

# Price-Quality

# Expenditure Proposal Overview

# Fibre has given New Zealand a gigabit headstart

## Our expenditure proposal seeks to help NZ capitalise on this advantage

- > COVID-19 confirmed broadband is an essential service and underlined the importance of continued investment in new products like our multi-gigabit Hyperfibre services.
- > We expect the pace of change in consumer demand for bandwidth and data volume to accelerate, as fast fibre availability proliferates in the developed world and enables new applications to emerge.
- > Our proposal helps make New Zealand broadband better by leveraging the substantial investment we've already made with incremental expenditure that:
  - completes and builds on our successful UFB deployment
  - maximises consumer value now and into the future by controlling costs, promoting fibre and investing in new products and technologies
  - smoothly transitions through major changes in our operational focus, regulatory arrangements and service mix.
- > Investments in automating and streamlining our systems and processes will help retail service providers enhance their own service delivery, driving longer term reductions in our operational costs, and enabling much better service to New Zealand consumers.
- > Our in-market incentives for retailers and the education channels we support will promote greater awareness of fibre and maintain a level playing field for more diverse and effective retail competition. This benefits consumers through better retail offers and choice, and, as more consumers connect to fibre, secures the sustainability of the fibre network.

# Overview of Price-Quality expenditure proposal

- > Chorus has submitted an operating and capital expenditure proposal to the Commerce Commission for the January 2022 to December 2024 regulatory period (RP1).
- > We've elected to release this overview of our proposal to assist investors in developing their understanding of our regulatory proposal before the financial reporting season in February.
- > The Commission is expected to release more detail of our proposals in Q3 for feedback from stakeholders.
- > Our proposal builds on our five-year business planning process with updates to reflect developments since the end of FY20:
  - it represents Board and management's best view of the operation and plans for our business in a dynamic market.
  - this includes judgments as to allocation of costs, with final allocation principles to be decided by the Commission.
  - Regulatory Period 1 (RP1) is calendar years 2022-2024 rather than financial years.
- > The proposal has been subject to independent external review to determine whether our forecasts reflect good telecommunications industry practice and are consistent with the efficient costs of a prudent fibre operator.

# Translating our regulatory proposal

## Our proposal differs from our financial reporting requirements

- > the proposal covers the cost of fibre fixed line access services (FFLAS) subject to Price-Quality regulation. It excludes:
  - other fibre and copper related costs that will be incurred in these future years
  - FFLAS costs in LFC areas
- > regulatory cost categories are based on functional groupings and do not reflect our current financial reporting categories.
- > our regulatory forecasts are provided on a calendar year basis rather than financial years.
- > other adjustments include:
  - IFRS16 lease cashflows are included in the opex proposal – this is for comparison with pre-IFRS16 period - but they will not be included in the opex building block
  - capital contributions (e.g. developer contributions for new property developments) are netted off capex
  - passthrough costs (e.g. local body rates and regulatory levies) are excluded from opex

### INCLUDES:

- fibre fixed line access services only
- IFRS16 lease cashflows as opex for presentational purposes
- regulatory inflation allowance

### EXCLUDES:

- non-FFLAS services costs (e.g. copper services)
- FFLAS costs in LFC areas
- capital contributions
- passthrough costs

# Cost allocation parameters

To be determined through the price-quality and information disclosure process

<b>Pre-December 2011 assets</b>	<ul style="list-style-type: none"><li>▪ included to the extent assets are employed to provide fibre fixed line access services under the UFB initiative.</li><li>▪ valued as per Chorus financial accounts.</li></ul>
<b>UFB costs from 1 December 2011 to 2022 (financial loss asset)</b>	<ul style="list-style-type: none"><li>▪ shared costs are allocated using accounting-based allocation approach.</li><li>▪ list of default allocators, with the Commission having the final decision: number of customers, end-users, or premises (intact, connected or passed); number of ports; revenue; central office space; peak traffic; average traffic; used length of linear assets; power usage; and number of events.</li><li>▪ cost allocation calculations to be updated annually.</li><li>▪ cap limiting the allocation of re-used assets to that which cannot be avoided in providing UFB.</li><li>▪ cost allocations to be applied consistently across costs and between years.</li></ul>
<b>Fibre costs post 2022</b>	<ul style="list-style-type: none"><li>▪ cost allocators to remain consistent with initial RAB unless there is a justifiable reason to change.</li></ul>

