQ determination; and*

(ii) *the actual ΔCPI for year t;*

(g) *the difference between:*

(i) *any forecast values of commissioned assets for the current regulatory period used to determine building blocks revenue for the next regulatory period; and*

(ii) *the actual values of commissioned assets for the current regulatory period; and*

(~~e~~h) *in respect of the final regulatory year of a regulatory period, the connection capex variable adjustment for that regulatory period as determined under clause 3.7.21(2).**

(10) *For the purpose of subclause (~~8~~9), the 'actual revenue allowance' for a regulatory year only includes the revenue or forecast of actual revenue impacts for that*

regulatory year of the matters specified in subclause (~~8~~9)(a) for the first regulatory period.

* The Commission has proposed a wash-up to include the revenue impact of the connection capex variable adjustment for that regulatory period. The connection capex variable adjustment is determined at the end of the regulatory period after the Commission receives the connection capex annual report for the last regulatory year of the period. The Commission's wash-up proposal raises two timing issues that we consider need to be addressed:

- when the wash-up for the connection capex variable adjustment is calculated relative to the determination of the 'closing wash-up account balance adjustment'; and
- accounting for the revenue impact of the timing of connection capex through the regulatory period.

When connection capex variable adjustment is calculated

As currently drafted, it appears the Commission expects to calculate the wash-up for the connection capex variable adjustment in the final year of each regulatory period. However, the final connection capex annual report (which is required to calculate the variable adjustment) is not received until after the end of the regulatory period: see clauses 3.7.18(1) and 3.7.21(1).

That leaves two options, either of which requires clarification in the IMs. Either the Commission can calculate a *forecast* accrual in the final year of the regulatory period reflecting a forecast of the connection capex variable adjustment. This would enable the variable adjustment to be included in allowable revenue for the immediately following regulatory period. This would require amendments to clauses 3.7.18-21 to clarify that the Commission may determine a *forecast* connection capex variable adjustment to enable a forecast wash-up accrual.

The alternative is to clarify in clause 3.1.1. that the wash-up for the connection capex variable adjustment is determined in the final year of a regulatory period in respect of that regulatory period. If the Commission adopts that approach, it would be appropriate to provide for the revenue impact of that wash-up accrual to be drawn down in the following regulatory period along with other wash-up items as opposed to waiting for the end of the next period to calculate the closing wash-up account balance adjustment. If not, the revenue impact of connection capex variable adjustments would be deferred.

Accounting for the timing of connection capex

Neither clause 3.7.21 nor clause 3.1.1 indicates how the Commission intends to account for the timing of connection capex through the regulatory period when calculating the connection capex variable adjustment. The connection capex variable adjustment reflects differences between forecast and actual connection volumes and the impact of those differences on Chorus' connection capex. Consistent with the Commission's treatment of all other capex, the calculation of the adjustment should reflect the timing of when the relevant assets enter the RAB (i.e. in the year they are commissioned). As currently drafted, clauses 3.7.21 and 3.1.1 could be read as providing that the connection capex variable adjustment does not include a time value of money adjustment for when the relevant assets entered the RAB and only accrues time value of money adjustments from

the date on which the wash-up accrual enters the wash-up account. To address this issue, and ensure connection capex is treated consistently with other capex, the Commission could amend clause 3.7.21 to either:

- provide for a time value of money adjustment to the value of the connection capex variable adjustment reflecting the timing of when assets entered the RAB; or
- calculate the connection capex variable adjustment annually, rather than at the end of the period, and provide for calculation of a wash-up accrual for each year of the period.

Amendments to correct technical errors

Correcting for use of post-tax WACC

The steps required to implement Chorus' preferred adjustment to address pre-implementation tax losses as a result of the Commission's use of a post-tax WACC are as follows:

1. **Derive the notional interest implicit in the use of a post-tax WACC to derive the "present value of total net cash flows"**
    - Amend the capitalisation factor that was used to produce the "present value of annual net cash flows" for each financial loss year to create a series of "present values" that correspond to the commencement of each year after the year to which the cash flow relates.
        - This is done by amending the formula in clause B.1.1.2(7) so that "days to implementation date" is replaced with "days to the start of cash flow year +1" and "days to the start of cash flow year +2", and so forth, the last of which is the commencement of the year prior to the implementation date.
        - Use the post-tax WACC that is attributable to the relevant cash flow year.
    - Multiply each of the "present value of annual net cash flows" values calculated as above by the product of the leverage and cost of debt that is relevant to the cash flow year to derive a series of "notional interest" amounts attributable to each cash flow year.
    - Sum the notional interest amounts calculated as above for each financial loss to derive the aggregate notional interest for each financial loss year.
2. **Derive the notional interest that has been avoided as a consequence of Crown financing[13]**
    - Calculate the avoided interest as a consequence of Crown financing raised in each financial loss year, for each of the subsequent years prior to the implementation date according to the following formula (where "A" and "B" are defined in clause

[13] The objective is to derive the tax deductible interest that would have been avoided as a consequence of the Crown finance, and in a manner that is consistent with the Commission's calculation of the "present value of Crown financing benefit"

B.1.1.2(5) and relate to the financial loss year in which the relevant Crown financing was raised):

$$\frac{A \times B}{1 - T_C}$$

- Sum the avoided notional interest amounts calculated as per above for each financial loss to derive the aggregate avoided notional interest for each financial loss year.

3. Derive the net notional interest

- For each financial loss year, deduct the aggregate avoided notional interest from the aggregate notional interest to derive the aggregate net notional interest.

4. Determine the unused interest deductions

- For each financial loss year, determine the value of the aggregate net notional interest for each financial loss year that could have been used in that year to reduce corporate taxation before tax was reduced to zero. Where any interest deductions could not be used in a given year, they should be carried forward (without any adjustment) to be available for use in future years.

- Calculate the unused interest deductions for each financial loss year as the difference between the aggregate net notional interest for that year and the extent of the aggregate net notional interest that could be used in that year.

5. Calculate the effect on the FLA and carried forward tax losses

- The adjustment to the FLA at implementation date is calculated as the sum of the present value of the unused interest deductions. The present value of the unused interest deduction for a given financial loss year is calculated as the unused interest deductions for that year, the mid-year timing factor for that financial loss year according to clause B.1.1.2(5) and the corporate tax rate.

- The adjustment to the (tax effect of the) carried forward tax losses at implementation date is calculated as the product of the interest deductions that would have been carried forward to the implementation date under step 4 above, and the corporate tax rate.

Correct calculation of present value benefit of Crown financing

Clause B1.1.2

Amend clause B1.1.2(5)(c) as follows:

(c) C is the amount determined in accordance with the following formula:

(0.75 × cost of equity for that financial loss year) + (0.25 × cost of debt for that financial loss year) (1 - T_c);

Correct default approach to financial loss asset life

Clause 2.2.10

Amend clause 2.2.10(1) as follows:

(1) 'Asset life' means, in the case of-

…

(d) the financial loss asset, either:

(i) the period equivalent to the weighted harmonic average life of the UFB-related core fibre assets in an initial RAB as at the implementation date, where the weights used are the initial RAB values of those UFB-related core fibre assets; or

(ii) a period adopted by the regulated provider under an alternative method; and

Correct treatment of incentive payments

Clause 1.1.4

Amend clause 1.1.4 as follows:

Core fibre asset means a fibre asset that is employed in the provision of regulated FFLAS (whether or not the asset is also employed in the provision of other services), and excludes

(a) the financial loss asset;

(b) intangible assets, unless they are-

(i) finance leases; or

(ii) identifiable non-monetary assets whose costs do not include (wholly or partly) pass-through costs; ~~and~~

(iii) recognised as an asset in accordance with NZ IFRS 15; and

(c) works under control;

Amendments to the Input Methodologies for Fibre

November 2021 amendments

CHORUS

Executive summary

Amendments to implement draft PQ and ID determinations

- Caution is needed regarding amendments to the input methodologies (**IMs**) for the purpose of implementing draft price-quality (**PQ**) and information disclosure (**ID**) decisions. Certainty is undermined if the Commission changes the rules in a significant way at a late stage to accommodate its desired approach to setting PQ paths or ID requirements. However, we have considered the Commission's proposed amendments and we think they are reasonable and do not violate this principle. Also, in light of the Commission's draft PQ and ID determinations, we think three further amendments are required.

Changes to the definition of "notional deductible interest"

- The Commission has proposed an amendment to the definition of "notional deductible interest" to reflect the fact the other local fibre companies (**LFCs**) will initially make disclosures for part years. This definition needs further amendment to address an inconsistency in the leverage assumptions and make the provision consistent with the requirements of the Telecommunications Act 2001 (**Act**).
- The way "notional deductible interest" is currently calculated with respect to regulatory tax allowance doesn't account for Chorus' actual mix of debt and equity Crown financing. This understates our regulatory tax allowance and is inconsistent with the Act which requires that the maximum revenues reflect, in respect of any Crown financing, the actual financing costs incurred by the provider.

Reopener for individual capex allowances

- The Commission's draft PQ determination proposes a significantly expanded role for individual capex proposals than we contemplated during engagement on IMs development. We strongly believe it is not appropriate to require individual capex proposals for expenditure on customer incentives and this is articulated fully in our submission on the draft PQ determination. Even if our position on incentives is accepted, the greater role contemplated in the draft PQ determination warrants reconsideration of the PQ path where individual capex proposals are accepted.
- The current proposal for individual capex allowances to be included in wash-up accruals means recovery will be deferred into the subsequent regulatory period, potentially well after the assets are in use to provide fibre fixed line access services (**FFLAS**). There is no clear justification for delaying the recovery of individual capex allowances once the relevant assets are in use. Also, if individual capex allowances are significant, deferral of recovery may have cashflow implications that affect Chorus' ability to efficiently finance its operations year to year. This may become more acute if regulatory periods are extended.

Annual benefit of Crown financing building block

- The Commission has proposed amendments to the Cost of capital IM which are necessary because of the different disclosure year timing for LFCs. We have identified a further issue with the timing of calculations in this IM in relation to Crown financing.

- The IMs as currently drafted will result in an inaccurate Crown financing adjustment being calculated for LFCs in respect of the 2022 disclosure year, and an overstatement of Chorus' avoided costs of Crown financing in the PQ determination. We propose a correction to prevent this and ensure the PQ determination reflects the actual financing costs incurred by Chorus as required by the Act.

Amendments to enhance certainty

- Providing certainty is the key function of the IMs and we welcome the Commission's decision to consider amendments where these will clarify the rules and allow us to better understand how PQ regulation will apply to us. We have identified three important amendments to support this purpose.

Depreciation in year of commissioning

- Under the IMs as currently drafted, in the post-implementation period, assets can only commence depreciation in the year after they have been commissioned. Deferring recovery of costs relative to when the asset is commissioned results in an unnecessary divergence between the GAAP treatment of depreciation in Chorus' audited accounts and depreciation in regulatory accounts, increases the risk of error, and is inconsistent with the approach in the pre-implementation period.
- The Commission accepted for Transpower that deferring depreciation created unnecessary operational complexity and aligning regulatory depreciation with GAAP would help to maintain consistency and transparency for stakeholders as well as minimise compliance costs. The Commission amended the Transpower IM to provide for part-year depreciation in the year of commissioning. Chorus requests the same.

Clarifying definition of connection capex

- The current definition of connection capex does not extend to upgrades to existing connections to support new or enhanced FFLAS services. However, capex to upgrade existing connections is highly demand driven and subject to the same forecast uncertainties as new connections. For consistency the definition of connection capex should extend to upgrades to existing connections to support new or enhanced services.
- This issue is most acute in relation to Chorus' next generation Hyperfibre service. Upgrading a GPON service to Hyperfibre requires premises-specific capex relating to replacement of the Chorus electronics in the consumer's premises. Capex allowances should account for upgrades to existing connections to allow the demand-driven component of Chorus' capex to be adjusted for actual uptake of enhanced services like Hyperfibre.

Addressing stranding risk

- The evidence base for asset stranding has continued to evolve since the Commission determined the IMs. It suggests the 10 basis points allowance is, or will soon be, outdated. It is evident that the risk of asset stranding is highly dependent on constantly evolving market circumstances. An approach that fixes the ex-ante stranding allowance across multiple regulatory periods fails to recognise the dynamic nature of stranding risk.

- Accordingly, we propose the Commission determine the stranding allowance as part of each PQ determination. This would allow the Commission to revise its assessment of stranding risk as part of each PQ determination to assure itself that the combination of regulatory tools is properly achieving the purpose of Part 6. It would also provide additional certainty to regulated providers that the risk of stranding will be appropriately accounted for. This would support ongoing investment.

Amendments to implement draft PQ and ID determination

1. The Commission is proposing amendments to the IMs because it considers these to be necessary to implement draft decisions it has made regarding the PQ path and ID requirements. Amendments for this purpose should be approached with caution. As we noted in our response to the Commission's first tranche of proposed IMs amendments, one way the IMs promote certainty is by requiring the Commission to demonstrate a degree of ex-ante commitment to the rule book that governs the setting of price-quality paths and information disclosure requirements.[1] In that sense certainty is undermined if the Commission changes the rules in a significant way at a late stage to accommodate its desired approach to setting PQ paths or ID requirements. The IMs provide no constraint and serve no purpose at all if they are routinely amended to permit the determination the Commission wishes to make.

2. Notwithstanding that, we have previously acknowledged that the PQ and ID processes may require the IMs to be amended to implement decisions and that it is important to adopt a flexible and pragmatic approach to addressing errors or gaps in the IMs that only become apparent as the detail of PQ and ID processes is worked through.[2] We have considered the changes proposed by the Commission for the purpose of implementing the draft PQ and ID determinations and we agree they do not undermine the purpose of the IMs.

3. Accordingly, we have considered the Commission's proposals in light of its draft PQ and ID determinations. In our view:

   3.1 Further changes to the definition of "notional deductible interest" are required to address an inconsistency in the leverage assumptions and make the provision consistent with s 171 of the Act;

   3.2 Given the significantly expanded role of individual capex proposals the Commission is proposing in its draft PQ determination, a reopener event needs to be added; and

   3.3 Changes to the calculation of annual benefit of Crown financing are required to account for the different disclosure year dates of LFCs and ensure the PQ determination reflects the actual financing costs incurred by Chorus as required by s 171 of Act.

4. We have provided further comments on the Commission's proposed amendments in Appendix A. Our proposed drafting for implementing the changes described below is set out in Appendix B.

Definition of "notional deductible interest"

5. The Commission is proposing to amend the definition of "notional deductible interest" in clause 2.3.1(7) of the Taxation IM to address the fact that Ultrafast, Enable and Northpower will be initially disclosing results in the 2022 disclosure year for reporting

[1] Chorus, *Amendments to the Input Methodologies for Fibre - August 2021 amendments*, 24 June 2021, para 6
[2] Chorus, *Submission on Fibre Regulation–Process and Approach*, 14 October 2020, paras 27-28

periods of three months and six months, as opposed to 12 months, which is what clause 2.3.1(7) currently assumes.

6. We have no objection to the Commission's proposed amendment, but ask that the Commission also take this opportunity to address an inconsistency in the leverage assumptions used to calculate notional deductible interest in clause 2.3.1(7).

7. This submission is related to the issue we raised in our response to the first tranche of the Commission's proposed IM amendments regarding calculation of the present value benefit of Crown financing.[3] There we submitted that the Commission had failed to apply the post-tax cost of debt to the portion of CIP equity securities that the Commission considers to have the characteristics of debt. This resulted in an inconsistency in the Commission's own reasoning and meant that the Commission was not properly applying s 171 of the Act as it was not calculating the actual benefit of Crown financing.

8. That was one of two issues we raised with the Commission at the time the IMs were determined. The other was that the Commission had not properly followed through the tax implications of its decisions on Crown financing in the post-implementation period. This is because the calculation of notional deductible interest in clause 2.3.1(7) assumes that the mix of debt and equity portions of Crown financing is equal to the notional leverage that is derived from the Commission's sample of comparator firms, rather than the Commission's determination of the relative proportions of Crown financing that are debt and equity. Again, this is an unjustifiable inconsistency in the Commission's reasoning and means that the Commission is not properly applying s 171 of the Act.

9. Section 171 of the Act directs the Commission to ensure that allowable revenues in price-quality determinations reflect the "actual financing costs" incurred by Chorus in respect of any Crown financing. The Commission, in the course of determining the benefit of Crown financing, concluded that the 50% equity portion of CIP securities should be weighted 75% to the benchmark cost of equity and 25% to the benchmark cost of debt. In the Commission's view, treating a portion of the CIP equity securities as debt best reflected the nature of the CIP equity securities.

10. Having made that determination, the Commission must then apply that characterisation consistently through the IMs wherever it is required to take into account the actual financing costs associated with CIP securities. To the extent it fails to do so, it has not properly applied s 171.

11. Clause 2.4.10 of the IMs calculates the annual benefit of Crown financing using cost of debt values expressed in vanilla terms based on the actual mix of debt and equity portions of Crown financing. However, clause 2.3.1(7) assumes that the mix of debt and equity portions of Crown finance is equal to the notional leverage that is derived from the Commission's sample of comparator firms operating in the telecommunications sector in other jurisdictions. In other words, the Commission has not consistently applied its determination of the nature of CIP equity securities for the purpose of calculating notional deductible interest.

[3] Chorus, *Amendments to the Input Methodologies for Fibre - August 2021 amendments*, 24 June 2021, paras 46-55

Re-opener for individual capex allowances

12. The Commission's draft PQ determination proposes a significantly expanded role for individual capex proposals than we contemplated during engagement on IMs development. In particular the Commission is proposing to require individual capex proposals for all incentive and innovation expenditure.[4]

13. We strongly believe that it is not appropriate to require individual capex proposals for expenditure on customer incentives and this is articulated fully in our submission on the draft PQ determination. Even assuming this is understood and accepted by the Commission, the requirement that innovation expenditure be supported by an individual capex proposal means these are likely to have a significant role when PQ regulation is implemented. Therefore, to support implementation of the Commission's draft PQ determination, we believe a re-opener is needed for individual capex allowances.

