

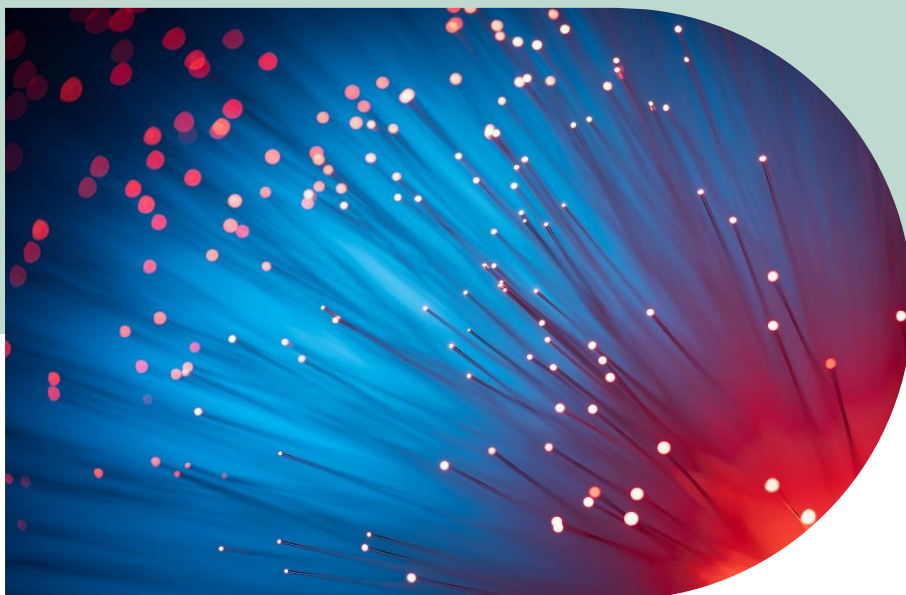
# Major transaction reopener

---

Fibre Input Methodology Review

Vhari McWha

August 2026



## Summary

Chorus has identified that there are shortcomings in the input methodologies that apply to a major transaction such as the acquisition of another fibre provider, or network. The input methodologies do not provide certainty about the extent to which any share of the efficiency benefits (cost savings) of such a transaction would be retained by an acquirer, both within the regulatory period in which the transaction occurs and in the subsequent regulatory period. This is inconsistent with the purpose of the input methodologies and undermines the regulated firms' incentive to improve efficiency.

### Price path reopener in the period the transaction occurs

In this paper, I recommend the IMs be amended to make it clear that following an acquisition the standalone costs of the two entities would be combined, that is that any adjustment to the price path would *not* be net of forecast cost efficiencies.

### Retention of incentives into subsequent regulatory period

I explain the weak incentive for efficiency improvements associated with acquisitions and identify a simple and more complex approach to strengthen this incentive. Conceptually, the recommended approach is simple: extend the period before the level of allowed revenue associated with the acquired entity is reset at the new efficient level.

I recommend allowing PQ regulated fibre service providers<sup>1</sup> to retain the efficiency benefits for the duration of the regulatory period following the period in which the transaction occurs, specifically strengthens the incentive to make efficiency savings via acquisitions. The rationale for allowing a larger proportion of savings to be retained following a transaction than is retained for other efficiency savings is to compensate the acquirer for bearing the risk associated with obtaining those savings.

While such a mechanism could share some design features with the electricity distribution incentive scheme (IRIS), I do not recommend the adoption of a broader IRIS mechanism for PQ regulated providers.

## Incentives

### Natural incentives in a price quality period

Section 162(b) of the Telecommunications Act 2001 (the Act) specifies that one of the purposes of regulation under Part 6 is so that fibre providers have incentives to improve efficiency.

One of the ways that this is achieved is by using forecasts to set the revenue allowance over a period of years. During a regulatory period, the regulated provider has an incentive to generate efficiencies

---

<sup>1</sup> At present there is only one, but there is scope for other LFCs to move from ID-only to PQ regulation.

relative to this forecast. It retains the benefit of these cost savings (via higher profits) during the regulatory period.

The natural incentive to improve efficiency declines as the end of the regulatory period gets closer, because the Commission passes efficiencies obtained in the previous period to customers at the start of each regulatory period. The mechanism for this is the use of a recent actual outcome as the base for the expenditure forecast in the new period (for example operating expenditure in the penultimate year of the regulatory period).

