Chorus Limited
Level 10
1 Willis Street
P O Box 632
Wellington 6140
New Zealand

Ben Oakley
Analyst
Regulatory Branch - Telecommunications
Commerce Commission
PO Box 2351
Wellington 6140

By email: ben.oakley@comcom.govt.nz

12 May 2015

Dear Ben

COMMISSION'S FOLLOW UP QUESTIONS FOLLOWING FPP CONFERENCE – CONFIDENTIAL VERSION

1 We refer to your email of 24 April 2015 setting out a number of questions following the Commission's FPP conference on 14 – 17 April 2015.

2 Set out below are our responses to the Commission's questions.

Asset Sharing

Question 1: Do LFCs use Chorus' ducts?

3 In summary, Chorus offers a lead-in duct service. **[CI:.]**

4 Chorus previously provided information on ducts to the Commission in its response to the Commission's section 98 notice dated 12 September 2014 (Notice). Under requirement 5 of that Notice Chorus was required to:

> *5 Please provide information on the commercial terms under which Chorus continues to offer ducts and poles to other parties, e.g. local power companies.*
>
> *5.1 Please confirm the percentage of Chorus' poles and ducts shared with other parties.*
>
> *5.2 Please provide information on the percentage of Chorus' local access routes (trenches, ducts, or cables) shared with other network operators, in particular with Spark New Zealand Limited and its subsidiaries.*

5 In our response to the Notice, dated 19 September 2014, we noted in the assumptions for that request that we had provided the Commission with a copy of two recent contracts between Chorus and another network operator and that we had two trial duct products in the market:

5.1 a trial lead-in duct agreement; and

5.2 a trial mainline duct agreement.

6 **[CI:]**

7 After the conclusion of the trials Chorus decided to develop a fully-fledged lead-in duct agreement and Chorus was developing a new lead-in duct agreement based on lessons learnt during the trial.

8 However, as a result of the trial we made the decision not to proceed with a mainline duct product and the trial agreement in place was being grandfathered as the product was not commercially viable.

9 Despite this agreement being available to all of Chorus' customers, **[CI:]**

Labour cost index

Question 2: TERA asked Chorus to provide strategy data plans to make more efficient for the next 3-5 years

10 At the conference, the Commission asked whether the labour cost index should be adjusted for productive efficiency gains in order to determine the long-term price trend for opex related labour, and what evidence could be provided to support that (see page 422 of the conference transcript). TERA then queried whether Chorus could provide information about such productivity gains, based on its 3 year plans.

11 Chorus' current Board approved 3 year plan (FY14/15) forecasts labour cost increases to 2017 of **[CI:]**.

12 While Chorus has efficiency initiatives planned (e.g. automation), this is offset by other factors such as new products and processes, salary adjustments and the level of product activity and maturity. For example, new low volume processes will not generally justify a business case for automation, so the processes will likely be manual in nature in the initial period on the product maturity cycle.

13 As Chorus noted at conference:

13.1 it's possible that the labour cost index used by the Commission already captures a productivity element. At this stage, we haven't had the opportunity to investigate this further; and

13.2 the Commission has already made a 50% downwards adjustment to Chorus' opex, and a further adjustment isn't warranted.

14 We also note that efficiency initiatives, such as automation, inevitably involve capital expenditure over the regulatory period that would also need to be accounted for in the cost modelling.

Asset Lives

Question 3: How does Chorus calculate asset lives?

15 Chorus reviews the useful life of assets annually, assessing the expected period of service, and the likelihood of the asset becoming obsolete as a result of technology advances. As required by the International Financial Reporting Standards (**IFRS**):

15.1 **[RI:**

15.2 **]**

Question 4: Is technology obsolescence adequately accounted for already in accounting asset live calculations?

16 Obsolescence is accounted for in asset lives and considered as part of the annual review.

17 However, as we explained in our 20 February submission on the draft determination, we think that the Commission also needs to take account of obsolescence in relation to its consideration of the WACC and/or TSLRIC price. We don't think the fact that obsolescence is accounted for in the account asset lives is sufficient because the asset lives in the accounts are only impaired if there is technological stranding within the financial projections and if it is the best estimate of the future, whereas the Commission must impair asset lives based on the probability of stranding in the future. The following summarises the key points made by Chorus in submissions to date.