14. The Commission's proposed amended price specification IMs include a mechanism for calculating wash-up accruals to address individual capex allowances determined in the regulatory period: clause 3.1.1(8)(c).

15. The Commission's proposed wash-up mechanism would require:

    15.1 The Commission to determine annually Chorus' actual allowable revenue, including the wash-ups in subclause (8); and

    15.2 Chorus to record annual wash-up accruals reflecting the difference between Chorus' total FFLAS revenue and the actual revenue allowance determined by the Commission.

16. Under the Commission's proposals, the wash-up account balance is only drawn down at the end of each regulatory period and applied in the form of wash-up amounts determined for each regulatory year of the subsequent regulatory period. The consequence is that a wash-up accrual recorded in the first year of a regulatory period will not be reflected in prices until – at the earliest – three to five years later in the first year of the next regulatory period.[5] In the meantime, the time value of money adjustments are applied annually to wash-up accruals to address the deferral of their recovery.

17. In general, Chorus accepts the Commission's proposal to draw down the wash-up account only at the end of each regulatory period. However, in relation to individual capex allowances, a re-opener mechanism would be more appropriate. Based on the Commission's draft PQ determination, individual capex allowances will potentially address substantial amounts of capex relating to assets that Chorus will commission during the regulatory period. Using the wash-up mechanism to recover individual capex allowances in prices means recovery of those costs will be deferred into the subsequent regulatory period, potentially well after the assets are in use to provide FFLAS.

18. This delay in recovering individual capex allowances is problematic because:

    18.1 There is no clear justification for delaying the recovery of individual capex allowances once the relevant assets are in use. In contrast, Transpower's Capex

[4] Commission, *Chorus' price-quality path from 1 January 2022 –Draft decision*, 27 May 2021, see para 4.47–4.53

[5] Depending on the length of the regulatory period which may change under s 207(2) of the Act

IM allows for annual re-openers of the price path to address the revenue impacts of major capex projects; and

18.2 If individual capex allowances are significant, deferral of recovery may have cashflow implications that affect Chorus' ability to efficiently finance its operations year to year. This may become more acute if regulatory periods are extended as permitted under s 207 of the Act.

19. To implement the draft PQ determination proposed by the Commission we therefore propose inclusion of an additional re-opener to address the revenue impacts of individual capex allowances.

Annual benefit of Crown financing building block

20. The Commission has proposed amendments to the Cost of capital IM to change the timing of the weighted average cost of capital (**WACC**) determinations for LFCs. This is necessary because of the differing disclosure year end dates for LFCs. We have identified a further issue with the timing of calculations in the Cost of capital IM which needs to be corrected both to account for the different timing of disclosure years for the LFCs, and to ensure the adjustment for Crown financing in the PQ determination reflects the actual financing costs incurred by Chorus as required by the Act.

21. As currently drafted, clause 2.4.11 of the IMs produces an adjustment for Crown financing that is likely to be inaccurate for the LFCs in respect of the 2022 disclosure year given the Commission's draft decision to adopt disclosure year durations of less than 12 months. Additionally, that clause, and clauses 2.4.10 and 3.5.11, currently produce an incorrect annual building block result relative to the forecast profile of repayments.

22. First, in respect of clause 2.4.11, a proportionate adjustment to the cost of debt and cost of equity is necessary to calculate the correct adjustment for Ultrafast (31 March balance date) and Enable and Northpower (30 June balance dates). This is a transitional matter for these entities who will be initially disclosing results in the 2022 disclosure year for reporting periods of three months and six months respectively.

23. Second, clause 2.4.11, as well as clauses 2.4.10 and 3.5.11, are likely to materially overstate the Crown financing benefit building block with respect to repayments of Crown financing occurring during a disclosure or regulatory year. Specifically:

23.1 The annual benefit of Crown financing building block currently multiplies the forecast balance of the Crown financing outstanding on the first day of each year by a rate calculated to reflect the avoided costs of the Crown financing. This calculation is effectively an "offset" to the WACC applied to the portion of the asset base financed by the Crown, and reduces maximum allowable revenues;

23.2 Repayments of the debt and equity portions of Crown financing for Chorus are scheduled to occur at intervals on 30 June in 2025, 2030, 2033 and 2036, reducing the outstanding balance on those dates.[6] The LFCs may also have repayment dates that do not fall on the first day of their disclosure years.

[6] It is possible that debt or equity could be retired on other dates that do not coincide with the first day of the regulatory or disclosure year. We note that further drawdowns of Crown financing from 1 January 2022 onwards should be minimal as the UFB deployment has largely been completed

23.3 As the formulae in the existing IM clauses do not have regard to repayments that occur during the year they overstate the Crown financing building block. The annual benefit of Crown financing building block for Chorus over PQP1 is forecast to be approximately $50m pa[7] and Chorus is likely to suffer material detriment from the treatment of future repayments. The overstatement is also likely to affect LFCs.

24. Because the IMs as currently drafted will lead to an overstatement of the benefit of Crown financing, they will result in a PQ determination which does not reflect the actual financing costs incurred by Chorus in respect of Crown financing in the regulatory period. Therefore, unless this is amended in the IMs, the PQ determination would be inconsistent with s 171 of the Act, which requires the maximum revenues set by the Commission to reflect the actual costs of Crown financing.

25. Chorus has included suggested amendments to clauses 2.4.10 and 3.5.11 in Appendix B.[8]

[7] Commission, *Chorus' price-quality path from 1 January 2022 –Draft decision*, 27 May 2021, see para 3.8; Table 3.3.
[8] In its *Proposed Amendments to Fibre Input Methodologies – draft decisions* the Commission has proposed amendments to cl 3.1.1 to include an annual wash-up for the difference between the forecast and actual values. Chorus' views on this proposal are set out in our 24 June 2021 submission on the August 2021 IM amendments, see paras 21-38

Amendments to enhance certainty

26. The Commission has proposed amendments it believes would enhance certainty about the rules, requirements and processes that apply to PQ paths. Certainty is the key purpose of IMs as set out in s 174 and one of the ways IMs promote certainty is by clearly articulating the rules with sufficient specificity that regulated providers can understand how PQ paths will be set. Accordingly, we welcome the Commission's decision to consider amendments to the IMs where these will clarify the rules and allow us to better understand how PQ regulation will apply to us.

27. We think three amendments to the IMs are required to support this purpose:

    27.1 Allowing assets to be depreciated in the year of commissioning to align with GAAP, reduce complexity and support transparency;

    27.2 Clarifying the definition of connection capex to ensure it captures all types of FFLAS connection work including connection upgrades; and

    27.3 Removing the hard coding of the asset stranding allowance and require revision of stranding risk as part of each PQ determination to ensure that the combination of regulatory tools is properly achieving the purpose of Part 6.

28. Our response to the Commission's proposed change to determining maximum revenues is set out in Appendix A together with other potential amendments to enhance certainty. Our proposed drafting for implementing the changes described below is set out in Appendix B.

Depreciation in year of commissioning

29. In the pre-implementation period, assets are depreciated in the year they are commissioned in accordance with GAAP. In contrast, in the post-implementation period, the IMs provide that depreciation for assets can only commence in the year after they have been commissioned. This:

    29.1 Defers the recovery of those costs relative to when the asset is commissioned; and

    29.2 Results in an unnecessary divergence between the GAAP treatment of depreciation in Chorus' audited accounts and depreciation in its regulatory accounts.

30. We propose an amendment to the asset valuation IM to allow assets to be depreciated in the year they are commissioned, with depreciation applied for the relevant part-year from the commissioning date. This change would be NPV neutral.

31. We note that Transpower, in 2014, requested that the Commission amend the Transpower IMs to permit depreciation of assets in the year of commissioning. Transpower explained that the requirement in the IMs to depreciate assets only from the year following the year of commissioning required Transpower to assess forecast and actual depreciation for revenue setting purposes using a separate process from its general GAAP-based corporate accounting. Transpower argued that this created unnecessary operational complexity and aligning regulatory depreciation with GAAP

would help to maintain consistency and transparency for stakeholders as well as minimise compliance costs.

32. The Commission agreed and amended the Transpower IM to provide for part-year depreciation in the year of commissioning. The Commission noted that the change would more closely align the calculation of regulatory depreciation with depreciation under GAAP, and is expected to reduce some of the costs and risk of error arising from Transpower reconciling its regulatory reports to its accounting asset books under GAAP.

33. For essentially the same reasons, Chorus requests that the Commission make an equivalent amendment to the Fibre IMs to permit part-year depreciation in the year of commissioning.[9] Like Transpower, Chorus is concerned that the ongoing misalignment between the GAAP approach used in its corporate accounting and a separate rule for regulatory depreciation will introduce operational complexity, cost and be an unnecessary source of potential error. To comply with the existing IM rules, Chorus needs to design and establish new regulatory accounting systems with the results to be checked prior to every PQ reset, and for the preparation of every annual ID disclosure. Removing this complexity and source of potential error will enhance certainty.

34. In addition, aligning regulatory depreciation with GAAP will align the timing of the recovery of asset values with their use to provide FFLAS. There is no compelling reason (economic or otherwise) to defer the commencement of depreciation of FFLAS assets from the time they become available for use.

35. Finally, this amendment would ensure a consistent approach to timing of depreciation pre-and post-implementation date.

Clarifying definition of connection capex

36. The current definition of connection capex is limited to capex incurred in new connections to end-user premises. It does not extend to upgrades to existing connections to support new or enhanced FFLAS services. However, capex to upgrade existing connections is also highly demand driven and therefore subject to the same forecast uncertainties as new connections. For consistency, therefore, the definition of connection capex should extend to upgrades to existing connections to support new or enhanced services.

37. An example where this issue currently arises is in relation to Chorus' Hyperfibre service. Hyperfibre uses an XGS-PON solution to deliver dramatically increased capacity, exceptionally low latency and speeds of up to 10 Gbps. If a consumer has a GPON fibre service, an upgrade to Hyperfibre requires the replacement of the existing optical network terminal (**ONT**) at the consumer's premises. Therefore Chorus incurs premises-specific capex in order to deliver Hyperfibre.

38. Hyperfibre is a new service and represents a significant evolution in fibre broadband. It is extremely challenging to forecast the level of Hyperfibre uptake we will

[9] The Transpower IMs were amended after the Transpower IPP regime had commenced so a pseudo-asset was created to account for the accumulated difference to that date. There would be no such requirement needed for Chorus as the fibre IMs would be changed prior to the fibre PQ regime commencing

experience, and therefore the additional capex associated with provisioning new ONTs to support Hyperfibre.

39. Because the definition of connection capex is limited to new connections, in our expenditure proposal we apportioned Hyperfibre installation costs between base capex (for intact connections) and connection capex (for new connections). However, like new connections, installations of Hyperfibre is highly demand-driven and subject to the same degree of forecast uncertainty. It is therefore appropriate for capex allowances to account for upgrades to existing connections to allow the demand-driven component of Chorus' capex to be adjusted for actual uptake of enhanced services like Hyperfibre.

Addressing stranding risk

40. The IMs currently provide for a fixed ex-ante allowance of 10 basis points to address asset stranding risk (in conjunction with other tools). The evidence base for asset stranding has continued to evolve since the Commission determined the IMs, which suggests the 10 basis points allowance is, or will soon be, outdated. We propose an amendment to the IMs to require the Commission to update the stranding allowance as part of each PQ determination to ensure the allowance properly reflects the best evidence of stranding risk.

41. Clause 3.3.5 of the IMs specifies a 10 basis point ex-ante allowance to address the risk of asset stranding. The Commission considered that this allowance, in conjunction with other tools such as keeping assets in the RAB and accelerated depreciation, was sufficient to address the risk of asset stranding.

42. In its January 2020 report, NERA, for Chorus, estimated that an appropriate allowance would be in the vicinity of 31 to 87 basis points.[10] This did not include the higher risk of stranding for the financial losses asset (**FLA**), or in the Wellington region. Accounting for these issues, NERA's May 2021 report estimated that an allowance between 57bp and 135bp was required to adequately compensate for stranding risk.[11]

43. NERA's analysis, in part, reflected updated information on the extent of fixed-wireless access (**FWA**) uptake. In its final IMs determination, the Commission concluded that FWA uptake appeared to have slowed. This was based on data through to June 2020. NERA's analysis of FWA uptake through to December 2020 demonstrated that FWA growth is continuing with no evidence of slowing. This is consistent with commentary and market announcements from Spark and Vodafone.

44. We have proposed, and the Commission has provisionally accepted, accelerated depreciation of the FLA, in part to address stranding risk that is otherwise not compensated for in the ex-ante stranding allowance. However, the adequacy of that approach for the next regulatory period and subsequent periods assumes that the underlying risk of asset stranding does not change.

45. What this ultimately illustrates is that the risk of asset stranding is highly dependent on constantly evolving market circumstances. In light of that, an approach that fixes the ex-ante stranding allowance across multiple regulatory periods fails to recognise the dynamic nature of stranding risk.

[10] NERA, *Assessment of Type II asymmetric risk for Chorus' fibre network – report for Chorus*, 22 January 2020
[11] NERA, *Frontloading depreciation to account for asset stranding risk – report for Chorus*, 12 May 2021

46. Accordingly, rather than fixing the stranding allowance in the IMs, we propose the Commission determine the stranding allowance as part of each PQ determination. This would allow the Commission to revise its assessment of stranding risk as part of each PQ determination to assure itself that the combination of regulatory tools is properly achieving the Part 6 purpose statement.[12] It would also provide additional certainty to regulated providers that the risk of stranding will be appropriately accounted for. This would support ongoing investment.

47. In our view, the Commission is justified in revisiting this issue at this point because it has become apparent that the evidence base on which the Commission relied on to determine the 10 basis point allowance has continued to evolve. This is new information that warrants reconsideration.

[12] In our submission on the draft PQ determination we have proposed how we think the ex-ante stranding allowance and depreciation could be used in concert to best account for stranding risk

Appendix A - Other amendments to support PQ/ID and enhance certainty

This table sets out our view on some of the Commission's proposed changes and suggests other changes we think would support better PQ and ID determinations and/or enhance certainty.

Reference	Issue	Recommended Solution
1.1.4(2), 2.5.1(1)(a)(ii) and 3.6.1(1)(a)(ii)	The Commission proposes amendments to the definition for "downtime" and downtime clauses of the Quality Dimensions fibre IM. We agree with the Commission that if not specified appropriately, availability performance measures can lead to perverse incentives. We support the proposal to remove planned outages from the calculations of "average downtime" and replace it with a calculation of "average unplanned downtime". We also support the change in the definition of "downtime" to replace "access seeker or end-user" with "connection". We agree this enhances certainty.	We are comfortable with the Commission's proposed drafting for: • The new definitions of "connection", "planned downtime" and "unplanned downtime" in 1.1.4(2); • The changes to the definition of "downtime" in 1.1.4(2); • The change in the quality metric in 2.5.1(1)(a)(ii) to "average unplanned downtime"; and • The change in quality metric in 3.6.1(1)(a)(ii) to "average unplanned downtime".
1.1.4(2) and 3.1.1	The Commission proposes amendments to clarify that the definitions of the Specification of Price and Revenues fibre IM for "total FFLAS revenue", "allowable revenue", "pass-through costs" and "building blocks revenue" can be applied on a forecast basis. We agree this change is necessary and we requested it be made earlier in the Rules and Processes consultation in May 2020.[13] The current	We agree with the Commission's proposed drafting for: • Changes to 3.1.1(1) • The new definitions of "forecast allowable revenue" and "forecast total FFLAS revenue" in clause 1.1.4(2).

[13] Chorus, *Submission on the Commerce Commission's fibre input methodologies –draft decision reasons paper (regulatory processes and rules)*, 29 May 2020, Appendix A

	drafting would require Chorus to be able to perfectly forecast demand ahead of time so that actual revenue did not exceed allowable revenue.	We are comfortable with the definition of "forecast wash-up accrual" subject to our comments in our submission on the August 2021 IM amendments.[14] We proposed changes to 3.1.1(2) in our submission on the August 2021 IM amendments.[15]
2.2.13(3)(a) B1.1.3 2(a)	Easements are generally regarded as protecting the rights and access to Chorus transport fibre laid in private land. They are not required for assets in road reserve. Primarily the costs involved are the transactional costs of registering the easement on the title, usually including both parties' legal costs. Chorus does not have any valuations carried out by registered valuers. Even if Chorus did get a registered valuer to value easements, it is highly unlikely the recorded value would be higher than any value a valuer would place on any of these easement assets (which would also take into account the importance of each easement with regards to its use). Total recorded easement value over the pre-implementation period is immaterial. The requirement to have easement valuations by a registered valuer is unnecessary and manifestly excessive.	Remove the requirement to limit the value of easements to their market value as determined by a registered valuer. Clauses 2.2.13(3)(a) and B1.1.3 2(a) should be deleted. As the only instance of the defined term "valuer" appears to be in relation to easements, the defined term can be deleted from clause 1.1.4(2).

[14] Chorus, *Amendments to the Input Methodologies for Fibre - August 2021 amendments*, 24 June 2021, paras 21-38
[15] Ibid

Appendix B – Drafting changes to IM Determination

Definition of notional deductible interest

Clause 2.3.1

Replace clause 2.3.1(7) with the following:

(7) For regulated fibre service providers subject to both information disclosure regulation and price-quality regulation, 'Notional deductible interest' means the value determined in accordance with the following formula:

Sum of all opening RAB values x leverage x cost of debt – Crown financing deductible interest

where:

'Crown financing deductible interest' is calculated as of the last day of the preceding disclosure year using the following formula:

Senior debt outstanding x cost of debt for that disclosure year + subordinated debt outstanding x (cost of debt for that disclosure year + 0.41%) + equity outstanding x (0.25 x cost of debt for that disclosure year)

Insert new clause 2.3.1(7A):

(7A) For regulated fibre service providers subject only to information disclosure regulation, subject to subclauses (8)-(9), 'Notional deductible interest' means the value determined in accordance with the following formula:

(sum of all opening RAB values – Crown financing outstanding) x leverage x cost of debt

where:

Crown financing outstanding is the amount of Crown financing outstanding as of the last day of the preceding disclosure year.