A profitable business case for acquisition generally relies on the acquirer being able to achieve cost efficiencies and retain the benefit of those efficiencies for some period, before they are competed away through price reductions as other suppliers achieve similar efficiencies. In the case of a regulated provider, the incentive to achieve efficiencies relies on the provider retaining the benefit of those efficiencies for a period before allowed revenue is adjusted to reflect the improvements and the efficiencies are passed to consumers through lower prices.

### **Incremental rolling incentive scheme (EDBs only)**

Subpart 3 of Part 3 of the EDB IMs establishes the incremental rolling incentive scheme (IRIS). The purpose of this scheme is to equalise the incentive on EDBs to generate efficiencies in each year of the PQ regulatory period. It eliminates the natural decline in the incentive rate described above.

The IRIS mechanism is an adjustment to revenue based on the difference between actual and forecast expenditure. This allows cost savings to be retained by EDBs for five years after the efficiency is made, irrespective of when in the regulatory period they are generated.<sup>2</sup> It provides a symmetrical sharing of expenditure above forecast, so that the EDB and consumers also share cost overruns. The IRIS also enables sharing of temporary savings which are otherwise retained by the regulated entity (as are temporary cost overruns).

Despite the relatively simple theoretical basis for the IRIS, the mechanism is quite controversial. It is claimed by EDBs that it has undermined appropriate opex-capex trade-offs. In my opinion, the low level of acceptance and understanding of the IRIS mean that it is unlikely to have achieved the efficiency benefits that it claims in theory. I do not recommend a mechanism similar to the IRIS be incorporated in the Fibre IMs.

### **Major transaction reopener**

The Fibre IMs provide for the reopening of the PQ path following a major transaction, which is defined (at a high level) as the acquisition or disposal of fibre assets over a certain value (clause 3.9.7). The threshold value is 10% of the opening value of the regulatory asset base in the year of the transaction. There is an equivalent clause in the EDB IMs (clause 4.5.8). To my knowledge neither of these clauses have been used in practice.

---

<sup>2</sup> The entity retains the savings for a total of six years, including the year in which the saving is made.

The framework for reopening a PQ path is similar in the EDB IMs and the Fibre IMs. This is a result of changes at the 2023 EDB IM Review to model the reopener provisions on the Fibre IMs. The framework has three parts:

1. Establish whether a defined reopener event has occurred.
2. If so, decide whether to amend the PQ path.
3. If so, decide by how much the PQ path should be amended.

I will focus on the third of these steps. Clause 3.9.9(2) of the Fibre IMs requires that “the Commission must not amend the price path more than is reasonably necessary to (i) take account of the change in costs... and (ii) address the relevant differences in values that contribute to the price path...”.

Following a major transaction, it could be argued that clause 3.9.9(2) limits the change in the PQ path to the incremental cost of delivering services across the newly acquired assets. Subclause (1) states that “the net effects” of the reopener should be taken into account. Such an interpretation risks undermining the business case for an acquisition, by removing any temporary profit due to efficiency gains.

The lack of certainty in what the Commission would interpret as “reasonably necessary” is itself undesirable and contrary to the purpose of the IMs. The purpose of the IMs is to promote certainty in relation to the regulatory rules, requirements and processes (s.174 of the Act). The current IMs do not promote certainty: the ability of a PQ regulated provider to retain efficiencies that result from a major transaction for any period of time is at the Commission’s discretion.

In my view, it would be consistent with the purpose of Part 6 of the Telecommunications Act, in particular section 162(b), and the purpose of input methodologies in section 174 to amend clause 3.9.9 of the Fibre IMs to state that when amending the PQ determination following a major transaction reopener event the reasonably necessary change in costs and values in subclause (2) are *not* net of forecast cost efficiency savings.

This recommendation is consistent with the approach used by the Commission in relation to amalgamations of EDBs that are subject to a price quality path. In that case, the relevant values for each entity are aggregated to form the new price quality path. Ideally, the Fibre IMs would make clear that this same approach would be adopted for an acquisition of another provider or network by a PQ regulated provider. I expand on this in the next section.

## **EDB amalgamations**

Under the Commerce Commission’s Electricity Distribution Services Input Methodologies (EDB IMs), when two electricity distributors that are both subject to price-quality (PQ) regulation merge (or one acquires the other), the Commission will aggregate the relevant revenue paths from the start of the year following the merger in accordance with clause 3.2.1. There is no equivalent clause in the Fibre Input Methodologies (Fibre IMs) because Chorus is currently the only provider that is PQ regulated under the Fibre IMs.