18 As CEG noted in its March 2015 paper on "Uplift asymmetries in the TSLRIC price", based on the framework and guidelines that accountants work within in respect of asset impairments, as set out in the New Zealand Equivalent to International Accounting Standard 36 (NZ IAS 36), it does not appear to be the case that an accounting practitioner would necessarily need to consider the probability of an asset utilised by Chorus, or its entire network, being supplanted by an alternative technology if that impairment were to happen beyond the range of management forecasts or was not the most likely future outcome (i.e., the best estimate).

19 The Commission has been set the task of determining the extent to which the asset lives of the HEO should be impaired given the risk of potential technological stranding. Relying on the confirmation of Chorus' auditors that its asset lives have been adjusted for obsolescence is not reasonable for this purpose because:

19.1 the Commission must take into account now the fact that technological stranding may occur over the life of a new asset in order to provide for present value neutral compensation over time. The task of accountants is not to provide for present value neutral compensation based on possible future outcomes, but to set a depreciation schedule for the purpose of estimating a firm's financial position and profitability. For example, obsolescence may take place outside the range of management forecasts or have only moderate probability; also

19.2 the assets of Chorus are not the same as the assets of the HEO. Chorus' assets consist of aged assets of a copper network. The HEO's are new assets of a fibre network.

20 **[RI:**

20.1

20.2

20.3

20.4 **]**

21 As CEG noted, the Commission's reliance on the statements of Chorus' auditors does not provide a reasonable basis upon which to conclude that Chorus' assets have been impaired for the type of stranding risks that Chorus (or the HEO) would require expected compensation for

under the Commission’s proposed implementation of TSLRIC. This continues to represent an uncompensated asymmetric risk to Chorus, which can only be addressed though an appropriate consideration of WACC and/or TSLRIC price uplifts.

Asset reuse

Question 5: For Chorus’ UFB deployment, what is your current estimate of the % of the deployment that will utilise existing Chorus ducts?

22 The Commission in its section 98 notice dated 28 April 2015 (**April Notice**) has requested information in relation to each of the classes of civil engineering assets that are used, including without limitation, ducts, poles and manholes and the proportion (%) of the asset that could technically be re-used. Accordingly, we believe that our response to the April Notice should provide the Commission with the information it is seeking regarding the reuse of Chorus’ ducts. If the Commission believes that addition information is still required however please let us know.

Question 6: Of the existing ducts to be utilised as part of the UFB, what is the approximate average age of those ducts?

23 Again, as part of the April Notice, the Commission has requested for each of the civil engineering asset classes listed the asset lifetime and estimated remaining asset lifetime. We believe that our response to the April Notice should provide the Commission with the information it is seeking regarding the asset lives of ducts. If the Commission believes that addition information is still required however please let us know.

Capital Contributions

Question 7: Please provide answers for the following for areas where Chorus is the UFB provider and areas where it is not

24 We have set out in Appendix 1 our response to the Commission’s questions on capital contributions.

25 We note that Chorus has various policies for recovering the cost of new connections. Until the IPP decision generally these policies only:

25.1 **[RI:**

25.2 **]**

Trenching Costs

Question 8: Provide TERA/Commission with details on the amount of trenching in Auckland used to derive the unit cost data

26 We are still finalising our response to this question and hope to respond tomorrow.

Confidentiality

27 We note that this letter contains confidential information. In order to provide our responses to the Commission as soon as possible we have not had time to carry out a detailed confidentiality review. If the Commission intends to release this information, or believes it is appropriate, we would be happy to identify the confidentiality status of the information and the reasons for our requests for confidentiality.

28 If you have any questions in relation to this letter, please do not hesitate to contact me.

Yours sincerely

Airihi Mahuika
Principal Counsel

APPENDIX 1 – CAPITAL CONTRIBUTIONS

Capital Contributions – *Please provide answers for the following for areas where Chorus is the UFB provider and areas where it is not*

What is Chorus' lead-in policy?

Copper lead-in policy

29 Chorus' copper lead-in policy come into effect on 20 May 2014. The policy relates to a service lead-in from Chorus' network access point to the ETP (i.e. within the property boundary). This was one of the initiatives Chorus took in response to the financial effect of the IPP prices.

30 On the installation of the copper service lead-ins we charge the following to the relevant service provider:

30.1 <100m – $195

30.2 >100m - POA ($195 for the first 100m then charging for the additional distance greater than 100m is based in time and materials).