Re-opener for individual capex allowances

Clause 3.9.1

Insert new clause 3.9.1(4):

(4) The Commission must reconsider and amend a regulated provider's PQ determination if the Commission determines an individual capex allowance under clause 3.7.28.

Clause 3.9.2

Insert new clause 3.9.2(6):

(6) *If the Commission determines an individual capex allowance under clause 3.7.28, it must publish notice on its website as soon as practicable thereafter of its intention to reconsider and amend the relevant PQ determination.*

Clause 3.9.8

Amend clause 3.9.8 as follows:

(1) *Subject to subclause (2), if the Commission is satisfied under clause 3.9.2(5) that a reopener event has occurred, then the Commission must have regard to at least the following matters when deciding whether to amend the relevant PQ determination:*

...

(2) *The Commission must amend the relevant PQ determination if it has determined an individual capex allowance under clause 3.7.28.*

Clause 3.9.9

Amend clause 3.9.9 as follows:

(1) *Subject to subclauses (2) and (4), if the Commission decides that the PQ determination should be amended, the Commission may amend the price path and the quality standards to take account of part or all of the net effects of the reopener event on costs, revenues, and PQ FFLAS quality outcomes.*

...

(4) *If the Commission has determined an individual capex allowance under clause 3.7.28, the Commission must amend the PQ determination to include all of the impact of the individual capex allowance on forecast allowable revenue for the relevant regulatory period or periods.*

Annual benefit of Crown financing building block

Clause 2.4.10

Amend clause 2.4.10 as follows:

(1) *In respect of regulated fibre service providers subject to both information disclosure regulation and price-quality regulation in regulations made under s 226 of the Act, 'annual benefit of Crown financing building block' for a disclosure year is calculated as the sum of the amounts calculated in accordance with the following formula for each day of the disclosure year-*

$$(A \times B) + (C \times D),$$

where-

(a) *A is the amount determined in accordance with the following formula:*

((proportion of 'B' that is senior debt × cost of debt for that disclosure year) + (proportion of 'B' that is subordinated debt × (cost of debt for that disclosure year + 0.41%))) × E;

(b) B is the amount of Crown financing outstanding in respect of the regulated provider (or related party as referred to in section 164 of the Act) ~~on the first~~ at the start of the day in question ~~of the disclosure year~~ that is debt (whether senior or subordinated);

(c) C is the amount determined in accordance with the following formula:

((0.75 × cost of equity for that disclosure year) + (0.25 × cost of debt for that disclosure year)) × E; ~~and~~

(d) D is the amount of Crown financing outstanding in respect of the regulated provider (or related party as referred to in section 164 of the Act) ~~on the first~~ at the start of the day in question ~~of the disclosure year~~ that is equity~~.~~; and

(e) E is determined in accordance with the following formula:

1 ÷ number of days in the disclosure year.

Clause 3.5.11

Amend clause 3.5.11 as follows:

(1) For the purposes of specifying a price-quality path, "annual benefit of Crown financing building block" for a regulatory year in a regulatory period is determined as the sum of the amounts calculated in accordance with the following formula for each day of the regulatory year-

$$(A \times B) + (C \times D),$$

where-

(a) A is the amount determined in accordance with the following formula:

((proportion of 'B' that is forecast to be senior debt × cost of debt for that regulatory period) + (proportion of 'B' that is forecast to be subordinated debt × (cost of debt for that regulatory period + 0.41%))) × E;

(b) B is the forecast amount of Crown financing outstanding in respect of the regulated provider (or related party as referred to in section 164 of the Act) ~~on the first~~ at the start of the day in question ~~of the regulatory year~~ that is debt (whether senior or subordinated);

(c) C is the amount determined in accordance with the following formula:

((0.75 × cost of equity for that regulatory period) + (0.25 × cost of debt for that regulatory period)) × E; ~~and~~

(d) *D is the forecast amount of Crown financing outstanding in respect of the regulated provider (or related party as referred to in section 164 of the Act) ~~on the first~~ at the start of the day in question ~~of the regulatory year~~ that is equity~~.~~; and*

(e) *E is determined in accordance with the following formula:*

1 ÷ number of days in the regulatory year.

Depreciation in year of commissioning

Clause 2.2.5

Amend clause 2.2.5(2)(b) as follows:

(b) *a core fibre asset with a FFLAS commissioning date in the disclosure year in question, ~~its value of commissioned asset; and~~ the value determined in accordance with the formula-*

value of commissioned asset – unallocated depreciation

Clause 2.2.8

Insert new clause 2.2.8(3A):

(3A) *For the purpose of subclause (1), in the case of a fibre asset with a FFLAS commissioning date in the disclosure year in question, a regulated fibre service provider must determine 'unallocated depreciation' and 'depreciation' using a depreciation method consistent with GAAP, unless:*

(a) *an alternative depreciation method is applied for some or all fibre assets in accordance with clause 3.3.2(5); or*

(b) *a different depreciation method is applied for some or all fibre assets in accordance with clause 3.3.2(6).*

Clarifying definition of connection capex

Clause 1.1.4

Amend definition of connection capex as follows:

Connection capex *means capital expenditure approved by the Commission as part of the connection capex baseline allowance or the connection capex variable adjustment and directly incurred by Chorus in relation to: (i) connecting new end-user premises, building or other access points, or (ii) upgrading existing connections to end-user premises to support new or enhanced services, where the communal fibre network already exists or will exist at the time of connection, and includes:*

Addressing stranding risk

Clause 3.3.5

Amend clause 3.3.5(2) as follows:

(2) The annual ex-ante allowance for asset stranding is the amount determined in accordance with the formula-

A x B

where-

(a) A is ~~0.001~~ specified in a PQ determination; and

(b) B is the average of-

(i) the sum of opening RAB values for each regulatory year of the regulatory period for all core fibre assets and the opening RAB value for the financial loss asset;

(ii) the sum of closing RAB values for each regulatory year of the regulatory period for all core fibre assets and the closing RAB value for the financial loss asset.

Proposed Amendments to Fibre Input Methodologies: draft decisions Reasons paper

Commerce Commission Consultation

2degrees submission, 8 July 2021

Introduction

2degrees welcomes the opportunity to submit in response to the Commerce Commission's Reasons Paper *"Proposed Amendments to Fibre Input Methodologies: draft decisions*", 27 May 2021, and to provide cross-submissions in relation to the *"Amendments needed in order to implement the proposed approach to determining Chorus' initial PQ RAB"*.

2degrees support a number of IM changes prior to the first statutory IMs review:

- We support the Commission making changes to the Input Methodologies (**IMs**) to allow for a draft Regulatory Asset Base (**RAB**) to be adopted for PQP1 and for the IMs to include a wash-up mechanism.
- We also support amendments to correct for errors. We acknowledge "As the fibre IMs are new, there was a greater chance of [correction for error] being necessary prior to the first reset (as was the case with the IM amendments ahead of the second default price-quality path reset (DPP2) for electricity distribution businesses (EDB))".
- We agree with the Commission that it can introduce new IMs outside the statutory IM review process.

However:

- We do not support the adoption of an 'unlimited' wash-up, as the Commission has proposed, which is in contrast with the approach it adopted under Part 4 of the Commerce Act.
- We consider the consideration of a Pricing Input Methodology, which may apply from PQP2, would meet the criteria to be considered outside the statutory IM process (i.e. it would both help promote competition and improve certainty).

We support amendment of the IMs to allow for a draft RAB to be adopted for PQP1

We do not agree with Chorus' position that the "Proposed amendments to process for determining initial RAB are unjustified, reduce certainty, and are inconsistent with the Act".

While Chorus claims "Certainty … is undermined if the rules are constantly subject to change, or if the Commission changes the rules in a significant way at a late stage to accommodate its desired approach to setting price-quality paths" it is clear the proposed amendments are justified and reflect the circumstances specific to transitioning to the new Part 6 fibre regime. The Commission adopting a process that will better ensure a robust RAB, that protects the long-term interests of end-users, does not undermine certainty.

We also disagree with Chorus' view "No … compelling and urgent rationale has been offered" and that "The only justification the Commission has offered for this change is

that it has run out of time to complete the exercise that Parliament originally intended it should complete by 1 January 2020 and then extended for a further two years to 1 January 2022". It is clear from the observations provided by the Commission and stakeholder submissions that the RAB values Chorus has proposed do not provide a suitable basis for the Commission to determine a final RAB value in time for the price-quality reset.

While we agree with Chorus "some form of transitional initial RAB is unavoidable", 2degrees continues to support amending the IMs to provide for Chorus' fibre RAB to initially be determined on a draft basis for the 2022 PQP1 with the RAB finalised prior to PQP2, and (forward-looking) wash-up applied to adjust for the difference in PQP2.

We also support the related proposals to amend "the Cost of Capital fibre IM to specify that the transitional initial PQ RAB inputs to the "term credit spread differential allowance" and "term credit spread differential" for PQP1 would be determined, in part, on "relevant estimates of historic values", rather than "relevant actual values"" and "the Capital Expenditure fibre IM to change the date by when we must determine a "base capex allowance" and "connection capex baseline allowance" for PQP1".

We agree with the Commission that it "do[es] not have sufficient time to complete the required scrutiny in 2021" and "at the time of determining the PQ path, scrutiny of unallocated asset values may not have been completed and the final cost allocators that will be applied to determine the actual initial PQ RAB asset values will not yet be available. Transitional assumptions are therefore needed to obtain an estimate of the initial PQ RAB". We also agree the Commission's proposed approach "will enhance certainty, consistent with s 174, about the requirements for calculating the transitional initial PQ RAB. We consider our proposed approach is preferable to other ways of managing uncertainty that might risk a material under- or over-statement of Chorus' initial PQ RAB (for instance, not carrying out any scrutiny of Chorus' initial PQ RAB proposal prior to determining PQP1)".

We do not support 'unlimited' wash-up

2degrees supports the wash-up mechanism being included in the IMs.

We consider the wash-up mechanism is something that should not vary over-time and therefore it is appropriate to include it in the IMs. We reiterate "Including a wash-up in the IMs would aid regulatory certainty and promote the long-term interests of end-users" and "we consider the wash-up mechanism should be included in the IM as it is under Part 4 of the Commerce Act".[1]

However, we do not support the wash-up mechanism being set to permit 'unlimited' wash-up, which is in contrast to the Commission's approach under Part 4 of the

[1] https://comcom.govt.nz/__data/assets/pdf_file/0029/217982/Two-Degrees-Submission-on-Fibre-input-methodologies-Regulatory-processes-and-rules-draft-decision-29-May-2020.pdf

Commerce Act, which applies to electricity distributors, Transpower and gas networks. We also do not consider that the Commission has provided reasonable grounds why 'unlimited' wash-up would be to the long-term benefit of end-users. We reiterate "We are concerned by Chorus' suggestion it should be able to operate an unconstrained wash-up for under-recovery. We consider that the Regulatory Rules and Processes IM should include the wash-up mechanism and should include specific limits on the extent of wash-up that is permissible. We note there is precedent for this under Part 4 that the Commission can draw on".[2]

We agree, for example, with the Commission's concern that "the wide scope of this wash-up – specifically the inclusion of an unlimited accounting for undercharging – could in some circumstances harm workable competition from FWA providers in access markets".

While it may be the case Chorus' cashflow incentives would limit the extent to which it would be likely to undercharge, there are reasons and circumstances under which Chorus might undercharge, not all of which are under Chorus' control.

By way of example, the Christchurch earthquakes resulted in Orion under-recovering its allowed revenue, but the Commission did not permit Orion to recover the full level of under-recovery. The Commission was very clear it did not allow full recovery of revenue foregone because:

- "Sharing of risks and costs provides incentives to manage risks"; and
- "Demand risk normally borne by suppliers in competitive markets".[3]

The Commission commented that "While it is clear that specific repair and replacement expenditure benefits consumers, it is less clear that compensating for a reduction in demand benefits consumers" and "allowing claw-back for additional net costs incurred after a catastrophic event helps strengthen regulated suppliers' incentives to invest in restoring their networks … Consumers benefit from this expenditure because it helps directly mitigate any deterioration in quality of service … In contrast, as noted by Professor Yarrow …, reduction in demand has no such direct or immediate implication for the quality of service provided to consumers".[4]

The Commission also noted:[5]

> "To the extent the submission is that demand risk following a catastrophic event should not be borne by Orion at all, we disagree. … the period for which a supplier is exposed to demand risk as a result of a catastrophic event is limited to the time between the event and the next reset of the path.

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[2] https://comcom.govt.nz/__data/assets/pdf_file/0030/173496/2degrees-Fibre-Regulatory-Processes-and-Rules-submission-9-September-2019.pdf
[3] https://comcom.govt.nz/__data/assets/pdf_file/0024/63159/Briefing-for-Orion-CPP-final-decision-29-November-2013.pdf
[4] https://comcom.govt.nz/__data/assets/pdf_file/0023/63158/Final-decision-for-setting-the-customised-price-quality-path-of-Orion-New-Zealand-Limited-29-November-2013.pdf
[5] https://comcom.govt.nz/__data/assets/pdf_file/0023/63158/Final-decision-for-setting-the-customised-price-quality-path-of-Orion-New-Zealand-Limited-29-November-2013.pdf

> "Demand is reforecast at the time a price-quality path is reset, therefore, demand risk is 'recalibrated' over the next regulatory period. This is a construct of the regulatory framework, which balances incentive properties against other objectives. …"

And that:[6]

> "B3 In our view, the financial impact of the earthquakes should be *shared* between Orion and its consumers. Imposing the entire financial impact of the earthquakes on consumers is not consistent with the Part 4 purpose because:
>
> B3.1 it is unusual for consumers to bear *all* the costs and risks of catastrophic events in a workably competitive market. Workably competitive markets tend to manage risks efficiently, by allocating identified risks to the party best placed to manage them;
>
> B3.3 regulated suppliers (and their investors) are generally better placed to manage the risks of catastrophic events than consumers; [244] and
>
> B3.3 from a forward-looking perspective, allocating all the costs and risks of catastrophic events to consumers would reduce the incentives for suppliers to manage these risks efficiently (ie, create a moral hazard). [245]

If the proposed fibre wash-up mechanism had applied to Orion it would have been able to fully recover its foregone revenue. There is no obvious reason for treating Chorus differently to Orion or other electricity networks under Part 4 Commerce Act or vice versa.

The adoption of 'unlimited' wash-up effectively allocates all revenue risk to end-users.

The Commission also suggests the proposed approach of permitting unlimited wash-up is "the least complex and most transparent way of implementing the wash-up" and "This should reduce compliance cost and the risk of unintended outcomes". The Commission has not identified what complexity issues have arisen from the alternative approaches they use under Part 4 of the Commerce Act where there are limits on the extent to which wash-up could occur, or what the potential negative "unintended consequences" may be. We are concerned about consequences, including unintended consequences, of not adopting the approach under Part 4 of the Commerce Act.

We reiterate it is "important for the Commission to be clear and transparent about where it exercises judgement. This includes the reasons for following and deviating from Part 4 of the Commerce Act …" and "Being clear about when previous precedent is not being used will be just as important as being clear about when previous precedent is being used".[7]

We consider the Part 4 precedent is directly relevant to this issue. Prior to making a final decision on the approach to wash-up, the Commission should have regard to the approaches adopted under Part 4 of the Commerce Act and determine whether

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[6] https://comcom.govt.nz/__data/assets/pdf_file/0023/63158/Final-decision-for-setting-the-customised-price-quality-path-of-Orion-New-Zealand-Limited-29-November-2013.pdf
[7] https://comcom.govt.nz/__data/assets/pdf_file/0022/111982/Two-Degrees-Submission-on-new-regulatory-framework-for-fibre-18-December-2018.PDF

there is reason why a different approach is justified and to the long-term benefit of end-users.[8].

The Commission is able to re-open other elements of the IMs outside of the IM review

We agree with the Commission there isn't "a firm rule against introducing new IMs outside the IM review".

There are other elements of the IMs that merit review prior to the IM statutory review.

We recognise section 195 required that the Commission must set PQPs on the basis of a revenue cap for each regulatory period that starts before the reset date, but it can invoke section 181(1) provisions to determine whether a price or revenue cap should be specified in the IMs in time for the following regulatory period if it precedes the timing of the statutory review of the IMs. L1 Capital has commented that "The revenue cap means there is no incentive to invest further in fibre take up or penetration – our recommendation in the absence of a better regulatory regime would be to minimise future investment while it earns a returns [sic] well below cost of capital".[9] This is consistent with submissions by RSPs on this topic.

While the Commission has stated "extending the IMs to cover an entirely new topic would in most cases be a fundamental change; one that needed to be considered in light of the scheme of the IMs as a whole, rather than in relative isolation" the matter of a potential Pricing Input Methodology can be considered an exception.

A Pricing Input Methodology would meet the criteria that the Commission "would only add new IMs if we thought that there was a gap in the mandatory IMs that meant that as a package they did not: … best give, or are likely to best give effect to s 166(2)(a) and s 166(2)(b) (where relevant); or … promote sufficient certainty to achieve the purpose of IMs in s 174". A Pricing Input Methodology would both help promote competition and improve certainty.

The Commission has detailed why circumstances and the legal requirements for PQP1 mean it hasn't adopted a Pricing Input Methodology at this time, but those reasons do not necessarily apply to PQP2 or beyond.

As we have noted previously, "If pricing principles are not adopted for the first regulatory period, it will be important to ensure they are considered before the second regulatory period. Under Part 6 the Commission is able to introduce new IMs at any time, so a decision not to introduce Pricing Principles before the first price-quality determination does not exclude their introduction in the future".[10]

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[8]While the Commission has suggested a difference in approach to Part 4 of the Commerce Act on the basis that some regulated suppliers are trust-owned and may not be commercially incentivised to fully recover their revenue allowance, this argument doesn't apply to Transpower or gas networks.

[9] L1 Capital, Submission to the Commerce Commission (untitled), 28 May 2021.