Clause 3.3.14 of the EDB IMs establishes that following an amalgamation the Commission is able to adjust forecast opex and/or total forecast value of commissioned assets where the Commission is

satisfied that there would otherwise be a material effect on the relevant incentive properties (i.e. the IRIS outcomes). The effect of the IRIS mechanism and this clause is that following an amalgamation the EDB could expect to retain any efficiencies for a period of five years.

I have not identified a compelling reason that this approach, of aggregating the pre-merger standalone costs of the two providers, should not be used in the event of the acquisition of a non-PQ regulated provider. While it arguably relies on an untested forecast (for the acquired entity), this is consistent with the status quo, that is, it is what consumers would have paid absent the acquisition. It is also consistent with the regulatory framework which allowed the pre-acquisition entity to determine its own expenditure forecasts subject only to disclosure. Consumers are no worse off.

ID-only regulated fibre providers are required to prepare and disclose five years of forecasts including for opex and commissioned assets. This means that it would be possible to establish at least four years of forecasts from the PQ year following the transaction, sufficient for the aggregation of values for the remainder of a regulatory period of up to five years.

## How are efficiencies shared?

As explained above, a PQ regulated provider retains efficiency gains only until the end of the regulatory period. This sets a relatively low maximum value for retained efficiencies for the acquirer. Under the Commission's revealed cost approach to regulatory PQP resets, at the start of the next period all achieved efficiencies are passed to consumers. Using the analytical model used for the EDB IRIS applied to Chorus' PQP2 settings, this suggests up to 24% of efficiencies would be kept by Chorus in PQP2.<sup>3</sup>

The PQ regulated provider also bears the total cost of achieving those efficiency gains. This imbalance may become more severe and have a greater effect on incentives to achieve efficiencies in the context of an acquisition than in other situations. The transaction costs of a merger are material, and include due diligence, legal and integration costs.

If all efficiency savings are allocated to consumers after only a couple of years, then these may not outweigh the transaction costs, even if the acquisition generates sufficient efficiencies overall to be beneficial for consumers. The structure of the IRIS means that EDBs do not experience this imbalance, because savings and additional costs are both shared.

To illustrate, suppose (in present value terms) an acquisition generated \$200 of efficiency cost savings and cost \$100 to execute and there was four years to run in the regulatory period. If both costs and benefits are shared in proportion, then the regulated entity would retain about \$24 of benefits. If only benefits are shared, and all costs are allocated to the regulated entity the transaction would not

---

<sup>3</sup> This estimate uses the Commission's model for the EDB opex IRIS and Chorus' weighted average cost of capital for PQP2 (7.17%). For a four-year retention window, the estimated retention factor (proportion of savings retained by the supplier) is 24.2%. The Commission's model can be found here: [https://www.comcom.govt.nz/\\_data/assets/excel\\_doc/0018/62640/Further-amendments-to-IRIS-Opex-scenarios-25-November-2015.xlsx](https://www.comcom.govt.nz/_data/assets/excel_doc/0018/62640/Further-amendments-to-IRIS-Opex-scenarios-25-November-2015.xlsx)

proceed, as the net cost to the entity would be \$52.<sup>4</sup> Consumers are worse off as they miss out on lower prices.

The closer the transaction occurs to the end of the regulatory period, the less incentive the regulated entity has to complete it, as their share of the benefits declines, while they still bear 100% of the costs.

## **Extend the retention of efficiency savings to two regulatory periods**

Efficiency sharing is based on a revealed cost approach. This ensures that consumers do not pay for efficiencies that are not achieved and is straightforward to implement. I do not recommend an IRIS mechanism as acquisitions can be expected to be relatively rare and the complexity is therefore unlikely to be warranted. A more generally applicable IRIS may introduce undesirable incentives in other areas.

As discussed, a PQ regulated provider does not have a constant incentive to achieve efficiencies; the strength of the incentive declines the sooner the PQ path will be reset. The suggested approach outlined below does not change this: the total retention will vary depending on the year of the regulatory period in which the transaction occurs. The earlier in the regulatory period, the greater the retention period and hence the greater the incentive to achieve efficiencies. This is the same as the existing framework and reflects an approach that is pragmatic noting the relative infrequency of transactions and therefore the limited value in developing a more complex method.

