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Introduction

L1 Capital appreciates the opportunity to make this submission following the release of the Commerce Commission's (Commission) paper: *Chorus' expenditure allowances for the second regulatory period (2025 – 2028) (Draft decision – Reasons paper)*, ahead of a final decision due in Q3 2024.

L1 has been a significant investor in Chorus from the early days of the UFB roll-out. We manage investments for a range of clients including large superannuation funds, global endowment funds, high net worth individuals and retail investors. We invest globally with North America, Europe, U.K., Australia and New Zealand being key focus areas.

In this submission, we flag key areas of concern with regards to the Commission's assessment of Chorus' PQP2 opex allowances. In summary, we note:

- An 18% cut to Chorus's proposed opex would require a substantial change to its operating model;
- The application of a 3% efficiency factor to a large portion of Chorus' operating expenditures is not supported;
- The Commission's assessment of opex savings from IT investment are not properly substantiated;
- The Commission's proposed retention of a totex-based allocator for certain corporate costs over-allocates costs to a sunset business;
- Artificially constraining the MAR by an underestimation of Chorus' actual operating costs provides negative signals for consideration around further investment in the business going forward and in NZ infrastructure more broadly.

Key areas of concern

An 18% cut to Chorus's proposed opex would require a substantial change to its operating model

The Commission cut 11% of Chorus' proposed opex for PQP1. This time the draft decision suggests that 18% should be cut, even though the current process has involved review by an Independent Verifier. A cut of this magnitude suggests a substantial change to the operations of Chorus' business with implications for end user services beyond the scope of regulated quality controls and sends a de-stabilising signal to capital markets. Changes of this magnitude should not be made lightly by the Commission if it is interested in investor certainty and confidence in the regulatory regime.

The application of a 3% efficiency factor to a large portion of Chorus' operating expenditures is not supported

Efficiency assumptions based on the U.K. are not applicable to Chorus and may significantly over-state the productivity gains available to Chorus. The Commission has referenced a 3% compounding efficiency factor to Chorus's non-network opex (with the exception of the IT portion), on the basis of Ofcom's model benchmarks being *"appropriate as reference points for Chorus' forecast opex because they are forward-looking and relate to a directly comparable network operator providing similar services"* [Para 7.43][1]. We note there are significant differences between the U.K. fibre rollout and the UFB in NZ, which the Commission itself has noted in prior regulatory papers. Further to this topic, we note the following:

- **Significant differences exist between the U.K. fibre rollout and that of Chorus:** Examination of the Ofcom fibre model demonstrates the reference points used are particular to the U.K. fibre roll out in Area 2. These points are substantially different to Chorus's fibre rollout in New Zealand which expands across all geographic types and population density types of its UFB coverage area. Moreover, Ofcom specifically notes that one shouldn't draw particular inferences selectively from the model. "*Only selecting a sub-group of input assumptions … could result in a biased estimate of costs and/or risks introducing inconsistency into the model*"[2]. It is wrong in principle and practice to selectively benchmark the components that support a preferred outcome without considering the model as a whole. We contend that the specific efficiency factors applied in the Ofcom model are not directly referable to Chorus's fibre rollout given the significant underlying cost differences between the two models. These include substantial differences in operating scale, rollout targeting and timing.
- **The Commission's selective benchmarking of cost productivity assumptions is inconsistent with its prior approach to fibre regulation:** On several occasions in the past, the Commission has warned against the pitfalls of incorporating international benchmarking to its decisions. We question why it is now so willing to selectively apply an international data point from the U.K. when it has cautioned against the risks of doing so in the past and when Ofcom itself counsels against selective application. In our view, it is unreasonable for the Commission to selectively apply estimates from other jurisdictions when it suits its purposes, and to disregard such estimates when they do not serve those purposes.

[1] Commerce Commission's (Commission) paper: Chorus' expenditure allowances for the second regulatory period (2025 – 2028) (Draft decision – Reasons paper)
[2] Ofcom (24 May 2023), Openreach proposed FTTP offer…, non confidential version. p.67 available here.

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While we note contextual differences exist, the following examples are relevant to this point.

- In 2015, at the conclusion of a multi-year process to model network costs in New Zealand, the Commission ultimately concluded that European benchmarks were not relevant because customers in New Zealand tend to be more spread out and so it costs more to provide, operate and maintain the infrastructure to service them. When specifically considering operating expenditure, the Commission rejected the use of international benchmarks saying Chorus' "*operating costs are the best objective starting point for estimating the network opex for a nationwide fixed line telecommunications network in New Zealand*."[3]
- In the 2020 IM review, several submitters – including Chorus – suggested the Commission refer to the asset betas proposed by Ofcom in its 2020 Wholesale Fixed Telecoms Market Review 2021-26 for different segments of BT Group (which is the same review the Commission proposes to rely on for its efficiency factors). The Commission's response was to dismiss the use of Ofcom estimates, saying "*FFLAS providers in New Zealand may well face a different systematic risk than other jurisdictions. Consequently, other regulators' determinations should not be relied on directly. As a result we have decided not to use Ofcom's estimates in our WACC and asset beta reasonableness checks*"[4].