[10] https://comcom.govt.nz/__data/assets/pdf_file/0022/161914/2-Degrees-Fibre-emerging-views-submission-16-July-2019.pdf

We reiterate we support other RSPs' positions that the Commission should consider development of an additional 'Pricing' IM, and we agree with previous commentary that:[11]

- Axiom Economics: "Chorus will understandably be motivated to engage in strategies to foreclose competition, which suggests it will often be preferable for the IMs to place a reasonably tight rein on its discretion to prevent it from acting on those commercial incentives (e.g., through the way in which it allocates common costs, determines prices for particular services, etc.)"
- Axiom Economics: "if the IMs provide Chorus with flexibility to act in ways that compromises competition in the wireless market (e.g., through the way it allocates common costs, sets prices, etc.), end-users could be deprived of the substantial benefits those services might otherwise deliver."
- Spark: "Given the likelihood of Chorus offering multiple substitutive services, whether layer 2 access products of differing speeds, or layer 1 access products that support competitive layer 2 services, there is a need for more prescription (compared to Part 4) of the pricing methodologies and principles Chorus will be expected to comply with when pricing services that use its RAB."
- Spark: "A more prescriptive pricing principles IM will be important to help guard against the incentive to price in a way that undermines the competitive outcomes the regime strives to emulate."
- Trustpower: "The allocation of shared costs will be a potentially challenging element of establishing the new fibre regulatory regime and we support the Commission in considering this important matter."
- Vocus: "The promotion of competition purpose is directly relevant to the Cost Allocation Input Methodology, as was evident from the statutory review of the Part 4 Input Methodologies. There was substantial debate about the impact Electricity Distribution Business involvement in emerging technology could have on competition, particularly if loose cost allocation rules were exploited to artificially raise the regulated business's costs, and to enable the regulated business to subsidise other activities."
- Vodafone: "... existing competition must be protected and enhanced through robust cost allocation rules."

[11] https://comcom.govt.nz/__data/assets/pdf_file/0013/120424/2degrees-Cross-submission-on-new-regulatory-framework-for-fibre-1-February-2019.PDF

Proposed amendments to the IM for fibre

Cross-submission | Commerce Commission

9 July 2021

Contents

Executive Summary

Thank you for the opportunity to comment on submissions relating to the Commission's draft amendments to the Input Methodologies for fibre (**the draft**).

We support the Commission's proposed amendments that provide for a transitional initial RAB. The Commission has been asked to consider a RAB proposal that is incomplete, appears inconsistent with the IMs in several areas, does not apply several important protections against over-recovery, and would require significant further work and assurance to be capable of being accepted[1].

The Commission has indicated that it will aim to make all key methodology and allocation decisions this year, leaving only the actual 2021 values to be finalised through 2022. Given the gaps in Chorus' proposal and effort required to build a creditable RAB, the proposed timetable is ambitious and there is a risk that rigid adherence to the timetable compromises end-user outcomes. For example,

- Chorus considers that any consideration of the final initial RAB beyond a "truing up" for differences between forecast and actual asset values would be contrary to the requirements of the Act, unjustified and inconsistent with s173 purpose.
- Chorus maintains a significant information asymmetry and - to determine key parameters and make decisions by December 2021 - more information will be required from Chorus.
- Chorus continues to request additional IM concession and revisiting of the anticipated approach set out in the IMs reasons paper.

We doubt the Commission will be able to arrive at a properly informed decision in the time it proposes. That is a direct result of the approach Chorus has taken to preparing its RAB proposal, and attempting to reopen already-settled IM settings. It is not fair of Chorus, in this context, to then demand the Commission adjust its process to consider these new issues in a rushed way and without any recognition of the risk of end-user detriments from such a process. Accordingly, we recommend that the Commission consider further process control and incentives. For example, the Commission could

- Reiterate that it won't be revisiting - or considering proposals to rethink - settled IM Reasons Paper approaches and positions.
- Clarify that it will also consider implementation of settled positions through 2022, i.e., the 2022 analysis will not be limited to a squaring up of forecast versus actual as Chorus has suggested.
- Reinforce that, if Chorus is unable to support a claim with reliable data and assurance, that the asset value will not be included in the transitional initial RAB.
- Ask Chorus to minimise the information it claims confidentiality for.

The Commission's principal focus should be on arriving at the correct decisions, and any timetabling consequences should be secondary to that focus.

Chorus has also proposed that the Commission amend the IMs to, amongst other things, provide more specificity relating to how the wash-up will apply, revise the past tax losses approach, specify FLA asset lives and specify that connection incentive payments are core assets. We don't support revisiting these decisions in isolation. If the Commission does decide to consider changes, it should ensure it considers other interested parties proposals submitted during the IM process and seek new submissions on other prospective changes those parties may consider worthy of Commission

[1] Discussed is our 28 May 2021 PQR submission.

consideration. Chorus Connection Incentive Payments, for example, remain a significant concern for Spark.

Introduction

1. Thank you for the opportunity to comment on submissions relating to the Commission's draft guidance on how it intends to apply s201 pricing requirements (**the guidelines**).

2. Chorus has set out its concerns on the proposed process to finalise the RAB and suggested a number of amendments to the IMs.

3. The Commission has updated its process in anticipation of making key RAB decisions by December 2021[2] .

The process to finalise the RAB

Determining a transitional initial RAB

4. We support the Commission's proposed amendments that provide for a transitional initial RAB. The Commission has been asked to consider a RAB proposal that is incomplete, appears inconsistent with the IMs in several areas, does not apply several important protections against over-recovery, and would require significant further work and assurance to be capable of being accepted[3]. There are substantive matters that the Commission will need to address.

5. The Commission's proposed approach should not have been a surprise to any of the parties. The Commission anticipated this risk in its 15 September 2020 process and approach paper where it foreshadowed such an approach[4], particularly in light of the information asymmetry Chorus holds in determining the first regulatory period[5].

6. Chorus has submitted that, while some form of true-up is inevitable for differences between forecast and actual costs, a more extensive exercise that includes scrutiny of asset related values is potentially unlawful and inconsistent with the Act[6].

7. Chorus notified the Commission that the Commission's proposed approach risks legal challenge and, to mitigate this risk, the Commission should limit any differences between transitional and final RAB to differences between forecast and actual asset-related values, and it should conduct a meaningful consultation on the draft initial PQ RAB before incorporating it into the PQP1 determination[7].

8. Chorus further noted that the transition to a building blocks model of regulation was decided by Cabinet in April 2016. While Chorus, its shareholders and investors have now spent five years waiting for certainty regarding the critical driver of the business' long-term value, the Commission's proposal means that we will have to wait another year for certainty on the value of the initial RAB.

9. The Chorus Chairman wrote to the Commerce Commission Chair on 4 June 2021 to underscore Chorus concerns, noting that the Commission had declined an earlier Chorus request to

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[2] https://comcom.govt.nz/__data/assets/pdf_file/0032/258278/Commerce-Commission-Determining-Chorus27-PQ-RAB-Process-update-29-June-2021.pdf

[3] Discussed is our 28 May 2021 PQR submission.

[4] Commission Proposed process and approach for the first regulatory period 15 September 2020 at 5.122

[5] Commission process and approach paper at 3.94 and 5.133

[6] Chorus submission at page 2, Chorus letter to Commissioner 20 May 2021 page 3. https://comcom.govt.nz/__data/assets/pdf_file/0029/258293/Chorus-Letter-to-Commerce-Commission-re-process-20-May-2021.pdf

[7] Chorus 20 May 2021 letter at page 5.

expedite the process but now appears to be seeking extra time which the legislation does not allow[8].

10. The Commission responded that it disagreed that the proposed two-stage process to setting the initial RAB may be unlawful in any respects set out in the letter but agreed that it would be preferable to provide as much certainty as possible on the initial RAB by finalising as many matters are possible in its planned 2021 determination[9].

11. The Commission indicated to interested parties in its subsequent 29 June 2021 process update that it would aim to finalise key issues by its December 2021 final PQ decision[10] - repeated below. The revised timetable would see the key RAB determinants – the identification and allocation of assets up to 2021 – finalised by December 2021. The Commission anticipating considering only 2021 values during 2022. These cannot be finalised prior to the end of the year as they will, at that stage, still be forecast values.

Figure 1: table from process update

Table 1. Timing of finalising RAB and cost allocation decisions

Matters that we are working to finalise by our final PQ decision (Dec 2021)	Matters that depend on future information from Chorus that will be finalised in 2022	Residual substantive issues that we will resolve in 2022
Actual capex, opex, allocator, and other values up to 2021	Actual 2021 values for unallocated capex for the initial RAB and financial loss asset	None proposed.
Direct attribution of assets, capex and opex to PQ FFLAS	Actual 2021 values for unallocated opex for the financial loss asset	
Allocation of opex to PQ FFLAS	Actual 2021 revenues for the financial loss asset	
Allocation of assets to PQ FFLAS	Actual 2021 allocator values	
Approach to capital contributions		
Approach to tax losses		
Allocation of pre-Dec 2011 assets		
Forecast cost and asset allocation for PQP1		

The process going forward

12. We support the Commission providing guidance on when decisions will be made that promote certainty for interested parties. In our 28 May 2021 submission, we suggested that the Commission could do this by addressing key IM compliance and methodological challenges posed by Chorus' proposal, narrowing the range of actual 2022 RAB outcomes[11].

13. While resolving these issues would narrow the range of actual RAB outcomes, we could see that there would be more movement in the final RAB beyond a squaring up between forecast and

[8] Chorus 4 June 2021 letter. https://comcom.govt.nz/__data/assets/pdf_file/0031/258277/Chorus-Letter-to-Anna-Rawlings-on-process-4-June-2021.pdf
[9] Commerce Commission letter to Chorus 21 June 2021 at page 2. https://comcom.govt.nz/__data/assets/pdf_file/0033/258279/Commerce-Commission-Response-to-Chorus-Initial-RAB-process-letters-21-June-2021.pdf
[10] Commission process update 29 June 2021. https://comcom.govt.nz/__data/assets/pdf_file/0032/258278/Commerce-Commission-Determining-Chorus27-PQ-RAB-Process-update-29-June-2021.pdf
[11] Spark 28 May 2021 submission at page 2

actual asset values. For example, Chorus has not applied proportionate allocations, an allocation cap or proper assurance as required by the IMs and unless there is a significant change in approach, we saw these protections being implemented through 2022[12].

14. However, the Commission has indicated that it will aim to make all key methodology and allocation decisions this year, leaving only the actual 2021 values to be finalised through 2022. Given the gaps in Chorus' proposal and effort required to build a creditable RAB, the proposed timetable is ambitious and there is a very real risk now that rigid adherence to the timetable compromises end-user outcomes.

15. Our principal concern is that, in meeting this challenging timetable, the Commission and/or Chorus will fail to properly apply the IMs as anticipated by the IM Reasons Paper and fail to apply the important validation and assurances set out in the process and approach paper:

    a. Chorus considers that any consideration of the final initial RAB beyond a "truing up" for differences between forecast and actual asset values would be contrary to the requirements of the Act, unjustified and inconsistent with s173 purpose.

    b. Chorus maintains a significant information asymmetry and - to determine key parameters and make decisions by December 2021 - more information will be required from Chorus. As Chorus notes in its letter, the utility model that would apply to Chorus was decided on in 2016 and the parties have had over 5 years to prepare supporting information and systems, i.e., pulling together asset and network information that would be applied under any scenario. Chorus requested the Part 4 utility regulation model as early as 2012.

       Given the time available, it is therefore concerning that Chorus has been unable to provide complete information - with sufficient categorisation and controls applied – to enable the Commission to complete the proposal. As set out in our earlier submission, there are significant gaps in Chorus' proposal, and this can only have contributed to the delays.

    c. Chorus continues to request additional IM concessions and revisiting of the anticipated approach set out in the IMs reasons paper, and these all take significant effort and rework to resolve. For example, Chorus has submitted proposals to, in 2021 alone, not apply the shared cost cap, not apply proportionate allocators, amend the financial losses depreciation profile, recalculate the stranding risk uplift and to further amend IM wash-up provisions (beyond that required to implement a transitional RAB).

       Chorus' "rolling maul" of proposals is difficult to respond to, adds complexity, and we believe has delayed the process. For example, Chorus' RAB proposal was based on decisions that had not been made, i.e., it assumes that proportionate allocations and a shared cost cap would not be applied, yet these decisions have not been made. Accordingly, rework is now required to apply these requirements.

16. To make material progress by December on the proposed issues will require a concerted effort. We believe that, to support setting the transitional RAB, that the Commission should consider further controls and incentives. For example, early in the process the Commission could

[12] See our 28 May submission at page 2

a. Reiterate that it won't be revisiting - or considering proposals to rethink - settled IM Reasons Paper approaches and positions. Any consideration should only relate to actual clarification of the Commission's intent.

   We note that the Commission RAB consultation paper, and our subsequent submission, highlight many "issues" that are simply a failure to apply the approach anticipated by the IM Reasons Paper. We do not need to revisit these matters prior to December 2020 – these matters can be done through a subsequent IMs review in any case.

b. Clarify that it will consider RAB implementation through 2022, i.e., the 2022 analysis will not be limited to squaring up of forecast versus actual as Chorus has suggested.

c. Reinforce that, if Chorus is unable to support a claim with reliable data, that the asset will not be included in the transitional RAB.

   The Commission indicated that its revised approach is dependent on the responses we receive in submissions on the draft initial RAB decision[13]. The approach should also recognise the dependency with Chorus' approach and information provided.

d. Ask Chorus to minimise the information it claims confidentiality for – there is a simple relationship between withheld information and the reliance the Commission can place on it. We have seen information omitted that seems to have limited value.

   For example, Analysys Mason for Chorus omitted a complete appendix that sets out where Chorus has not applied the IMs. It is difficult to see how the whole appendix can be considered commercially sensitive, and it means that interested parties have no idea of the materiality of these omissions or whether the appendix was complete.

Other proposed amendments

17. Chorus has proposed that the Commission revisit other IM decisions.

The washup

18. Chorus has proposed a number of amendments to the wash-up provisions. While we agree that providing further guidance on how the wash-up will work could be provided, we do not support revisiting the IMs at this stage outside amendments necessary to implement the Commission's revised approach. Wash up provisions will have implications for the allocation of risk, forecast incentives, and incentives to withhold capacity and investment, and any amendments would require consideration in light of all IM settings. This would be best done through a separate IM review.

19. Nonetheless, if the Commission did decide to revisit how the wash-up will apply, the Commission should also reconsider access seeker proposals submitted through the development of the IMs. While submitters made a number of suggestions relating to how the wash-up should apply[14], the Commission decided to determine the wash-up process primarily through the PQR decisions.

[13] Commission updated process 29 June at para 6

[14] For example, Spark submission and cross-submission on Fibre regulation emerging views: technical paper 31 July 2019 and we summarised different submitters views and approach in our 19 June 2020 cross-submission

20. If the Commission does decide to provide more guidance in the IMs as Chorus has proposed, it should also consider the proposed guidance suggested by other submitters at the time is was considering the IMs.

Tax losses

21. Chorus proposes to make an adjustment for the time value of tax losses, i.e., between being incurred earlier in the UFB roll-out and when they are used through the regulatory period.

22. If the Commission did decide to revisit its approach, we would also like it to consider the basis for adopting a standalone approach to the losses. In practice, Chorus would have taken the value of any implicit fibre business losses through reduced tax paid on its other revenues. We recommended that the tax benefit be fully taken at the time the loss was incurred, i.e., on the basis these would at the time be applied against other taxable profits.

23. The Commission considered that the time value of the tax loss benefit would not be material. In which case, this would have meant the difference between recognising losses and the time (our preferred approach) and from future BBM revenues approach would not be material.

24. Accordingly, if the Commission does decide to revisit this issue, it should likewise revisit its approach in light of the principle that Chorus is a multi-service provider with the ability to use losses across its business.

Specifying the asset life to apply to financial losses

25. Chorus proposes that the Commission amend the IMs so that the FLA asset life is a weighted average of the depreciation of initial assets rather than weighted average of the asset lives. We understand this accelerates FLA depreciation in earlier years over the IM alternative.

26. It is unclear why any change is necessary. As Chorus notes, the IMs permit an alternative FLA asset life and that has been adopted and proposed by the Commission in its draft price-quality determination. Accordingly, it is unclear why an amendment is required as the Commission could equally adopt Chorus' alternative in any subsequent decision. This could be considered properly prior to the second regulatory period.

Incentive payments

27. Chorus has proposed that the IMs be amended so that core fibre assets include, for the avoidance of doubt, Connection Incentive payments that would be recognised under accounting standards[15].

28. We do not believe that Chorus' current Incentive Payments are in end-user interests or permitted by the Act. The IMs shouldn't be amended to provide specifically for the practice without consideration of the end-user, competition and compliance implications of the practice.

[End]

[15] Chorus submission at 64

CONSULTATION ON PROPOSED AMENDMENTS TO FIBRE INPUT METHODOLOGIES: DRAFT DECISIONS

Submission/cross-submission to the Commerce Commission

PUBLIC VERSION

8 July 2021

EXECUTIVE SUMMARY

1. Vocus supports the Commerce Commission reopening aspects of the fibre Input Methodologies (IMs) before it finalises the first price-quality path (PQP1).

2. The time available to implement the new Part 6 Telecommunications Act fibre price control regime has meant it is not reasonably practicable to determine a final Regulatory Asset Base (RAB) for the PQP determination that does not risk substantial capitalisation of excessive returns.

3. The risk that the RAB is inflated is reflected in the concerns the Commission and RSPs have raised, both before and after Chorus' submission of its RAB proposal. For example, the Commission has noted *"the information asymmetry between us and Chorus is likely to be higher in PQP1 than in subsequent periods. This is compounded by the incentive and potential ability for a profit maximising regulated provider to set and/or advocate for baselines for expenditure and quality that favour it, but not end-users"*.[1]

4. Chorus' statements that the RAB value it submitted wasn't actually a proposal does not fill us with confidence it should be relied on. Based on Chorus' submission it appears no one is endorsing the RAB value Chorus' 'proposed'.

5. We consider the approach the Commission is proposing to adopt a draft transitional RAB for PQP1, with subsequent wash-up in PQP2 after the RAB is finalised, is a pragmatic and sensible approach and will help better protect the long-term interests of end-users. We don't agree with Chorus that the approach the Commission has proposed to address this matter of establishing a robust RAB is "*unjustified*".[2]

6. We support the related proposal to adopt a wash-up mechanism in the IMs, and for the wash-up mechanism to provide for wash-up of the RAB value. However, adopting an 'unlimited' wash-up mechanism is not needed to implement a transitional RAB and would not be in the long-term interests of end-users.