It is important to set a relatively mechanical approach for retention of efficiency savings in an acquisition to ensure that the PQ regulated provider has confidence to proceed with transactions that achieve efficiency benefits. Regulatory unpredictability undermines investor confidence and impairs dynamic efficiency – the most valuable kind of efficiency.

Conceptually, the recommended approach is simple: extend the period before the level of allowed revenue associated with the acquired entity is reset at the new efficient level. This extends the period over which the PQ regulated provider retains the efficiency saving, specifically strengthening the incentive to make efficiency savings via acquisitions. The rationale for allowing a larger proportion of savings to be retained following a transaction than is retained for other efficiency savings is to compensate the acquirer for bearing the risk associated with obtaining those savings.

ID-only regulated fibre providers provide a five-year forecast of operating and capital expenditures, as well as commissioned assets. This means that it is possible to use a revealed cost approach to identify the level of actual efficiencies achieved: the difference between these forecasts and actual expenditure represents efficiency gains arising from the transaction. While the difference may incorporate other factors, such as forecasting error, this is already an element of the framework. These errors may be positive or negative, and are not introduced by the suggested approach.

---

<sup>4</sup> This calculation is based on a retention factor of approximately 24% over a four-year period, calculated using a cost of capital of 7.17% (the PQP2 value). If both costs and benefits are shared the provider retains 24% of the net present value is \$100 (net benefit \$24). If only benefits are shared the provider retains 24% of \$200 (\$48) and faces a cost of \$100 (net cost \$52).

Mathematically, there are different ways that it would be possible for a PQ regulated provider to retain a greater portion of the efficiency savings. The preferred approach may depend on costs of implementation.

A relatively simple approach would be to use an earlier base year for operating expenditure associated with the target firm than is used for other opex when resetting the price path in the following regulatory period. If the disclosure year of the acquisition is used, then all efficiency savings would be retained until the end of the PQ period following the acquisition. This would require separating the operating expenditure for the acquirer and the target firm at least in the relevant base year. Integration costs would need to be adjusted out of the base year.

One way to do this would be to estimate the incremental operating expenditure of the target firm in the base year of the regulatory period. An allocation methodology, based on a measure of network size, would be required with appropriate auditing to assure its correct implementation.<sup>5</sup> For example, suppose an acquisition was made in year two of a five-year period and year four actual expenditure was to be used as the base year in the following regulatory period. Year two actual expenditure of the target (adjusted for cost inflation) would be added to year four actual expenditure of the acquirer excluding the incremental cost of the target. An alternative would be to add the forecast opex of the target in the relevant year (year 4 in the example) to the actual opex of the acquirer excluding the incremental cost of the target in that year. The advantage of this approach is that it adjusts for expected changes in opex since the acquisition date. The disadvantage is that it may perpetuate forecasting error.

A different approach would be to continue to separately account for operating expenditure for the target firm and calculate the efficiency savings (forecast less actual expenditure) in each year remaining in the regulatory period. The efficiency savings could then be added back to the operating expenditure allowance as an incentive adjustment in each year of the following regulatory period. This approach is more complex than the first option and in principle could be based on a simplified IRIS. While it might appeal on the basis that it would support a disclosure of annual efficiency savings, the first option also reveals the value of efficiency savings and is likely to be less costly to implement.

It is important to ensure that integration expenditure is treated appropriately when estimating efficiency savings. This could be achieved by allocating these costs to the acquiring firm-only portion of the combined entity. This would mean that the incentives in relation to incurring these costs are unchanged, temporary overruns are borne by the acquirer, permanent changes are shared with consumers at the end of the current regulatory period.

---

<sup>5</sup> There is already a cost allocation framework established in the IMs for allocation of costs between FFLAS and services that are not regulated FFLAS. It would be desirable for any allocation to a part of a network to be consistent with this existing framework.

Alternatively, any such expenditure could be identified and accounted for in the adjustment (as in the IRIS). Failing to correctly account for any new temporary costs would incorrectly diminish the value of (permanent) efficiencies achieved.<sup>6</sup>

The second approach could be modified to allow for an incentive adjustment for efficiencies in capital expenditure. However, this may not be a significant advantage as capital expenditure is less likely to be a material source of efficiency following a major transaction for fibre than for electricity distribution. Due to the structure of the BBM, the difference in the value of forecast and actual commissioned assets would be used to calculate the relevant revenue adjustments (rather than the value of capex).<sup>7</sup> As in the IRIS, the capex adjustment should be based on a percentage adjustment, this allows for the variable nature of annual capex.