  The Commission referenced in its decision a submission to that process from CEPA that argued: *"These submissions argue that the Commission should consider Ofcom's estimates as a benchmark. While other regulatory determinations can be useful to highlight relevant issues, we do not agree that this evidence can be relied upon to directly set cost of capital parameters. This is because estimates adopted by other regulators will naturally depend on the specific nature of their regulatory framework, the context of each regulator's previous decisions, and the characteristics of the services that are being regulated. Without careful consideration of these issues, relying on point estimates adopted by other regulators' risks selecting parameters that are simply not relevant for New Zealand."*[4]

The Commission's assessment of opex savings from IT investment are not properly substantiated

We note the Commission suggests that Chorus has undervalued the opex savings that are likely to result from IT capex investment and applied its own model, resulting in opex savings of $20.4m – an additional $7.7m opex savings over PQP2 compared to those proposed by Chorus. It is not clear to us why the Commission has determined that its investment modelling is more accurate than Chorus'. Chorus itself must understand the rationale for this change so it is able to accurately assess the Commission's understanding of investment appraisal. **We urge the Commission to work through this analysis in detail with Chorus.**

[3] Final pricing review determination for Chorus' unbundled copper local loop service, December 2015, paragraphs M12-M16 at p478 available here.
[4] Fibre input methodologies: Main final decision – Reasons paper, October 2020 Para 6.940-6.941.

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The Commission's proposed retention of a totex-based allocator for certain corporate costs over-allocates costs to a sunset business

We note the Commission's proposed retention of a totex-based allocator for certain corporate costs rather than the revenue-based allocator proposed by Chorus for PQP2. While investors consider consistency in approach an important feature of regulatory regimes, and this may support retaining totex as a cost allocator, it also needs to be balanced against the need to avoid anomalous cost allocations.

With the fibre network build largely complete and operations well-established, revenue-based allocation is now likely to be a more predictable and reliable basis of joint cost allocation and provide more reliable signals to stakeholders. This becomes even more important as copper comes to the end of its economic life and all joint costs effectively revert in time to FFLAS. Given the acceleration of copper migration to fibre and other alternative networks, as recognised by the Commission's recent announcement of a review of copper services regulation, we believe the Commission must consider the risk that the continued use of totex could lead to anomalous allocation outcomes. While consistency in approach is desirable this should be weighed against consistency in outcome and avoiding anomalous impacts.

We urge the Commission to weigh these criteria in considering the extent to which retaining the use of totex may distort the impact on the FFLAS MAR and distort long term outcomes. The proposed reduction in allowed FFLAS cost allocation is not a well-measured outcome. The effect is to impose an excessive reduction in allowed cost. As the Commission has itself stated, underestimating the proportion of costs attributable to FFLAS "*…would be inconsistent with the principle of FCM and could result in under-investment in services, to the detriment of end-users.*" [para 4.299][5]

As investors, we certainly expect Chorus to maintain an efficient cost structure including in relation to joint and common costs and to remaining competitive in non-FFLAS areas. A consistent and measured approach in terms of outcomes (i.e. allocations between FFLAS and copper) would provide a better signal for ongoing productive efficiency and infrastructure investment.

Concluding comments

As significant long-term investors in New Zealand infrastructure we well appreciate the need for consistent and reliable regulation of Chorus FFLAS given its market position. We also appreciate the role of the Commission as an independent regulator in objectively reviewing key parameters of price regulation. In turn, that requires the regulator to be time-consistent, objective and measured in establishing price control inputs.

[5] Fibre input methodologies: Main final decisions – reasons paper, 13 October 2020

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The lack of consistency and objectivity in setting efficiency measures and the lack of measure in setting shared cost between FFLAS and copper are causes for concern to long-term value investment.

It sends a negative signal to both further committed investment in New Zealand infrastructure as well as to incentives for optimal use of established capacity.

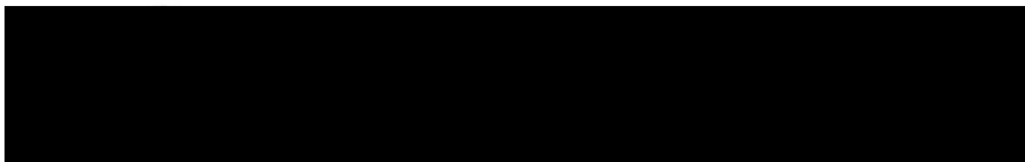
If the draft decision were to be applied, investors would expect Chorus to:

- **In the short term (i.e. within the limits of established capacity) reduce innovation that may expand its business model regardless of incremental value-in-use to end users or the needs and preferences of retail service providers in order to work within the parameters of a tighter-than-optimal revenue cap.** The revenue cap should allow for efficient cost not just dampening of cost for the sake of constraining near term revenue. That requires objectivity and consistency in cost parameters sufficient to allow Chorus to maximise the value end users may derive from the level of capacity invested capital has provided.

- **In the long term, show restraint with regard to worthwhile but discretionary incremental network investment.** This may include, for instance, investment to lift network resilience and operational capacity that may enhance value in use or network expansion. When the Commission constrains the MAR in ways that are not consistent, objective or measured, the signal sent to investors goes beyond a numeric estimate of the impact on investment returns and adds a further element of risk that is inherently difficult to quantify. Beyond well-established objective measures of efficiency, consistent application of cost allocation and measured estimates of joint cost control, no investor can foresee how a regulator may selectively apply cost targets. The use of selective criteria turns the regulatory model into an unpredictable exercise weighted against long term investment. The consequences of this may not be apparent in the near term, but would play out over the long term as future demands for ongoing capital investment are not sufficiently met and investors instead focus on how to best recoup the investment that has already been made.

We thank the Commission for the opportunity to comment and look forward to engaging further in the regulatory process.

Yours sincerely,



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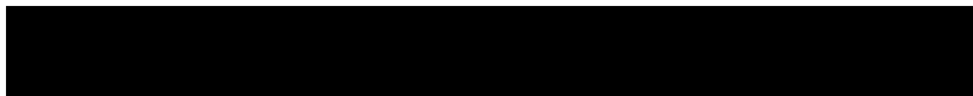

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