7. We note the Part 4 Commerce Act IMs include wash-up mechanisms but they do not provide for unlimited wash-up. The Commission has provided no explanation why Part 4 precedent is not appropriate, other than commentary specific to the EDB IMs.

8. As part of the re-opening of the IMs, Vocus reiterates the Commission should review whether pricing methodology requirements should be adopted, after it has finalised its PQP1 determination.

9. The Commission has detailed why it does not consider it necesssry to establish pricing methodology requirements for PQP1. It should be recognised though that the matter of cost allocation and pricing for different FFLAS services is a live issue, with Vodafone and Vocus facing ongoing issues with Chorus' proposed pricing of unbundled fibre. Vocus and Vodafone announced a joint venture to unbundle Chorus' fibre network in June 2018 which has not progressed due to Chorus' intransigence.[3] We agree with Vodafone *"under*

[1] Commerce Commission, Chorus' price-quality path from 1 January 2022 Draft decision, Reasons paper, 27 May 2021.
[2] Chorus, Amendments to the Input Methodologies for Fibre: August 2021 amendments, 24 June 2021.
[3] https://new s.vodafone.co.nz/article/vocus-group-and-vodafone-announce-joint-venture-accelerate-fibre-innovation

the current settings there is no prospect of commercial unbundling actually occurring at any scale, which is why we have asked the Commission to intervene to help ensure that this critical part of the regime can become a reality".[4]

[4] Vodafone, New regulatory framework for fibre: Submission on Fibre Regulation Draft Decision, 28 January 2020.

INTRODUCTION

10. Vocus welcomes the opportunity to submit in response to the *"Proposed Amendments to Fibre Input Methodologies: draft decisions"*, 27 May 2021, and to cross-submit in relation to the potential August 2021 Input Methodologies (IMs) amendments.

11. If you would like any further information or have any queries about this submission, please contact:

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TRANSITIONAL RAB

12. Vocus supports adoption of the IM changes required to adopt a transitional RAB for the first price-quality path (PQP1) determination. We agree with Chorus that *"some form of transitional initial regulatory asset base (RAB) is unavoidable"* but do not consider that Chorus has demonstrated the *"Proposed amendments to process for determining initial RAB are unjustified, reduce certainty, and are inconsistent with the Act"*.[5]

13. We note the Chorus submission has not addressed or responded to other submissions stakeholders have previously provided on this matter.

14. We reiterate from our submission in response to the Chorus' RAB proposal, that a transitional RAB is needed for the first PQP determination with subsequent wash-up depending on whether the final RAB is above or below the transitional value. We also reiterate, from our submission in response to the *"Proposed process and approach for the first regulatory period"*, that *"There is a substantial risk overstatement of the initial PQ RAB will lock in excessive prices and returns"*.[6]

15. Other submissions made in response to Chorus' RAB proposal made similar points and highlighted there are substantive concerns the Chorus' RAB is inflated and cannot be relied on e.g.:

    15.1 Spark: *"We support the Commission's intention to set the actual initial PQ RAB through 2022. … a high-level comparison of the proposal outcomes against other UFB providers suggests a significant loading of assets onto the regulated fibre business. … We should expect Chorus to act on its natural incentives to maximise the regulatory asset base (RAB). It is the nature of these cost exercises that the cumulative effect of the model construct, assumptions and allocation choices, have a significant impact on the results. … Accordingly, it is unlikely the Commission could*

[5] Chorus, Amendments to the Input Methodologies for Fibre: August 2021 amendments, 24 June 2021.
[6] Vocus, FIBRE INFORMATION DISCLOSURE AND PRICE QUALITY REGULATION: PROPOSED PROCESS AND APPROACH FOR THE FIRST REGULATORY PERIOD, 14 October 2020.

lawfully accept the submitted proposal, and certainly not Chorus' non-compliant alternative, as consistent with the Act."

15.2 2degrees: *"2degrees considers Chorus' Financial Loss Asset (FLA) and Regulatory Asset Base (RAB) proposal are likely to be substantially and materially inflated, such that a robust asset value will not be available to input into the draft and final fibre Price- Quality Path determination for 2022 (PQP1)."*

16. Chorus' statements that the RAB value it submitted wasn't actually a proposal does not fill us with confidence it should be relied on. Chorus' vague but sweeping claim that *"The cumulative effect of the Commission's decisions to date creates a real risk that Chorus' past economic costs will be underestimated"*,[7] as we have noted with other statements of this ilk, is unsubstantiated and should be disregarded.

17. We also find it extraordinary Chorus' would submit that *"To best give effect to s 177, the Commission should apply a proxy allocator that allocates 100% of the relevant shared costs that were incurred as a direct result of taking on the UFB initiative"* given the clear requirement to apply ABAA not ACAM, but it appears consistent with the intent of the cost and asset value allocations Chorus has 'proposed'.

18. The approach in the proposed IMs amendment is a pragmatic way of addressing the limited time the Commission has to make the PQP1 determination for 1 January 2022. If the Commission is not able to establish a robust RAB it would effectively capitalise excess returns to the (short and long-term) detriment of end-users. Our submission in response to the process consultation detailed why *"There is substantial risk overstatement of the initial PQ RAB will lock in excessive prices and returns"*.[8]

19. We note there are direct parallels with the proposed transitional approach and the mid-period reset the Commission adopted for the first electricity distribution PQP under Part 4 Commerce Act.

WASH-UP MECHANISM

20. Vocus continues to support the inclusion of a wash-up mechanism in the IMs. This accords with our position that *"As a general principle, regulatory processes and rules should be prescribed in the IM unless it would be desirable for the Commission to have flexibility to enable different approaches to be taken at each reset"*.[9]

21. We welcome the Commission's change in position on this matter, from holding the view wash-up *"would be more effectively dealt with outside of the current IM-setting process"*, to now being of the view wash-up should be included in the IMs.

22. Vocus recognises wash-up is required for the implementation of the transitional RAB, and there is potential value in providing for wash-up to address forecast errors and

[7] Chorus, Submission on Commission's consultation on Chorus' initial PQ RAB, 28 May 2021.
[8] Vocus, FIBRE INFORMATION DISCLOSURE AND PRICE QUALITY REGULATION: PROPOSED PROCESS AND APPROACH FOR THE FIRST REGULATORY PERIOD, 14 October 2020.
[9] Vocus, Fibre Input Methodologies – Regulatory processes and rules, Submission to Commerce Commission, 9th September 2019.

uncertainty about pass-through costs etc. We are comfortable with the Commission statement that *"In accordance with ss 195 and 196 of the Act, this wash-up will account for any under or over recovery of revenue due to differences between demand levels used to determine prices, and actual demand levels"*.

23. The proposed wash-up mechanism goes well beyond the requirements to implement a transitional RAB though and adopts Chorus' proposed 'unlimited' wash-up. We do not support adoption of wash-up that extends beyond the equivalent provisions under the Part 4 Commerce Act IMs.

24. We reiterate unlimited wash-up *"would provide no surety against price shocks. At the extreme, it would mean Chorus could set fibre prices at whatever level it wanted in the first regulatory period (from zero, with recovery in the next regulatory period, or double or more than the Commission's price determination). This is clearly untenable and not envisaged by the legislation"*.[10]

25. An unlimited wash-up would also mean Chorus could use the PQP determinations as part of its marketing and promotions, for example, by artificially lowering prices to increase uptake knowing it will be able to recoup the revenue through higher prices once the new customers are signed up. The Commission has similarly noted *"there is a risk of Chorus artificially lowering prices in the short term on certain products in an effort to limit competition from FWA providers. Chorus has the ability to temporarily under-recover with a future wash-up, giving it an advantage over FWA providers"*.[11] This is not appropriate and should not be permissable under the wash-up mechanism.

26. We reiterate *"We consider that the Commission should follow Part 4 Commerce Act precedent and adopt an "Undercharging limit" for wash-up. This would help reduce the risk of price volatility or instability (with Chorus adopting 'catch-up' to its pricing)."*[12]

27. While the Commission has commented in relation to the limit on undercharging for trust-owned EDBs it hasn't commented on the gas and Transpower precedent. The Commission has provided no justification why – other than the special case of the transitional RAB – a different approach is justified which is more favourable/permissive to Chorus than the approaches under Part 4 Commerce Act.

DEVELOPMENT OF A NEW PRICING INPUT METHODOLOGY SHOULD BE UNDERTAKEN DURING PQP1

28. As part of the re-opening of the IMs, Vocus reiterates the Commission should review whether pricing methodology requirements should be adopted, after it has finalised its PQP1 determination.

[10] Vocus, Fibre regulation emerging views, Cross-submission to Commerce Commission, 31st July 2019. June
[11] Commerce Commission, Chorus' price-quality path from 1 January 2022 Draft decision, Reasons paper, 27 May 2021.
[12] Vocus, FIBRE INFORMATION DISCLOSURE AND PRICE QUALITY REGULATION: PROPOSED PROCESS AND APPROACH FOR THE FIRST REGULATORY PERIOD, 14 October 2020.

29. We reiterate *"If the Commission does not adopt pricing principles for the first price-quality determination it should reassess its position immediately after".*[13] The Commission could do this by either reopening the Cost Allocation Input Methodology or developing a new separate Pricing Input Methodology.[14]

30. It should be recognised the matter of cost allocation and pricing for different FFLAS services is a live issue, with Vodafone and Vocus facing ongoing issues with Chorus' proposed pricing of unbundled fibre. Vocus and Vodafone announced a joint venture to unbundle Chorus' fibre network in June 2018 which has not progressed due to Chorus' intransigence.[15] We agree with Vodafone *"under the current settings there is no prospect of commercial unbundling actually occurring at any scale, which is why we have asked the Commission to intervene to help ensure that this critical part of the regime can become a reality".*[16]

31. From our perspective as an access seeker, the sooner certainty is provided over layer 1 and 2 service pricing the sooner we will be able to make firm commitments in relation to our investments and service delivery. We reiterate *"This is a particularly significant issue in relation to layer 1 unbundling which we consider already warrants regulatory intervention, as reflected in joint submissions and correspondence from Vocus and Vodafone".*[17]

32. We agree with Axiom, for example, that *"businesses contemplating acquiring layer 1 dark fibre services need to know how the prices will be set in, say, 2025 so that they can be factored into their investment plans today, i.e., they may be disinclined to deploy capital towards these endeavours if there is a risk that Chorus' prices will ultimately prove uneconomic".*

33. We agree with the Commission there *"are … risks of inefficient price structures, including price structures that may have anticompetitive effects" and support the intention "to monitor prices through targeted ID requirements and assess whether further intervention is required in the future".*[18]

34. We also agree with the Commission that *"The information asymmetry between us and Chorus is likely to be higher in PQP1 than in subsequent regulatory periods. As a result, a profit maximising regulated provider might have a greater incentive in PQP1 (relative to subsequent periods) to engage in behaviours such as: … pricing individual FFLAS in inefficient and/or potentially anti-competitive ways".*[19]

35. The Commission has made a repeated number of references to its view that decisions on cost allocation rules between FFLAS and economic Pricing Principles should be

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[13] Vocus, Fibre regulation emerging views: Submission to Commerce Commission, 16th July 2019.
[14] https://comcom.govt.nz/__data/assets/pdf_file/0011/120431/Vocus-Cross-submission-on-new-regulatory-framework-for-fibre-1-February-2019.PDF
[15] https://news.vodafone.co.nz/article/vocus-group-and-vodafone-announce-joint-venture-accelerate-fibre-innovation
[16] Vodafone, New regulatory framework for fibre: Submission on Fibre Regulation Draft Decision, 28 January 2020.
[17] Vocus, FIBRE INFORMATION DISCLOSURE AND PRICE QUALITY REGULATION: PROPOSED PROCESS AND APPROACH FOR THE FIRST REGULATORY PERIOD, 14 October 2020.
[18] Commerce Commission, Fibre information disclosure and price-quality regulation: Proposed process and approach for the first regulatory period, 15 September 2020.
[19] Commerce Commission, Chorus' price-quality path from 1 January 2022 Draft decision, Reasons paper, 27 May 2021.

considered in the future (after the first price-quality determination for regulated fibre services) e.g.:

> *"We consider that these legislative restrictions on Chorus' prices limit, at least in PQP1, Chorus' ability to set prices in ways that could lead to long-term harm to competition or to detriment to end-users of telecommunications services. This is one of the reasons why in our final IM decisions we decided to not determine a pricing methodologies IM. However, … we are aware of the risks to end-users that might arise from inefficient pricing structures, including potentially anti-competitive pricing, and we intend to monitor prices through ID disclosures and determine whether further intervention is required in the future."*[20]

> *"... our emerging view is that an additional principle on pricing is not necessary at this stage, because ... the Act (at s 195) prevents us from specifying the prices that regulated suppliers can charge prior to the reset date for the regime (as declared under s 225) for any FFLAS other than anchor services and DFAS (as specified in 198(2)(d) and s 199(2)(d), respectively)"*[21]

> *"We note that the adoption of a pricing principle might be more appropriate in subsequent regulatory periods given that market developments might require revisions to other aspects of the regime, eg a move from a revenue cap control to a price cap control."*[22]

> *"... the decision on how to allocate costs between FFLAS may be better determined in the future. This will allow for future analysis such the application of economic pricing principles that consider the future context."*[23]

[20] Commerce Commission, Chorus' price-quality path from 1 January 2022 Draft decision, Reasons paper, 27 May 2021.
[21] Commerce Commission, Fibre regulation emerging views: Technical Paper, 21 May 2019, paragraph 135.
[22] Commerce Commission, Fibre regulation emerging views: Technical Paper, 21 May 2019, paragraph 136.
[23] Commerce Commission, Fibre regulation emerging views: Technical Paper, 21 May 2019, paragraph 326.

Cross-submission on Amendments to the Input Methodologies for fibre

22 July 2021

CHORUS

Consultation process

1. The Commission has published a number of documents under the heading "Submissions on potential November 2021 Input Methodologies amendments". However, many of these documents appear to be submissions on the potential August 2021 Input Methodologies amendments (submitted after the deadline) and/or cross-submissions on our submission on the potential August 2021 Input Methodologies amendments (when no primary submission was made).

2. For the purposes of this cross-submission, we have considered the documents published by the Commission and set out our views on some of the issues raised. However, we request that when the Commission makes its decisions on the proposed amendments to the input methodologies (**IMs**) (in both August and November tranches) that it be clear on the submissions it has considered.

3. During the process to set the IMs the Commission published detailed records of the submissions it did not consider because it believed they were out of scope.[1] We think the Commission should do the same for this amendment process.

Issues raised in submissions

Amendments for determining the initial RAB

4. 2degrees, Vocus and Spark have expressed their support for continued consideration of the initial asset value (**IAV**) into 2022. The points made essentially restate the Commission's assertion that it does not have time to complete the IAV evaluation exercise, and describe issues they have with the IAV. We disagree with the arguments advanced and do not believe they are new or compelling.

5. Our view remains as expressed in our submission on the potential August 2021 Input Methodologies amendments.[2]

Wash-ups

6. Vocus and 2degrees have expressed support for more detail around wash-ups being included in the IMs. We agree this additional detail in the IMs, which provides certainty as to how wash-ups will apply, is welcome.

7. However, Vocus and 2degrees also state they do not support a wash-up mechanism which doesn't limit the amount of under recovery that may be added to a wash-up balance (referred to as "unlimited" wash-up). The submitters cite examples of limited wash-ups under Part 4 of the Commerce Act and state they do not believe there are reasons for departing from that approach. The simple answer to this is that s 196 is unique to Part 6 of the Telecommunications Act and explicitly requires

[1] See for example: Commission, *Out of scope material received as part of submissions on the FLA further consultation paper (published on 13 August 2020)*, 3 November 2020
[2] Chorus, Submission on proposed amendments to the IMs for Fibre – August 2021 amendments, 24 June 2021, paras 9-20

an "unlimited" wash-up. A wash-up that limited the amount of under recovery that could be added to a wash-up balance would be inconsistent with s 196(2).

8. We have commented further on the issue of wash-ups in our cross-submission on the draft PQ determination.

Pricing IM

9. 2degrees and Vocus have requested the addition of a pricing input methodology to constrain Chorus' ability to price fibre services within its portfolio. Both have recognised the Commission has definitively rejected this for PQP1 and prior to a 'reset' being declared under s 225, but seek the addition of a new IM in case it is needed in future regulatory periods.

10. We submitted extensively on why a pricing input methodology was unnecessary and inconsistent with the Act during development of the IMs.[3] From that discussion we reiterate the comments of Vogelsang & Cave in their report for the Commission on competition (emphasis added):[4]

> *In our pricing report (Vogelsang & Cave, 2019) we recommended that at this time the Commission not introduce additional pricing principles/methods besides those already available via the current tool set. We did this, because we felt that the LFCs already face a bewildering set of pricing constraints and that such principles would only address those services not already fully covered by currently available constraints.*

11. For the purposes of this process it is clear the addition of such an IM fails the Commission's criteria for IMs amendments out of cycle: It would not support incremental improvements to PQ paths; it would not enhance certainty about – or correct technical errors in – the existing IMs; it is clearly fundamental; and there is no compelling or urgent rationale given the Commission could not use such an IM unless and until a reset is declared for future regulatory periods.

12. Also, the Commission should not pre-empt the outcome of a price-quality review under s 209 or the declaration of a reset (which can only be made following completion of a price-quality review) by deciding now to change the IMs to accommodate forms of control inconsistent with current statutory requirements.

[3] See for example: Chorus, *Cross-submission in response to Fibre Regulation Emerging Views*, 31 July 2019, paras 15-27

[4] Vogelsang and Cave 2019, *Framework for promoting competition*, 19 November 2019, at p 17

Fibre ID and PQ draft decisions

Cross-submission | Commerce Commission

22 July 2021

Contents

Executive Summary

Thank you for the opportunity to provide feedback on the submissions made on the draft Amendments to Fibre Input Methodologies decision (**the draft**).