If no specific adjustment was made for capex any efficiencies would be retained for the remaining duration of the period in which they occur. This is the existing incentive for other capex efficiencies.

Due to the relatively rare nature of a major transaction of this nature, I recommend that if an incentive adjustment for capital expenditure were introduced a fixed percentage be set in the IMs, rather than a rate that changes at each reset. This provides certainty and avoids the cost of redetermining the value in each regulatory period. A value of 50% is not inappropriate. This shares the benefits equally between consumers and the provider. It is equivalent (at the PQP2 cost of capital) to the acquirer retaining the benefits of efficiencies for two regulatory periods, which is the maximum retention period for opex savings in the approach discussed above. Finally, a 50% sharing rate is not out of step with rates used by comparable overseas regulators for rewarding efficiencies obtained on allowed expenditure.<sup>8</sup> A somewhat higher rate compared to the normal retention factor recognises the risk associated with an acquisition.

---

<sup>6</sup> Using the earlier example, if \$100 of integration costs were incurred in just one or two years, they would easily swamp any annual efficiency gains. Permanent efficiency benefits with a present value of \$200 are equivalent to less than \$15 per year. The revealed "efficiency" in a single year could be a net cost of \$85. Adding this amount to the following year as a negative adjustment would unfairly penalise the acquirer.

<sup>7</sup> Commerce Commission, Electricity distributors' expenditure incentives under the current Part 4 approach and under a totex approach, Staff working paper to inform 7 November 2022 workshop 'Forecasting and incentivising efficient expenditure for EDBs', 1 November 2022, footnote 33.

<sup>8</sup> For example, in RIIO-1 Ofgem set company specific incentive rates between 50%-70%. In RIIO-2 and RIIO-3 these were generally lower between 25% and 50%. See for example <https://digital.utilityweek.co.uk/issues/2025-07-03/ofgems-riio3-draft-determinations>

## About Sapere

Sapere is one of the largest expert consulting firms in Australasia, and a leader in the provision of independent economic, forensic accounting and public policy services. We provide independent expert testimony, strategic advisory services, data analytics and other advice to Australasia's private sector corporate clients, major law firms, government agencies, and regulatory bodies.

'Sapere' comes from Latin (to be wise) and the phrase 'sapere aude' (dare to be wise). The phrase is associated with German philosopher Immanuel Kant, who promoted the use of reason as a tool of thought; an approach that underpins all Sapere's practice groups.

We build and maintain effective relationships as demonstrated by the volume of repeat work. Many of our experts have held leadership and senior management positions and are experienced in navigating complex relationships in government, industry, and academic settings.

We adopt a collaborative approach to our work and routinely partner with specialist firms in other fields, such as social research, IT design and architecture, and survey design. This enables us to deliver a comprehensive product and to ensure value for money.

### For more information, please contact:

Vhari McWha

Mobile:



Email:



| Wellington                                                           | Auckland                                                                               | Melbourne                                                                 | Sydney                                               | Canberra                                 | Perth                               | Brisbane                                                |
|----------------------------------------------------------------------|----------------------------------------------------------------------------------------|---------------------------------------------------------------------------|------------------------------------------------------|------------------------------------------|-------------------------------------|---------------------------------------------------------|
| Level 9<br>1 Willeston<br>Street<br>PO Box 587<br>Wellington<br>6140 | Level 20<br>151 Queen<br>Street<br>PO Box 2475<br>Shortland<br>Street<br>Auckland 1140 | Level 11, North<br>Tower<br>80 Collins<br>Street<br>Melbourne<br>VIC 3000 | Level 18<br>135 King<br>Street<br>Sydney<br>NSW 2000 | GPO Box 252<br>Canberra City<br>ACT 2601 | PO Box 1210<br>Booragoon<br>WA 6954 | Level 18<br>324 Queen<br>Street<br>Brisbane<br>QLD 4000 |
| +64 4 915 7590                                                       | +64 9 909 5810                                                                         | +61 3 9005 1454                                                           | +61 2 9234 0200                                      | +61 2 6100 6363                          | +61 8 6186 1410                     | +61 7 2113 4080                                         |

[www.thinkSapere.com](http://www.thinkSapere.com)

independence, integrity and objectivity