31 The policy is the same both within and outside Chorus' UFB areas.

Fibre lead-in policy

32 Inside Chorus coverage areas, the UFB Reference Offer requires Chorus to provide a standard install[1] for either single dwelling units or multi dwelling units (see for example clause 3.1 of the Bitstream 2 Service Description). This covers the fibre lead-in from the Fibre Access Point (**FAP**) to an ETP (we note that we also need to install the ONT and fibre from the ETP to the ONT).

33 In addition to the standard install, Chorus provides an additional amount of lead-in from the FAP at the boundary to the ETP (Chorus Basic Installs) under:

33.1 the UFB Business Install Offer (**BIO**), which came into effect on 2 October 2013. The BIO offers a fibre lead-in in an approved conduit, up to 200 metres in length, if the approved conduit is already in place at the time of installation; and

33.2 the Next Generation Access (**NGA**) Residential Installation Offer (**RIO**), which came into effect on 15 December 2012. The additional lead-in results in a maximum of up to 200 metres per premise.

34 Under the UFB Reference Offer all standard installs are at no charge (see item 1.1 of Appendix 1 to the UFB Price List). The additional installs under the RIO and BIO are also at no charge. Chorus may receive a contribution from the RSP for a lead-in from the FAP at the boundary to the ETP for the incremental any amount in excess of such installs (see item 7.2 of Appendix 3 to the Price List).

[1] Details of the standard install are set out in the relevant Bitstream Service Description: 100m of approved conduit (already in place at the time of installation); or a single span of aerial drop lead (available only in areas where there is overhead deployment); or 15m of buried lead-in (available only in areas where there is underground deployment).

35 It should be noted that when Chorus connects a business end user, the RSP pays a connection charge equal to one months' rental for Bitstream 2, 3 and 3a Service and 2 months' rental for Bitstream 4 services (see items 1.2 to 1.4 of Appendix 1 to the UFB Price List).

36 Chorus receives no funding from CFH for any fibre lead-in from the communal infrastructure outside the premise (FAP) to the ETP. CFH's funding for the UFB build (for which Chorus issues debt and equity securities) is limited to passing a premise with communal infrastructure.

37 In greenfield developments inside or adjoining our UFB areas (which Chorus can claim as "Premises Passed" under the NIPA) we apply the same install policy for lead ins as in our UFB areas, i.e. Chorus will provide at its cost the Chorus Basic Install. In greenfields and brownfields areas outside our UFB areas, Chorus will provide at its cost the standard install under the Bitstream Service and any work over and above a standard install will be charged for lead-ins on a POA basis.

38 The extension to a "standard install" in the RIO is funded by Chorus pursuant to agreements with Crown Fibre Holdings in June 2012 ($20M) and March 2014 (a further $8M). This amount of $28M is commonly referred to as the Non-Standard Installation Fund or NSI Fund, but it should be noted that it is not a separate fund, rather it is a cap on the contributions that Chorus must pay for the incremental costs of residential non-standard installs (to the limits described in the RIO). Each year Chorus must agree the "draw-down" against the fund with CFH. The RIO will terminate on 6 months' notice to RSPs once the $28M NSI fund is used up.

What is Chorus' policy for subdivisions, including if / when ownership transfers from the developer to Chorus? What does Chorus pay nothing or something?

39 We have identified and reviewed subdivision policies from May 2001[2], August 2004, October 2010, September 2011, and May 2014. The subdivision policy applies to four or greater lots.

Subdivision Policy	**Standard Design and Supervision Charges**	**MPAs**	**High cost subdivisions**
May 2001	Including GST were: • $125 per unit/dwelling for subdivisions for 4 to 9 lots • $105 per unit/dwelling for subdivisions of 10 to 20 lots (inclusive) • $95 per unit/dwelling for subdivisions with	• High MPA plus commercial and industrial subdivisions and residential multiunit developments (where reticulation is to the boundary) in medium MPA areas: standard design and supervision fees. • Medium Market Planning Area (MPA): $1125	High cost subdivisions: [3] • Sent to service company for a quote • Design charges for high cost subdivisions: no charge per unit/dwelling for subdivisions less than 20 lots/dwellings and $22.50 per unit/dwelling for subdivisions of 20 lots/dwellings or greater (including GST). Total design charges will not exceed $1125 per subdivision (including GST),

[2] Prior to May 2001 there may have been some minimal/partial contributions for subdivisions but we have not been able to identify or locate a policy.