Chorus generally supports the Commission's proposed amendments and proposes wide ranging amendments to the treatment of Crown Financing, the wash-up, capex and various assets, and to recalculate the stranding allowance prior to December 2021.

Chorus' additional proposals are all substantive changes to how the price quality path will be determined, yet none of them are consistent with the scope of the s179 notification to amend the IMs to enable the anticipated transitional and actual initial RAB process and to implement specific planned draft decisions.

Accordingly, the Commission cannot consider Chorus' additional proposals as part of this process. If the Commission did decide to consider Chorus' proposed amendments, it should set out the scope of the considerations and process as required by s179 of the Act.

In any case, we do not believe that the Commission should consider further amendments prior to making final decisions later this year. Chorus' proposals relating to Crown Financing, the stranding allowance and washup all traverse ground that was considered at length through the IM process, and we are still only part way through the process of implementing those decisions. We are not aware of any underlying change in the market from when the IMs were completed in October 2020 that suggests a rethink of the stranding allowance. Customers continue to migrate off poorly performing legacy copper services on to wireless and fibre alternatives, wireless provides an option for customers who previously had no broadband service, and we continue to see strong growth in UFB fibre connections.

Conversely, proposals to amend default FLA asset lives and make individual capex proposals a potential price path re-opener are unlikely to make a material difference and could be considered later as part of a wider review. Accordingly, we believe these proposals are better considered further prior to the second regulatory period – if at all - when we have further information and wider review of a particular approach is warranted and possible.

As set out in our submission on the proposed amendments, the Commission already faces a challenging timetable to apply the current IM by December 2021, and to launch further s179 reviews at this stage and issues in parallel can only further undermine delivering on its obligations. The Commission should not be looking to revisit – or entertain proposals to rethink – settled IM positions.

Introduction

1. Thank you for the opportunity to provide feedback on the submissions made on the draft Amendments to Fibre Input Methodologies decision (**the draft**).

2. On 29 and 30 April 2021 the Commission published notices in accordance with section 179 of the Telecommunications Act 2001 (**the Act**) setting out the scope of the potential amendments under consideration, and the proposed process and indicative time frames for considering and consulting on these potential fibre IM amendments.

3. The notices set out a narrow range of proposed amendments:

    a. To provide for the revised process to determine the initial RAB, comprising a transitional and then later an actual initial RAB. In order to implement this approach, the Commission indicated it would consider amendments to the wash-up, asset valuation, term credit spread and dates by which capex allowances would be set.

    b. To correct technical errors in formula and some defined terms (the **August amendments**).

    c. To implement the draft decisions the Commission planned to make to:

        i. LFC ID requirements to reflect the fact that - due to differing start and end dates - each will have a 2022 disclosure year of different length[1], and to address a practical timing issue relating to the WACC used for disclosure[2].

        ii. The Quality Dimensions IM definition of "downtime", splitting out planned from unplanned downtime.

    d. To clarify that defined prices and revenues can be applied on a forecast basis, and to clarify the meaning of "income" (the Commission indicated that having considered the matter further, no clarification was necessary)[3] (the **November amendments**).

4. Chorus generally supports the Commission's proposed amendments, and has also proposed a range of additional IM amendments to:

    a. Change how the Commission valued the "debt" portion of Crown financing[4] and assumed tax implications of this financing[5].

    b. Provide that the IMs wash-up for difference between actual and forecast cost allocator metrics, commissioned assets, and CPI[6].

    c. Change the default FLA asset life[7].

    d. Provide that disputed connection incentive payments are core capex[8].

[1] This applies for the purposes of asset revaluations and taxation. See 4.7 and 4.13 of the proposed amendments reasons paper 27 May 2021.
[2] Reasons paper at 4.17
[3] Reasons paper at 5.9
[4] Chorus submission on November amendments at para 7
[5] Chorus at para 8
[6] Chorus submission on August amendments at page 2.
[7] Chorus on November amendments at page 3
[8] Chorus on November amendments at page 3

e. Provide that the current period price-quality path may be "re-opened" when the Commission receives an individual capex proposal (rather than build into the next regulatory period)[9].

f. Change how the value of Crown financing is calculated when repayment falls part way through the year[10].

g. Change the depreciation methodology for newly commissioned assets[11].

h. Change the way costs to upgrade existing connections are treated for capex expenditure purposes[12], and

i. Require the Commission to recalculate the stranding allowance prior to December 2021[13].

Comment

Considering Chorus' proposals would require a specific s179 process

5. Chorus' additional proposals are all substantive changes to how the price quality path will be determined, and none relate to the scope set out in the Commission notification, i.e., to enable a transitional and actual initial RAB setting process and implement planned draft decisions.

6. A s179 notice sets out the scope and process for an IM review, it is not an invitation for parties to raise any number of concerns or relitigate settled positions. One of the purposes of s179 notices is to ensure parties are notified of an issue and have an opportunity to fully participate in considering proposed IM changes, this cannot occur when new and unrelated issues and concerns are added to a process that is already underway.

7. Accordingly, the Commission should not consider proposals that are not related to the scope of the original s179 notice.

8. Therefore, if the Commission did decide to consider Chorus' proposed amendments, it should set out the scope of the considerations and process in a new s179 notice as required by the Act. Section 179 notices should see to expose the underlying issue and linkages across related IMs, avoiding parties' incentives to "cherry-pick" review of only some elements that go to an IM position of a particular matter. For example,

    a. Proposed amendments to the wash-up IM would also need to consider 2Degrees concerns relating to "unlimited" washups and our IM proposals to apply similar wash-up limits to those applying to Part 4 regulated firms, and WACC. The current WACC would be further disconnected from comparator firms that face risks which – in New Zealand – are pushed on to end-users through the wash-up.

    b. In addition, to the extent the stranding risk is real, the lower-than-expected regulatory cost base and likely future prices, and proposed accelerated depreciate of the FLA (which relates to both core and connection assets contribute) suggests a lower stranding allowance is warranted, if any. Any new consultation should focus on all aspects of the proposal, not the specific amendments proposed by one party.

[9] Chorus at para 12
[10] Chorus at para 23-24
[11] Chorus at 33
[12] Chorus at 39
[13] Chorus at 46

9. Even if the Commission could consider Chorus' additional amendments in the current process, we do not believe it should. Given the time pressures and other priorities for the December PQ decisions, the process needs to remain focused on finalising the limited number of proposed amendments set out in the notice rather than expanding the scope. Chorus has proposed substantive changes and consideration would be required of related IM settings.

The Commission shouldn't re-visit settled issues

10. In any case, we do not believe that the Commission should consider further amendments prior to making final decisions later this year.

11. Chorus' proposed amendments would imply a substantive change to settled IM settings. However, when we considered each proposal in the table below, a number of the proposals such as the within regulatory period treatment of individual capex proposals and amendments to default FLA asset lives will make no material difference and could be considered in a wider review if at all.

12. Of the substantive matters, the Commission's approach to Crown Financing was considered at length through the IMs process and we are not aware of any fundamental change in the market from when the IMs were completed in October 2020 that suggests a rethink of the stranding allowance is warranted. Customers continue to migrate off poorly performing legacy copper services on to better wireless and fibre alternatives, wireless provides a viable option for many customers who previously had no broadband service, and we continue to see strong growth in UFB fibre connections. We would also be concerned that the proposed continual resetting of the stranding allowance reduces Chorus' incentives to mitigate that risk as the allowance would be driven by the consequences of Chorus' own actions.

Table 1: high level view on proposals

Proposed amendment	Comment
a. Amend Crown financing approach and assumed tax implications	A settled matter that was considered in detail through IMs process – this was a significant and contentious issue[14]
b. Expand wash-up to cost allocator metrics, commissioned assets and CPI	A settled matter. The Commission decided that it would not set out this level of detail in the IMs, this would be left to PQ decisions
c. Change the default FLA asset life	No material difference as Commission can already approve alternative Chorus wants
d. Provide that disputed connection incentive payments are core capex	Disputed expenditure – likely no material difference
e. Individual capex proposals as a price path re-opener	No material difference – there are no expected individual capex proposals that could plausibly result in the claimed cashflow concerns. For example, Chorus refers to connection incentive capex which would comprise around 3% of proposed expenditure in RP1
f. Change how the value of Crown financing is calculated when repayment falls part way through the year	No material difference – first payment is at end of regulatory period
g. Change the depreciation methodology for newly commissioned assets	Approach was determined in IMs

[14] IMs Reasons Paper from 3.172

Proposed amendment	Comment
h. Change the way costs to upgrade existing connections are treated for capex expenditure purposes	No material difference
i. Require the Commission to recalculate the stranding allowance prior to December 2021	Settled position – no real change in context. Chorus largely reiterating arguments made through IM process.

13. We have not considered Chorus' proposals in detail, including the implications the amendments would have for other IM settings. Chorus is asking that the Commission consider specific elements of the IMs, but there are inevitably wider impacts that would also need to be considered in any new s179 review. Nonetheless, on the face of it, it is difficult not to conclude that Chorus is simply seeking to revisit settled positions. While we would also like the Commission to revisit our concerns with the IM decisions, we appreciate the decisions were only finalised a little over 8 months ago and are still in the process of being implemented.

14. We believe that Chorus' proposals are better considered – if at all - when we have further understanding of the effectiveness of current IM settings, the future market context, and therefore implications of proposal amendments on wider IM settings. If warranted, the Commission could consider the proposals further prior to the start of the second regulatory period or possibly in the mandated wider review.

Proposed wash-up amendments

15. Submissions also highlight that the draft wash-up amendments may be overly prescriptive for their intended purpose. In particular, while the Commission indicated through the IMs that wash-up settings would be detailed further through PQ decisions[15], the draft amendments suggest a prescriptive IM approach. For example, 2Degrees submits that it does not support the "unlimited" wash-up implied by the proposed amendments, and in our IM submissions we recommended a more nuanced sharing of risk between Chorus and end-users.

16. On the face of it, the proposed amendments go further than necessary to enable a transitional and actual initial RAB setting process and could suggest a detailing of the wash-up that has not been determined. We recommend the Commission review the proposed amendments to ensure they do no more than required to enable the planned draft decision to set a transitional and actual initial RAB. If the Commission wished to consider wider amendments, it would likely need to provide a further s179 notice and consultation.

[End]

[15] See IM Reasons Paper at X41

30 Sep 2021

c/o TelcoFibre@comcom.govt.nz

L1 Capital appreciates the opportunity to make this submission following the release of the *Fibre PQID initial RAB draft decision*, ahead a final decision due in the December quarter of this year.

L1 manages money for a range of clients including large superannuation funds, global endowment funds, high net worth individuals and retail investors. L1 invests globally and has been a shareholder of Chorus since 2012. L1 would like to thank the Commission for the opportunity to present its views as an equity investor.

The Commission has acknowledged that the initial RAB value is an important consideration for both for end-users and investors. Particularly the Commission noted that "our decisions may affect investor expectations about future regulatory decisions. This matters for future investment."

Confidence Has Been Lost by Investors

L1 agrees that it is crucially important to restore confidence in the regulatory process. Many investors have lost faith in the regulatory process, raising the cost of capital for Chorus at a time when it needs to continue to invest and innovate.

While section 162 refers to regulated fibre service providers being "limited in their ability to extract excessive profits", the cumulative effect of the Commission's RAB and WACC decisions to date have made it increasingly doubtful that investors can even earn a fair return.

Since ComCom released its initial paper outlining its 'Proposed process and approach for the first regulatory period' on 15 September 2020, the Chorus share price has declined by 28%. This decline is even greater when considered in the context of strong equity markets over the same period, with the ASX up 26% and the NZ50 up 9%.

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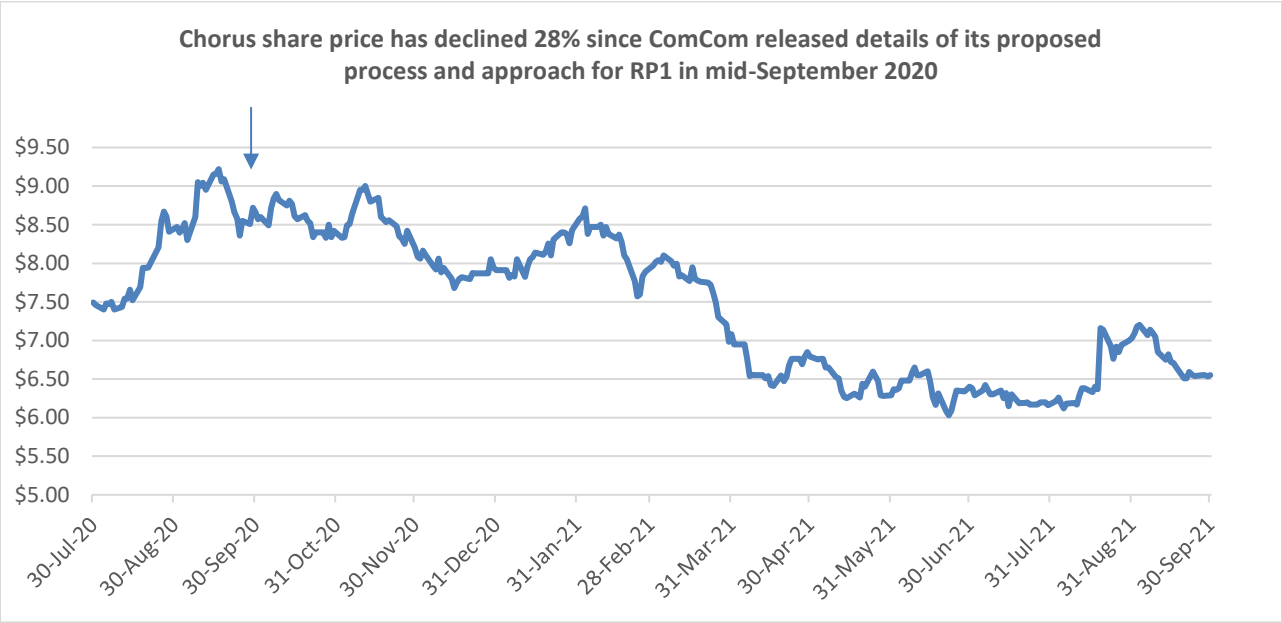

Unfortunately, we must agree with New Street Research that increasingly investors have taken the view that a **"…predisposition to favour access seekers over access providers is a pattern of behaviour by the Commission and reflects a systemic bias against access seekers with committed investment in favour of access seekers' claimed future prospects."**

This has been reflected in our experience as Chorus shareholders.

In 2015 the Commission dismissed investors' legitimate expectation of backdating for copper pricing after it was determined copper prices should have significantly higher than suggested by initial benchmarking. The Commission's approach meant Chorus lost hundreds of millions of dollars in revenue, laid off staff and delayed investment. Ultimately, the benefits of lower copper prices were not passed to consumers but ended up enhancing the profits of large RSP's.

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L1 CAPITAL

The draft RAB of $5.4b is not in itself sufficient to restore investor confidence in New Zealand regulatory outcomes.

As we and others have submitted throughout the current regulatory process, the investment risks faced by Chorus investors haven't been adequately recognised. A $5.4 billion RAB grossly undervalues the true investment that has been made. The need to rely on accelerated depreciation to support regulated revenues in the first regulatory period makes it abundantly clear that there has been a regulatory failure.

As we have pointed out in our July 2021 submission there are 8 key areas of concern by investors, which have cumulatively served to:

(a) raise sovereign risk and Chorus's cost of capital,
(b) significantly depress the IAV compliant RAB,
(c) underestimate the allowable operating expenditure,
(d) leave little incentive for investment going forward.

We reproduce these concerns in brief below.

1. **Risks faced by Chorus in the early stages of the rollout have not been appropriately recognised by the Commerce Commission leading to an underestimation of the loss asset and RAB:** Chorus committed to its UFB investment a decade ago, facing a materially higher cost of capital than it does today, significant uncertainty over rollout costs and end user demand, and faced financial penalties if delivery milestones were not met. By not recognising the environment at the time the initial investment was made, the Commerce Commission has materially under-estimated the loss asset, and hence the RAB.
2. **The capped MAR removes Chorus's incentives to innovate and invest:** The revenue cap means there is a disincentive to invest further in fibre take up or penetration. Our recommendation in the absence of a better regulatory outcome would be for Chorus to minimise future investment while it earns an incremental return well below its cost of capital.
3. **The Commission's draft determination is significantly below the 8% to 9% WACC originally envisaged by CFH when the project was announced:** While we understand that there has been a structural shift in some elements of the project's cost of capital over this time, the Commission's approach completely ignores the cost of capital faced by investors at the outset of the project and represents a convenient change in return expectations only after private capital has vended in assets and taken on the majority of the implementation risk;
4. **A WACC of 4.52% (post-tax) sets a rate of return that is one of the lowest returns for a regulated fibre network anywhere in the world.** This outcome suggests that investors are better off investing in other global fibre networks where risks are appropriately recognised. Although differences in risk free rates do impact the calculation of WACC, if we delve into the drivers of the WACC calculations we can see that the ComCom has under-estimated risk parameters relative to other regulators – specifically the asset beta and the WACC uplift;

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5. **Stranding risk has not been sufficiently allowed for in the WACC determination, meaning investors can seek similar returns via investment in less risky regulated assets.** We note recent commentary by Spark NZ, Vodafone NZ and Ericsson on the accelerating adoption and future growth prospects for fixed wireless broadband solutions, which represents a significant risk to network adoption. We do not see the 10bps WACC allocation as sufficient compensation for the associated risks, given lost revenues are at a high incremental margin due to the fixed cost nature of the business.
6. **Depreciation tilting is being used to fill the revenue gap, but this does not bring any economic value to Chorus and is not in itself sufficient.** Implementation of depreciation tilting does not provide compensation for stranding risk, which should be addressed through the correction of the WACC estimates via the stranding allowance, or through recognition of the costs associated with Chorus' participation in the UFB contract.
7. **There is an efficiency regime being applied to costs where no efficiency adjustment is necessary.** The Commission's suggested 10.7% cut in opex allowance implies the business is being run inefficiently today and that Chorus has not been upfront with its owners with regard to cost initiatives.
8. **Private capital and public capital continue to be treated differently:** Fairness between public and private capital is at heart of sovereign risk and investing in NZ. The current fibre legislation makes a distinction between private capital (regulated through a PQ regime) and public capital (regulated solely through an ID regime). While both have invested in an equivalent fibre network, the legislation allows for wide latitude to determine key parameters under PQ regulation and imposes an impossibly high efficiency standard for private capital.