# Operating expenditure proposal

We model total FFLAS opex (nominal) of \$625.5m for RP1

- > This total:
  - includes IFRS 16 finance leases of ~\$41m (nominal) for presentational and comparative purposes
  - excludes passthrough costs of ~\$45m (nominal)
  - includes regulatory inflation

Regulatory Period 1 (RP1)			
2022	2023	2024	TOTAL
\$204.5m	\$207.5m	\$213.5m	\$625.5m

# Operating expenditure categories

Regulatory opex categories	Sub-categories	Description	Financial reporting opex categories
<b>Customer</b>	▪ Customer operations	Demand driven activity (e.g. call centre and projects)	Labour
	▪ Product, Sales & Marketing	RSP relationships, activity to attract and retain end users	Labour, Other
<b>Network</b>	▪ Maintenance	Reactive, recoverable and preventative work	Network maintenance
	▪ Network operations	Network operations centre and associated support	Labour, IT, Other network costs
	▪ Operating costs	Leases, electricity, security and building costs	Electricity, Other network costs, Property maintenance
<b>Support</b>	▪ Asset management	Investment, programme, contract and property management	Labour, Other
	▪ Corporate	Corporate functional units, office expenses	Labour, Insurance, Consultants, Other
	▪ Technology	Non-capitalised business, customer and network IT	Labour, IT, Other

# Opex regulatory template

Opex categories	Sub-categories	2022	2023	2024	
<b>Customer</b>	▪ Customer operations	5.6	4.9	4.4	
	▪ Product, Sales & Marketing	25.0	25.3	25.8	
<b>Network</b>	▪ Maintenance	30.1	33.1	34.8	
	▪ Network operations	20.1	20.8	21.7	
	▪ Operating costs	18.2	20.0	22.2	
<b>Support</b>	▪ Asset management	23.7	22.8	23.0	
	▪ Corporate	61.2	59.7	60.0	
	▪ Technology	20.6	20.9	21.6	
<b>TOTAL (\$m)</b>		<b>204.5</b>	<b>207.5</b>	<b>213.5</b>	<b>\$625.5m</b>

- > This template:
- includes IFRS 16 finance leases of ~\$41m (nominal) for presentational and comparative purposes
  - excludes passthrough costs of ~\$45m (nominal)
  - includes regulatory inflation



# Opex: indicative FFLAS share of FY20 statutory opex

We estimate FFLAS opex was 55% of FY20 total opex

- > FFLAS proportion of opex is expected to increase significantly as fibre uptake grows and the copper network is retired
- > FY20 – FFLAS (indicative):
  - includes passthrough costs of \$11m
  - excludes IFRS 16 finance leases (treated as network fixed assets in FY20 statutory reporting)

	FY20 reported \$m	FY20 – FFLAS (indicative) \$m
Labour	80	73
Network maintenance	64	13
Other network costs	29	7
IT	47	29
Rent, rates and property maintenance	25	8
Regulatory levies	7	6
Electricity	15	4
Provisioning	5	2
Consultants	9	6
Insurance	3	2
Other	27	20
<b>Total</b>	<b>311</b>	<b>170</b>

# Capital Expenditure proposal

We estimate total FFLAS capex of \$1,029m (nominal) for RP1

- > capex is net of capital contributions of approximately \$56 million
- > excludes FFLAS in LFC information disclosure areas
- > includes regulatory inflation
- > we're proposing a wash-up mechanism for installation capex volumes

Regulatory Period 1 (RP1)			
2022	2023	2024	TOTAL
\$399.9m	\$333.2m	\$295.9m	\$1,029m