[3] **[RI:]**

	greater than 20 lots	(including GST) per unit/dwelling • Low MPA: $2025 (including GST) per unit/dwelling	i.e. charges are payable for a maximum of 50 lots. • Standard subdivision charges plus a surcharge apply to all exceptions. The surcharge is the difference between the relevant standard charge and the project quote (where the quote exceeds the standard charge).
August 2004	**[RI:** • **]**	• **[RI:** • **]**	**[RI:** [4] • **]**
October 2010	**[CI:]**	• **[CI:]**	**[CI:**[5]**]**
September 2011	Change was no subdivision fee in UFB areas		
May 2014	See summary below	See summary below	See summary below

40 **[CI:]**

41 This response is based on Chorus' current subdivision policy (for fibre reticulation), from May 2014.

General Description	**Standard Charge**
Chorus contracted UFB areas (as defined in NetMap)	$900 (plus GST) per premises for any fibre subdivision development = > 4 land parcels No fee if the whole greenfield fibre development is < 4 lots (land parcels)
Standard charge within non Chorus contracted UFB areas	$1600 (plus GST) per unit/dwelling in areas where all of the following conditions are met: 1. Spare network and cable capacity is available at the front gate of the development to feed this subdivision. Minimal network augmentation is needed (<= $500 for feeder per lot). 2. No trenching or manhole work (including road crossing and reinstatement) is required to be provided by Chorus. 3. Average Lot Size <= 1000m2
High cost subdivisions within non Chorus	POA (plus GST) if any of the following

[4] **[RI:]**
[5] **[RI:]**

contracted UFB areas	conditions is met: 1. Feeder augmentation >$500 per lot 2. Trenching or manhole work is required to be provided by Chorus 3. Average Lot size > 1000m2 4. Rural Feeder
Non-standard architecture or specific copper reticulation request	POA (plus GST) if any of the following conditions is met: 1. Non-standard architecture requests 2. Copper request or dual feed in areas where fibre is offered as our standard solution. 3. Any copper subdivision or development within the Chorus contracted UFB areas. 4. MDU building backbone or campus cabling outside Chorus UFB laid areas.

42 **[CI:]**

43 The subdivision fee is a contribution towards the following costs of providing telecommunications reticulation to the street boundary:

43.1 design planning work;

43.2 supply of materials required for the telecommunications infrastructure, including cabling and any roadside cross-connection cabinets;

43.3 supervision of cable-laying;

43.4 feeder augmentation;

43.5 records upates;

43.6 installation of the pillars or fibre access points;

43.7 Chorus project management and administration costs; and

43.8 Chorus retains ownership of all network infrastructure.

44 The subdivision fee does not cover any costs in connection with the installation of lead-ins for each premises within the subdivision. Chorus does not receive any contribution from service providers or end users to relation to installations of fibre lead-ins where these are standard or Chorus Basic installations; see above for more detail on fibre lead-ins.

45 Within Chorus contracted UFB areas, the maximum standard fee of $900 (plus GST) for development = > 4 lots (new land parcels) was agreed with CFH in March 2014. No fee if the whole greenfield fibre development is less than 4 premises (4 x land parcels).

46 **[CI:]**

47 **[RI:]**

48 **[RI:**

48.1

48.2

48.3

48.4

48.5

48.6 **]**

Chorus owns the distribution cable

49 Chorus retains ownership of all network infrastructure. For the fibre network, this is extended from the ETP to the ONT. It is not practicable in most cases to connect to Chorus at the subdivision boundary (ie the developer owns the distribution cable):

49.1 we incur other costs and would still require a contribution from the developer;

49.2 Chorus would not be obliged to provide ongoing maintenance of the distribution cable (although separate arrangements could be made);

49.3 where the network runs along the road, legislation and local bodies often require a network operator to maintain network plant; and

49.4 You would need to provide an access point to which Chorus would deliver service.

What was Chorus' policy for third party contributions prior to IPP?

50 The policies in place prior to the IPP are summarised above. Chorus standard subdivision policy was revised in May 2014 due to the impact of IPP pricing – this is the current policy. The main changes were: $900 + GST per lot for development within Chorus UFB areas. For development outside the Chorus UFB areas, the standard fee is $1600 + GST or POA.

Have any of Chorus' capital contributions policies changed since separation from Telecom?

51 The Chorus standard subdivision policy was revised in September 2011 (just before the demerger). The main change was that Chorus would not charge any subdivision fee (i.e. zero fee for subdivisions given CFH contributed to the communal infrastructure) for any subdivision development within Chorus UFB areas. This change was to support the UFB agreement with CFH. For development outside the Chorus UFB areas, the existing subdivision fee applied. Following demerger the policy was changed in May 2014.