L1 believes it is vital that the remaining decisions made by the Commerce Commission better reflect commercial realities faced by Chorus in building and operating the fibre network to restore confidence and allow Chorus to invest in what is a piece of essential infrastructure for NZ.

A key component of that is recognising there is a need to look at (a) alternative approach to RAB calculation to recognise past undervaluation, (b) to not impose impossible efficiency standards on Chorus in operating its fibre network and (c) to incentivise rather than penalise Chorus to continue to market take up of fibre services, which drive significant productivity growth for all of NZ through enablement of the digital economy.

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RSP's claims that the asset base should be lower don't stand up to scrutiny.

Spark tries to suggest the Commission's $5.4 billion valuation is so grandiose it "risks undermining innovation and driving out competition and competing investment."

If RAB returns are indeed too high, then Spark will surely have an even greater opportunity to promote uptake of its alternative fixed wireless services. Concerns about competition certainly don't appear to have held back their own recent media announcement about a 5G rollout partnership with Nokia. The only conclusion to be drawn is that access seekers are again focused on providing themselves with better margin, at the access provider's cost.

As Chorus' submission shows, the draft RAB decision has made assumptions that yet again undervalue the contribution Chorus and its investors have made to the UFB rollout. We are particularly concerned by the issues Chorus has identified regarding the Commission's treatment of common costs and ducts.

As recent market analyst reports have highlighted, there is an emerging view that fibre costs have not been adequately reflected in Commission decisions to date. This means that copper customers will ultimately be left to shoulder significant price increases in the near future, or the copper network will likely become uneconomic for ongoing investment. This assessment of commercial reality highlights the fundamental flaw in RSP claims that network analysis from the copper pricing process can be used as a benchmark for the RAB valuation today.

It is L1's view that Chorus' proposed alternative RAB of $6 billion better reflects the true allocation costs to fibre, given the requirements of the UFB initiative. We strongly believe the Commission should consider Chorus' alternative RAB valuation to ensure copper consumers are not disproportionately affected.

L1 also agrees with Chorus' statements that the Commission needs to reconsider its proposed treatment of pre-2011 ducts. It is concerning that after consumers have already benefitted from these assets being artificially vended into the RAB below by the new legislative framework, at less than their commercial value, the Commission is potentially applying more optimisation assumptions in its RAB assessment. If this is the case, it would only strengthen investor concerns about the Commission's tendency to favour assumptions that do not reflect network costs and reality.

Finally, we note that RSPs suggest the wash-up process should not be clarified until nearer the implementation of the second regulatory period. As we've stated, investor confidence in the transition to the new regulatory regime has been severely dented. Any unnecessary delay in spelling out the details of the new framework will only add to investor concerns about future regulatory intent. Based on recent experience we want to know what rules will apply from the outset rather than being told what we should have expected in hindsight.

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Conclusion

We thank the Commission for the opportunity to make a submission at this critical stage.

We remain passionate about the issues at hand given the impact for both Chorus and the New Zealand public, and remain concerned over the cumulative impact of outcomes reached thus far.

Given the findings of the most recent determinations, it is important to flag that every incrementally negative outcome going forward is likely to have an outsized impact on Chorus's ability to invest and innovate.

We encourage the Commission to weigh these considerations carefully if it is to encourage ongoing investment for the benefit of end users.

Signed:

Lev Margolin
Portfolio Manager

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Proposed amendments to fibre IMs: wash-up mechanism revised draft

21 October 2021

CHORUS

Contents

Executive summary

1. This is Chorus' response to the Commission's proposed amendments to the fibre input methodologies (**IMs**) – Wash-up mechanism revised draft (**Draft Wash-up Amendments**). We are pleased the Commission is proposing to add two of the additional wash-ups Chorus suggested in our response to the Commission's first proposal to specify the wash-up mechanism in the IMs on 27 May 2021 (**May Amendment Proposal**).

2. We are also pleased the Commission has taken on board many of our proposed changes to the wash-up mechanism in the IMs to improve its workability.

3. However, as a matter of process it is not clear to us consultation on the Draft Wash-up Amendments was necessary. The Commission proposed specifying the wash-up mechanism in the May Amendment Proposal and stakeholders submitted views on the proposal, including us proposing the two additional wash-ups contemplated here. Other stakeholders were able to (and did) comment on our proposed additional wash-ups and detailed drafting suggestions in cross-submissions. Stakeholders' views on the additional wash-ups proposed are known to the Commission which calls into question the purpose of an additional consultation.

4. Nevertheless, in this submission we confirm our support of the proposed additional wash-ups and suggest drafting changes which might further improve the workability of the wash-up mechanism.

5. We continue to support the following additions to the wash-up IM:

   5.1 a wash-up for forecast allocator values used in setting the revenue path; and

   5.2 a wash-up for any forecast consumer price index (**CPI**) values used in a price-quality (**PQ**) determination.

6. In our submission on the May Amendment Proposal, we also recommended a wash-up for differences between forecast and actual values of commissioned assets to the extent they affect opening RAB values for the next regulatory period. We continue to believe this wash-up is desirable and would advance the purpose of Part 6 of the Telecommunications Act 2001 (**Act**). This wash-up is equivalent to the capex wash-up adjustment that has been in place for regulated energy firms for some time.

7. Even though this wash-up would not be calculated for the first regulatory period (**PQP1**), it makes sense to include this in the IMs now to avoid another consultation on amendment to the IMs wash-up mechanism in advance of the second regulatory period (**PQP2**).

8. Finally, we note that the draft notice to supply information (**section 221 notice**) creates new audit and reporting requirements for Chorus. The draft requirements are not aligned with the multiple other reporting obligations being imposed on Chorus through the Part 6 regulations.

9. Given the vast array of PQ and information disclosure (**ID**) reporting obligations Chorus will be subject to, the Commission needs to rationalise and streamline the set of reporting requirements. Otherwise the new regime will place an unreasonable regulatory burden on Chorus and, ultimately, end-users of FFLAS. We recommend the Commission change the deadline for annual actual wash-up reports from 50 working

days after the end of a regulatory year to 5 months after the end of the regulatory year – this would be more achievable and would also align with ID reporting, meaning we can expect to combine many aspects of the audit for both.

Input Methodologies amendment process

10. The Commission should re-examine its process for amending IMs, and specifically its preference for publishing narrowly confined notices of intention (**NOIs**). The Commission's current approach is unnecessary and unduly burdensome on affected parties considering the already challenging time frames for finalising the PQ path for PQP1.

11. The Draft Wash-up Amendments incorporate a number of proposals Chorus made in response to the May Amendment Proposal. Rather than consider Chorus' submissions in the context of the May Amendment Proposal, the Commission has instead decided that it is necessary to issue a further NOI and conduct a separate round of consultation. This is the fourth NOI that the Commission has issued since April 2021.

12. The Commission's position appears to be that this is necessary because of the narrowly confined scope of its earlier NOIs, despite the fact that other submitters had the opportunity to (and did) submit in response to Chorus' proposals (including specific IM determination drafting suggestions) on the May Amendment Proposal.

13. The consequence of the Commission's approach is that we are only now, at a very late stage in the process, dealing with matters that Chorus raised in response to the Commission's consultation as far back as June. This has also introduced another process step – a separate consultation exercise – when this could have been avoided had these matters been dealt with in the Commission's earlier consultation.

14. The Commission's recent NOIs have very tightly defined the range of issues the Commission proposes to look at when amending IMs. This level of specification is not required by the Act. Section 181 provides that, if the Commission proposes to amend an IM to make a material change, section 179 applies as if the amendment were a new IM. Section 179 in turn provides that when the Commission begins work on an IM amendment, it must "give public notice of its intention to do so that—

    14.1 outlines the process that will be followed; and

    14.2 sets out the proposed time frames."

15. In order to meet those requirements, it is sufficient that the Commission indicate the IM that it proposes to amend, outlines the process steps that it intends to follow and indicates the timing of those steps. It is not necessary to describe, as the Commission has in its recent NOIs, the exact proposals on which the Commission proposes to consult in its draft determination.

16. We are concerned that one of the results of unduly narrowly framed NOIs is to artificially constrain the scope of issues that stakeholders can raise in responding to consultation. While we accept that IM amendments are at the Commission's initiative, and therefore the Commission can place some limits around the scope of the consultation process, it is not appropriate to seek to constrain consultation responses to simply accepting or rejecting the specific proposals the Commission outlines in its draft determinations.

17. Having decided to re-open an IM to address a particular issue, the Commission can and should be open to accepting submissions that are reasonably related to the issues the Commission is addressing in its consultation. A basic requirement of consultation is the obligation to consider alternative proposals with an open mind. For example,

given the May Amendment Proposal focused on the wash-up mechanism, the Commission was entitled to consider any submissions that related to the functioning of the wash-up mechanism.[1] It was not necessary (as the Commission has now done) to issue a further NOI and commence an entirely separate consultation process to consider Chorus' submission. Other stakeholders had an opportunity to comment on Chorus' proposals in the course of cross-submission, and they in fact did so.

18. The Commission's approach has not resulted in a more efficient or expeditious process. Instead, the approach has encouraged submitters to engage on the scope of the NOI rather than to engage with the substance of the proposal.[2] That undermines the value of consultation, and the need to participate in additional consultation processes places an avoidable burden on stakeholders when timing is already tight.

19. The result is that the IM amendment process has become unnecessarily unwieldy. It is difficult to engage meaningfully in an IM amendment process in which several different sets of amendments are at different stages of consultation and in which the content, timing and process are repeatedly changed prior to finalisation. Stakeholders are unable to consider the interdependencies between the various issues the Commission is separately dealing with. A better approach would be for the Commission to issue more broadly defined NOIs and then be explicitly open in consultation to the full range of possible solutions to the issues, and adjacent issues, identified in the draft determination.

[1] The Commission appears to acknowledge this in paragraph 3.17 of the Draft Wash-up Amendments reasons paper
[2] See for example: Spark "Cross submission on Fibre IM Amendments draft decision" (8 July 2021) paragraphs 11-15

Proposed additional wash-ups

Wash-ups for allocator values and CPI

20. The Commission has proposed to include two additional wash-ups to those proposed in the May Amendment Proposal:

    20.1 a wash-up for forecast allocator values used in setting the revenue path; and

    20.2 a wash-up for any forecast CPI values used in a PQ determination.

21. As recognised by the Commission, both of these were suggested by Chorus in our submission on the May Amendment Proposal, together with specific IM determination drafting suggestions.[3] We continue to believe they are desirable and that including them in the IMs will better promote the purpose of Part 6, relative to the May Amendment Proposal. In particular:

    21.1 A wash-up for forecast allocator values will promote the long-term benefit of end-users by preserving the expectation of an NPV=0 outcome and reducing the risk of windfall gains or losses. It will promote competition by ensuring the allocation of costs between FFLAS and non-FFLAS services is correct over time.

    21.2 A wash-up for forecast CPI values will promote the long-term benefit of end-users as it will preserve investment incentives by ensuring Chorus can recover its allowable revenue and ensuring that prices are consistent with actual rather than forecast CPI over time.

22. For further discussion of these two wash-ups we refer the Commission to our submission on the May Amendment Proposal.[4]

Wash-up for forecast commissioning values for PQP2 and later

23. In our submission on the May Amendment Proposal we proposed a third additional wash-up for differences between forecast and actual values of commissioned assets for the regulatory period to the extent they affect opening RAB values for the next regulatory period.

24. We continue to believe this wash-up is desirable and consistent with the criteria the Commission has established for including explicit wash-ups, namely where:

    24.1 Chorus not bearing the risk that outcomes differ from forecast best promotes the purpose of Part 6 or workable competition; and

    24.2 There is no existing mechanism that provides for that.

25. A wash-up for the difference between forecast and actual commissioning values in a prior period will promote investment incentives, and hence the long-term benefit of end-users, by ensuring that Chorus can expect to recover the actual cost of its new

[3] Chorus, Amendments to the Input Methodologies for Fibre August 2021 amendments (24 June 2021) at [30 to 32 and 36 to 38]
[4] Ibid at [21 to 38]

investments in future periods and minimises excessive profits by ensuring that prices over time can more closely reflect actual expenditure on these investments.

26. We recognise that this wash-up would not be required to be calculated for PQP1 (given that opening RAB values at the start of PQP1 are effectively trued-up by the proposed wash-up for the transitional and final initial RABs), but we think it should be specified now to promote certainty and minimise further consultations in IMs amendments. The wash-up should be straight-forward to implement,[5] and is equivalent to the capex wash-up adjustment that has been in place in the IMs for regulated energy firms for some time.

[5] See Chorus' drafting suggestions contained in its June 2021 submission – "Amendments to the Input Methodologies for Fibre: August 2021 amendments" (24 June 2021) at [page 23]

Wash-up process and draft section 221 notice

Process will be ongoing and require resources

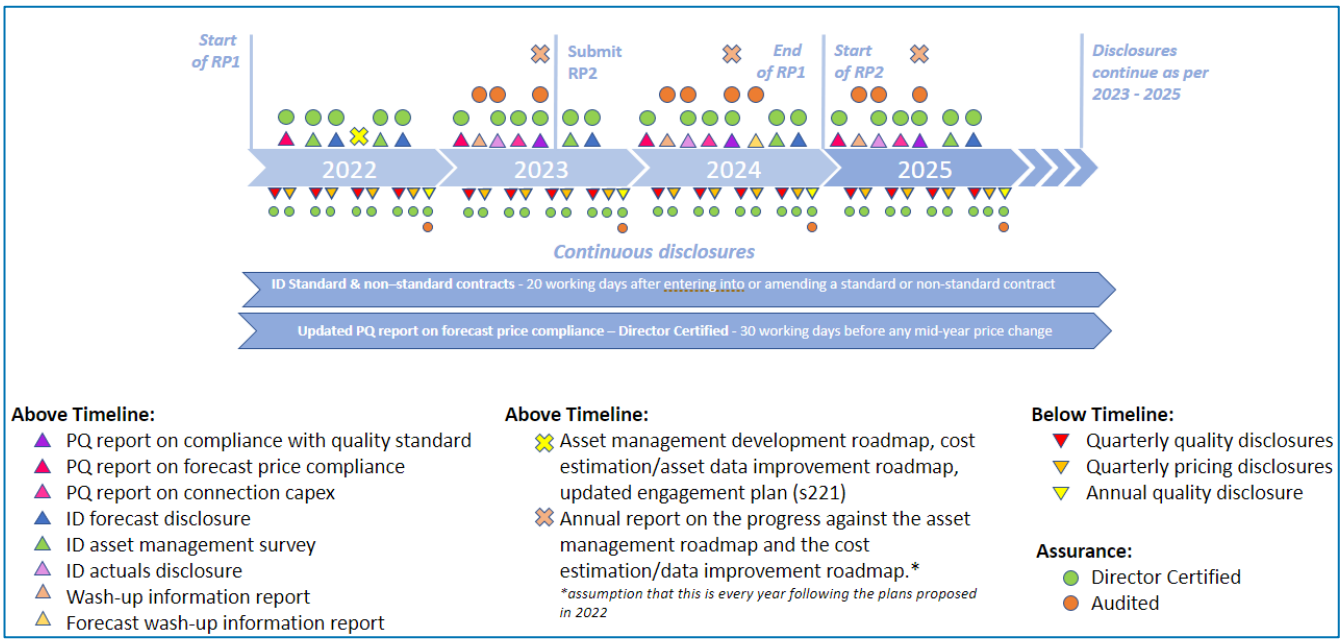
27. We support the Commission's approach of determining the wash-ups in accordance with rules contained in the fibre IMs. This provides certainty and a clear process for us to follow. We agree with the approach of annual actual wash-up reports after the end of a regulatory year, plus a forecast wash-up report for 2024. This means the wash-up draw-down amount for PQP1, which will be carried into PQP2 pricing, will include actual wash-up values for 2022 and 2023 plus forecast wash-up values for 2024.

28. The Commission's proposed approach involves updating the BBM model used for PQP1 revenue setting each year out to March 2025 in order to generate the necessary wash-up accruals. We note this will require Chorus and the Commission to ensure staff are available across that timeframe with the necessary expertise to understand and accurately update the existing model each year. Both Chorus and the Commission will need to ensure that plans are put in place now for this ongoing exercise.

Extent of PQ and ID reporting and compliance requirements

29. The section 221 notice creates new audit and reporting requirements for Chorus. While we agree audited reporting is needed for wash-ups, the draft requirements are not aligned with the multiple other reporting and compliance obligations being imposed on Chorus through the Part 6 regulations.

30. The graphic below shows Chorus' full set of PQID reporting and compliance requirements across 2022-2025 based on the draft PQ and ID decisions (it has been updated from a similar graphic in our July ID submission to include the wash-up reports). This extent of reporting is excessive, costly and goes far beyond what is necessary for the regulation of a business that faces competition from alternative access technologies and is incentivised to respond to market demands.



31. Additional to the items shown here, we have a raft of other regulatory reporting and compliance obligations outside of the Part 6 regime. The graphic also does not show the lead-times and resourcing required for preparation and evaluation of the PQ proposal for PQP2 during PQP1, nor the other parallel financial accounting, company law and market disclosures required by other regulatory regimes.

32. As noted, we agree with the need to make wash-up reports. We encourage the Commission to rationalise and streamline the set of reporting requirements or the new regime will place such a regulatory burden on Chorus (including needing to be on the agenda of virtually every Chorus board meeting) that it will distract our focus from other priorities, including growth and service quality improvements. We do not see this as benefitting end-users.

33. We also have concerns whether all of the information we produce will actually be used. The Commission should only require disclosures where it has capacity to use the information and we question if it will be able to promptly and fully assess all of these reports and disclosures from Chorus each year. Interested parties will also find it very difficult to keep across the mass of information where it is made public, particularly if the release of information is staggered across years and different regulatory periods.