Regulatory capex categories	Sub-categories	Description	Financial reporting capex categories
<b>Extending the network</b> <i>(communal infrastructure)</i>	▪ Augmentation	Infill within existing footprint or extension to new communities	Other fibre connections & growth
	▪ New property development	New subdivisions, business parks	Other fibre connections & growth
	▪ UFB communal	UFB programme rollout	UFB communal
<b>Installations</b> <i>(connecting communal network to the ONT, including provisioning and incentive costs)</i>	▪ Complex	Installations for specific business requirements	Fibre connections & layer 2
	▪ Standard	Most installation work, including backbone for multi-dwelling units and rights of way	Fibre connections & layer 2, customer retention costs
<b>IT &amp; Support</b> <i>(IT and corporate capex)</i>	▪ Business IT	Supporting business activities	Common - IT
	▪ Corporate	Sundry investment and product development	Common - Other
	▪ Network & customer	Supporting network or customer activities	Common – IT, Fibre products & systems
<b>Network capacity</b> <i>(ongoing investment in network electronics and systems to optimise for capacity growth and lifecycle needs)</i>	▪ Access	Enabling connections to fibre	Fibre connections & layer 2
	▪ Aggregation	Link access networks to RSP points of interconnection	Fibre connections & layer 2
	▪ Transport	Optical transport network to carry data medium/long distances	Fibre connections & layer 2, Other fibre connections & growth
<b>Network sustain &amp; enhance</b> <i>(investment in physical network assets)</i>	▪ Field sustain	Assets outside of network sites (e.g. poles, fibre, terminators)	Other fibre connections & growth
	▪ Relocations	Roading authority, undergrounding programmes and 3 <sup>rd</sup> party requests	Other fibre connections & growth
	▪ Resilience	Diversity, robustness or contingency investment to keep the network running	Other fibre connections & growth
	▪ Site sustain	Investment in network buildings, including power and cooling.	Common – building & engineering services

# Capex regulatory template

> The regulatory categories generally reflect our FY20 results definition of sustaining vs non-sustaining capex

- FFLAS **non-sustaining capex\*** of \$526m in RP1

\*includes some provisioning related customer retention costs that would be treated as sustaining and assumes <10k of complex, ~165k of standard and ~20k of backbone installations in RP1

- FFLAS **sustaining capex** of \$503m in RP1

> The total RP1 proposed capex spend of **\$1,029m**:

- is net of capital contributions
- excludes FFLAS in LFC information disclosure areas
- includes regulatory inflation



Capex Categories	Sub-categories	2022	2023	2024
<b>Extending the network</b>	▪ Augmentation	2.9	3.9	4.0
	▪ New property developments	6.5	7.4	8.0
	▪ UFB communal	40.9	-	-
<b>Installations</b>	▪ Complex	11.8	10.2	9.2
	▪ Standard	176.9	136.9	107.6
<b>IT and support</b>	▪ Business IT	9.4	12.9	11.5
	▪ Corporate	13.8	15.0	15.5
	▪ Network & Customer	26.0	25.6	27.4
<b>Network capacity</b>	▪ Access	22.0	29.8	23.6
	▪ Aggregation	12.7	21.1	16.8
	▪ Transport	12.5	17.2	19.9
<b>Network sustain &amp; enhance</b>	▪ Field sustain	20.9	21.7	22.7
	▪ Relocations	4.6	4.6	4.7
	▪ Resilience	23.2	14.1	14.8
	▪ Site sustain	15.8	12.8	10.2
<b>TOTAL (\$m)</b>		<b>399.9</b>	<b>333.2</b>	<b>295.9</b>