Timeframe for wash-up reporting

34. The section 221 notice requires actual wash-up values to be provided within 50 working days of the end of each regulatory year and forecast wash-up values for 2024 to be provided by 6 September 2024. The timeframes for the actual wash-up reports are unnecessarily tight.

35. For the annual actual wash-up reports, 50 working days after the end of a regulatory year is approximately mid-March each year. This is unreasonable and will be onerous in practice. The proposed timeframe does not align with other audit deadlines and only provides a short space of time to collate and audit the data after year end:

    35.1 Chorus and audit staff tend to be on leave early in the regulatory year – meaning 15 to 20 working days are automatically lost.

    35.2 Chorus' half-year financial results are published in the third week of February each year. Key Chorus personnel and our auditors will be focused on producing the half-year results until that time. Requiring them to also produce the wash-up report at that time would unnecessarily add to the workload.

    35.3 Chorus' half-year results will also be relied upon to produce the wash-up results, so we can be confident we are using accurate information. As the results will not be completed until late February, there would only be limited time to finalise the wash-up report each year.

36. Instead, we recommend the Commission requires this report 5 months after the end of the regulatory year – this would be more achievable and would also align with ID reporting, meaning we can combine the audit for both. There should be no downside from this proposal – we do not see any reason why the Commission would need the wash-up reports 50 working days, rather than 5 months, after the end of the regulatory year.

37. Reporting of the wash-up information to the Commission so quickly after the end of a regulatory year may trigger market disclosure obligations. This is another reason why aligning the wash-up reporting to the ID reporting timeframe would be helpful.

38. The requirement to provide forecast 2024 wash-up information by 6 September 2024 is workable from Chorus' perspective. It should enable us to use FY24 full year results and thus only have to forecast for the second half of the regulatory year. We note the Commission will receive the forecast wash-up report relatively late in the process for determining PQP2 revenue path and will need to ensure it has enough time to build in the forecast wash-up information.

Audit and certification

39. For the annual actual wash-up information reports, the draft section 221 notice requires audit and no certification. We support this approach.

40. For the forecast wash-up information report for 2024, the draft section 221 notice also requires audit. We assume this is an error – it is not practicable to audit a forecast and we are not aware of the Commission requiring audit for any other forecast. A certification requirement would be more appropriate for this report.

Drafting clarifications

Input Methodologies amendments

41. Appendix A sets out Chorus' detailed comments on the drafting of the proposed IM amendments.

42. We agree with most of the clarifications outlined in table 3.1 as they provide more certainty about how the wash-up mechanism works.

43. However, we would like more certainty on the connection capex variable adjustment. We previously submitted that there were two timing issues to be addressed.[6] The Commission has not proposed to address either of the issues:

    43.1 First, it appears the Commission expects to calculate the wash-up for the connection capex variable adjustment in the final year of each regulatory period. However, the final connection capex annual report (which is required to calculate the variable adjustment) is not received until after the end of the regulatory period as per clauses 3.7.18(1) and 3.7.21(1). As a result, this wash-up would be deferred by one regulatory period. This would mean the wash-up for the connection capex variable adjustment relating to PQP1 would not be calculated until PQP2 and only available to draw down in PQP3. In Appendix A we propose a new subclause 3.1.1(9)(d) to provide certainty that a forecast of the connection capex variable adjustment is included in the forecast wash-up drawdown amount.

    43.2 Second, neither clause 3.7.21 nor clause 3.1.1 indicate how the Commission intends to account for the timing of connection capex through the regulatory period when calculating the connection capex variable adjustment. The connection capex variable adjustment reflects differences between forecast and actual connection volumes and the impact of those differences on Chorus' connection capex. It does not specify how that capex would affect the forecast allowable revenue due to WACC, depreciation, revaluations and other associated building block revenue effects during the regulatory period. In Appendix A we propose changes to subclause (11)(g) that would provide additional certainty that these effects are included.

44. In Appendix A we also set out a number of smaller changes to clause 3.1.1 we think should be made to provide additional certainty and simplify the drafting.

Section 221 notice

45. Appendix B sets out Chorus' detailed comments on the drafting of the section 221 notice.

46. Our suggested changes to paragraphs A7.3 to A7.6 of the section 221 notice generally improve the workability and flexibility of the notice. The Commission's specific cell references to the model have the potential to cause issues and a more general set of requirements will aid implementation. The changes remove the cell references from the request which will mean that the notice will be less likely to become incorrect and won't need any changes if the structure of the model changes. The changes do not

[6] Chorus, Amendments to the Input Methodologies for Fibre August 2021 amendments (24 June 2021) at [page 24]

change the intended effect of the requests and they align with the drafting for paragraphs A7.1 and A7.2.

Appendix A: Detailed Input Methodology comments and drafting proposals

Text in black in the "Proposed IM with Chorus proposed drafting" column is as per the Commission's *"[Revised draft] Fibre Input Methodologies (wash-up mechanism) Amendment Determination 2021"*. Our suggested changes are included in red text.

Reference	Proposed IM with Chorus proposed drafting	Chorus response
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** must not exceed **forecast allowable revenue** specified in the **PQ determination** for that **regulatory year**.	We agree with removing "derived by a regulated provider" as the wording was redundant. No changes suggested.
(2)	'Forecast allowable revenue' means the sum of the following for a **regulatory year**: (a) forecast **building blocks revenue**; (b) forecast **pass-through costs**; and (c) the **wash-up amount**, and is calculated in accordance with the methodology specified in a **PQ determination**.	Our understanding is that the forecast pass-through costs referred to in paragraph (b) are those calculated at the beginning of each regulatory year as specified in Schedule 2 of the PQ determination. For paragraph (c), any wash-up amount is *specified* in the PQ determination, but the *methodology* for determining the amount is set out in clause 3.1.1 of the IMs (not the PQ determination). The drafting could be clarified accordingly.
(4)	For the purpose of subclause (2), the 'wash-up amount' for each **regulatory year** of the **second regulatory period** onwards comprises amounts (which may be positive or negative) determined by the **Commission** and the sum of those amounts:	We agree with the proposed change. This is consistent with our previous submission on (4) which recommended

Reference	Proposed IM with Chorus proposed drafting	Chorus response
	(a) in present value terms as of the final day of the preceding **regulatory period**; equals (b) the **wash-up draw down amount** for the preceding **regulatory period**.	changing "includes" to "comprises" and clarifying that the wash-up amount could be positive or negative. [7]
(5)	'Wash-up draw down amount' for a **regulatory period** means a positive or negative amount as determined by the **Commission**, where such amount must be ~~and that must be~~: (a) (i) no greater ~~in absolute terms~~ than the sum in present value terms as of the final day of the **regulatory period** of: (~~i~~A) the **wash-up account balance** for the final completed **regulatory year** of the **regulatory period**; and (~~ii~~B) a **forecast wash-up accrual** for the final **regulatory year** of the **regulatory period**; where the sum of (A) and (B) is positive. (ii) no less than the sum in present value terms as of the final day of the **regulatory period** of: (A) the **wash-up account balance** for the final completed **regulatory year** of the **regulatory period**; and (B) a **forecast wash-up accrual** for the final **regulatory year** of the **regulatory period**; where the sum of (A) and (B) is negative.	The use of absolute value is incorrect since, without further specification, it permits the wash-up draw down amount to be the opposite sign of the wash-up account balance. For example, a wash-up draw down amount of -$100m in absolute terms is no greater than a +$100m wash-up account balance so would satisfy the condition but would be $200m less. Limb (c) ignored the fact that section 170(3) of the Act provides for more than one PQ determination to be made for a regulatory period, and limb (d) was not effective in limiting the determination of a draw down amount to a final year of PQP1 and beyond. We have proposed corrected drafting in red.

[7] Chorus, Amendments to the Input Methodologies for Fibre August 2021 amendments (24 June 2021) at [26.2]

Reference	Proposed IM with Chorus proposed drafting	Chorus response
	(b) deemed to accrue on the final day of the **regulatory period**; (c) determined by the **Commission** in the final year of a ~~for the current~~ **regulatory period** ~~at the same time as the **PQ determination** for the next **regulatory period**~~; and (d) not determined by the **Commission** prior to ~~at the same time as the **PQ determination** for~~ the **first regulatory period**.	
(8)	'Wash-up accrual' means an amount for a **regulatory year**, being the difference between the **actual allowable revenue** and actual **total FFLAS revenue** for that **regulatory year**, and is deemed to accrue ~~182~~ 148 days prior to the final day of that **regulatory year**.	The accrual date should match the revenue date to align with when revenue is received. This is consistent with the description in Table 3.1 – that the date is equivalent in PV terms to 12 equal revenue amounts on the 20th of each month.
(9)	'Forecast wash-up accrual' means an amount for a **regulatory year**, being the forecast difference between the **actual allowable revenue** and actual **total FFLAS revenue** for that **regulatory year**, and is: (a) determined by the **Commission** ~~at the same time as the **PQ determination** for the next~~ in the final year of a **regulatory period**; ~~and~~ (b) not determined by the **Commission** for any regulatory year prior to ~~at the same time as the **PQ determination** for~~ the **first regulatory period;** and	We recommend adding an accrual date for consistency with subclause (8). For certainty we have included paragraph (d) to clarify that the forecast wash-up accrual includes a forecast of the connection capex variable adjustment and its modelled impacts on forecast allowable revenue. We previously submitted that the final connection capex annual report is not received until after the final year of the regulatory period but that the wash-up amounts (and therefore forecast wash-up accrual) would be specified before the end of each regulatory period and as a result this would mean this wash-up would be deferred.[8] Not correcting for this error would mean that the wash-up for the connection

[8] Chorus, Amendments to the Input Methodologies for Fibre August 2021 amendments (24 June 2021) at [page 24]

Reference	Proposed IM with Chorus proposed drafting	Chorus response
	(c) deemed to accrue 148 days prior to the final day of that **regulatory year**. (d) for the avoidance of doubt inclusive of a forecast of the **connection capex variable adjustment** specified in subclause 11(g) and its associated modelled impacts.	capex variable adjustment for PQP1 would not be calculated until PQP2 and only available to draw down in PQP3.
(11)	'Actual allowable revenue' means the sum of forecast **building blocks revenue**, forecast **pass-through costs** and the **wash-up amount** for a **regulatory year**, as specified by the **Commission**, for the purposes of calculating a **wash-up accrual** or **forecast wash-up accrual**, and must include the ~~actual~~ modelled impacts on **forecast allowable revenue** (for a **wash-up accrual**) or forecast of ~~actual~~ modelled impacts on **forecast allowable revenue** (for a **forecast wash-up accrual**) (whichever is applicable) for that **regulatory year** of:	We have proposed the use of "modelled" rather than "actual" impacts. The impacts to forecast allowable revenue that are required for the wash-up calculation are only due to substituting actual data for the wash-ups in subclauses (11)(a) to (g), not all data is updated for actuals.
(11)(d)	~~the difference between:~~ ~~(i) the sum of:~~ ~~(A) the **base capex allowance** determined in respect of the current **regulatory period**; and~~ ~~(B) any **individual capex allowance** determined in respect of the current **regulatory period** that was determined before the current **regulatory period** commenced; and~~ ~~(ii) the sum of:~~ ~~(A) the **base capex allowance** determined in respect of the current **regulatory period**;~~	We propose simplifying this calculation since the difference between the sums in subparagraphs (i) and (ii) is the amount specified in subparagraph (C).

Reference	Proposed IM with Chorus proposed drafting	Chorus response
	~~(B) any **individual capex allowance** determined in respect of the current **regulatory period** that was determined before the current **regulatory period** commenced; and~~ ~~(C)~~ any **individual capex allowance** determined in respect of the current **regulatory period** that was determined after the current **regulatory period** commenced;	
(11)(e)	the difference between: (i) the forecast **pass-through costs** for that **regulatory year**; and (ii) the actual **pass-through costs** for that **regulatory year**;	Our understanding is that the forecast pass-through costs referred to in subparagraph (i) are those calculated at the beginning of each regulatory year as specified in Schedule 2 of the PQ determination.
(11)(f)	the difference between: (i) any forecast **CPI** values referred to in a **PQ determination** for the purposes of calculating **forecast allowable revenue** under subclause (2) for that **regulatory year**; and (ii) the corresponding actual **CPI** values for that **regulatory year**; and	We support this change. As we have previously submitted, in order to maintain an ex-ante expectation of real FCM forecast ΔCPI_t needs to be used to calculate the forecast building block revenue and this needs to be washed-up for actual CPI.[9]
(11)(g)	~~in respect of the final **regulatory year** of a **regulatory period**,~~ the **connection capex variable adjustment** for the~~that~~ **regulatory period** as determined under clause 3.7.21(2), where the modelled impacts take account of the respective differences referred to in clause 3.7.21(2) for each **regulatory year**.	As we have previously submitted, the IMs need to be updated to ensure that the connection capex adjustment can be included in the wash-up draw down amount for the following regulatory period and to ensure the modelled impacts of the connection capex adjustment are included.[10]

[9] Chorus, Amendments to the Input Methodologies for Fibre August 2021 amendments (24 June 2021) at [36 to 38]
[10] Ibid at [page 24]

Reference	Proposed IM with Chorus proposed drafting	Chorus response
12	For the purpose of subclause (11), the 'actual allowable revenue' for a **regulatory year** only includes the ~~actual~~ modelled impacts on **forecast allowable revenue** (for a **wash-up accrual**) or forecast of ~~actual~~ modelled impacts on **forecast allowable revenue** (for a **forecast wash-up accrual**) for that **regulatory year** of the matters specified in subclause (11)(a) for the **first regulatory period**.	We have proposed the use of "modelled" rather than "actual" impacts. The impacts to forecast allowable revenue that are required for the wash-up calculation are only due to substituting actual data for the wash-ups in 11(a)-(g), not all data is updated for actuals.

Appendix B: Detailed section 221 notice drafting proposals

Reference	Chorus response with proposed drafting
Definition of "initial RAB model"	The reference to a model version published on the Commission's website is incorrect, and should be removed, since the public version is redacted and will not contain the confidential information needed to calculate the MAR. There are currently two versions of the IAV model required to run the MAR model and therefore this definition needs to reference both. Currently, the MAR model links to a version of the IAV model that calculates pre-implementation values (without changes to the forecast capex and opex in the first half of FY22) and a second version for post-implementation calculations which includes post-implementation date modifications to the forecast opex and capex, both will need to be updated to reflect the final decision (other than the forecast capex and opex, and everything derived from these, these two copies of the IAV model are identical). This reference should be updated when the final version of the notice is updated to include a reference to both of the final version(s) of the IAV model.
Definition of "opex allocation model"	There are currently two versions of the opex model required to run the MAR model and therefore this definition needs to reference both. Currently, each of the two IAV models links to a version of the opex model. One calculates pre-implementation values and a second version is used for post-implementation calculations incorporating changes to the forecast opex post-implementation, both will need to be updated to reflect the final decision. This reference should be updated when the final version of the notice is updated to include a reference to the final versions of the opex model.
Paragraph A5	As discussed above, the requirement to provide wash-up information reports 50 working days after the end of a year is too tight and does not line up with other requirements. We propose the following change to subparagraphs A5.1, A5.2 and A5.3 to align the wording to the year-end information disclosure rules: "~~within 50 working days~~ no later than 5 months after ~~of~~ the end of regulatory year…"

Reference	Chorus response with proposed drafting
Paragraph A7.3:	We propose the following drafting to make the request more consistent with the wording in A7.2 while giving the same effect: the benefit of Crown financing inputs for the relevant **regulatory year** ~~in cells "Z4658:AC4668" of the "SMARInputsFromIAV" sheet of the **BBR model**~~ updated to reflect actual benefits of Crown Financing as determined under clause 2.4.10 of the **IM determination**;
Paragraph A7.4:	We propose the following drafting to make the request more consistent with the wording in A7.2 while giving the same effect: the **capex allowance** inputs ~~sourced from the **initial RAB model** in cells Z4684:AC6183, Z6190:AC7689, and Z7696:AC9195 of the "SMARInputsFromIAV" sheet of the **BBR model,**~~ updated to include the value of any **individual capex** determined in respect of the **first regulatory period** determined after the **first regulatory period** commenced
Paragraph A7.5:	We propose the following drafting to make the request more consistent with the wording in A7.2 while giving the same effect: actual **pass-through costs** ~~in cells Z9217:AC9221 of the "SMARInputsFromIAV" sheet of the **BBR model**~~ for that **regulatory year** in place of forecast **pass-through costs**;
Paragraph A7.6:	We propose the following drafting to make the request more consistent with the wording in A7.2 while giving the same effect: in respect of **regulatory year** 2024, the **connection capex variable adjustment** for the **first regulatory period** as determined under clause 3.7.21(2) of the **IM determination** ~~in cells Z4684:AC6183, Z6190:AC7689, and Z7696:AC9195 of the "SMARInputsFromIAV" sheet of the **BBR model**~~; and

Reference	Chorus response with proposed drafting
Paragraph A8: Specifies that 'Total FFLAS revenue' is calculated using this formula: $\sum_i (P_i - D_i) \times AQ_i$	This formula assumes all Chorus' PQ FFLAS revenue is earned from fibre products on a P*Q basis. As we have explained in a similar context,[11] while the majority of Chorus' forecast total PQ FFLAS revenue is calculated on a P*Q basis, a portion is not. This includes revenue from products such as Colocation and handover links. We therefore suggest an additional term (AR, meaning any PQ FFLAS revenue not derived on a P*Q basis) is added to this formula to account for other PQ FFLAS revenues.
Paragraph A10.3	This clause requires an audit report to be provided with both the actual and forecast wash-up reports. As discussed above, we assume the requirement for audit of the forecast report to be an error. We suggest: For the purpose of clause A5, be accompanied by an assurance report meeting the requirements in clause A11; and for the purpose of clause A6, be accompanied by a certificate in the form set out in clause [xx], duly signed by one director of Chorus

[11] Chorus, Submission on price-quality path draft decision (8 July 2021) Appendix B item B3, and Appendix C item C3.