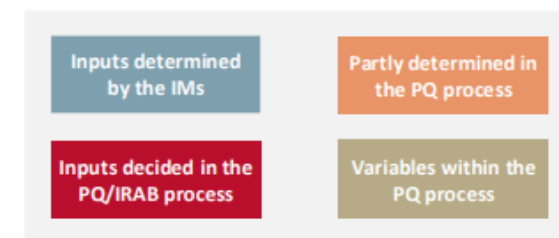
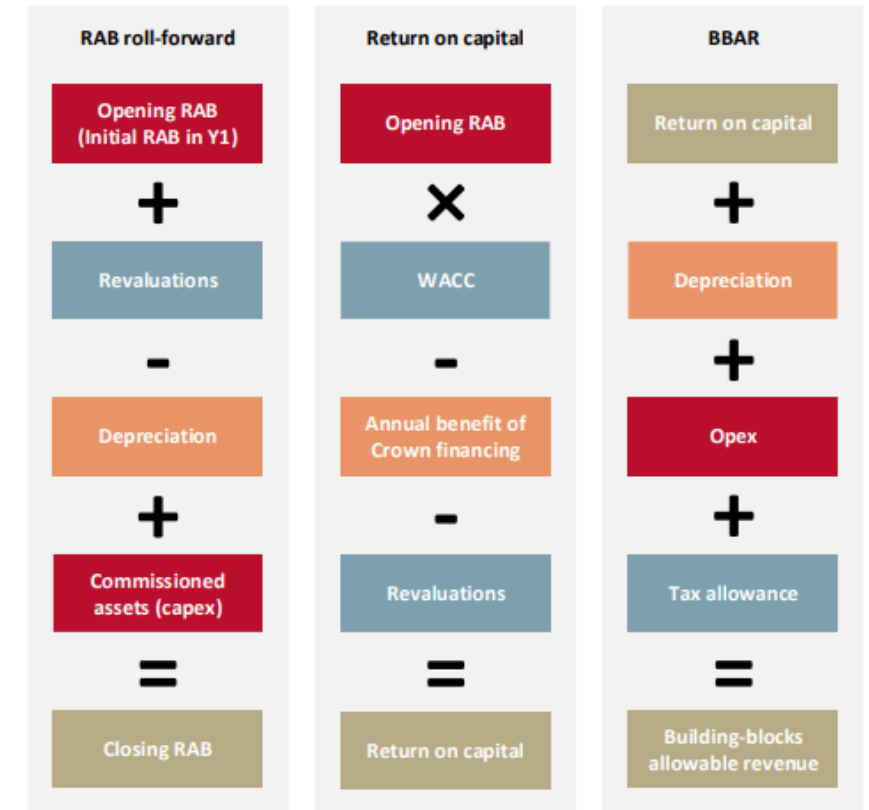
# Appendix A: Copper Withdrawal Code finalised

## The Commerce Commission has determined:

- > Chorus must provide end users with 6 months' notice of copper withdrawal
- > notices can be sent to end users from 1 March 2021 onwards
  - three notices are required in advance of withdrawal: 6 months, 3 months and 20 working days
  - Chorus must provide notices direct to end users, rather than via their RSP
  - notices should include information on fibre services, not fibre marketing
- > copper cannot be withdrawn at the end of the notice period if the end user wishes to have fibre installed but:
  - it is still in the process of being installed, or
  - it cannot be installed due to circumstances outside the end user's control, and they have taken all reasonable steps to address these circumstances
- > fibre installations are free for aerial connections
- > the workability of the Code will be reviewed in late 2021

# Appendix B: RAB implementation

Phase	Timing	Scope
<b>Initiation</b>	Q4 2020 to Q1 2021	Process and approach paper
		Submissions on process and approach
		Chorus PQ information request and prososal
		Chorus PQ expenditure proposal
		Submissions on PQ expenditure proposal
		Workshop on quality of service
<b>Draft decisions</b>	Q2 2021	ID draft decision
		Chorus transitional PQ initial RAB draft decision
		PQ draft decision
		Submissions on all draft decisions
		Cross-submissions on all draft decisions
<b>Final decisions</b>	Q3 to Q4 2021	PQ WACC determination
		Final decision on Chorus expenditure
		Final PQ decision
		Final ID decision
<b>Post-final implementation</b>	2022	Disclosure of the initial RABs
		Determination of the financial loss asset



Source: Commerce Commission

# Appendix C: Input methodologies key parameters

	Pre January 2022 period (financial loss asset)	First regulatory period
Risk free rate	5-year rate, 1 month average, calculated as at middle of year, or mid each part year for 2012 and 2021	3-year rate, 3 months average, calculated as at 1 June 2021
TAMRP	7% until Oct 2020 then 7.5%	7.5%
Debt risk premium	BBB, 7-year term, 1 month average	BBB, 5-year term, 5-year trailing average
Leverage	29%	29%
Debt issuance cost	0.14%	0.33%
Asset beta	0.5	0.5
WACC uplift	none – 50 <sup>th</sup> percentile	none – 50 <sup>th</sup> percentile
Asymmetric stranding risk	no allowance	10 basis points
Crown financing	Financing rate reflecting Chorus' actual senior debt/subordinated debt/equity mix	Financing rate reflecting Chorus' actual senior debt/subordinated debt/equity mix

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