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STOCK EXCHANGE ANNOUNCEMENT

5 August 2019

Moody's update on Chorus

Moody's Investors Service has released the attached update on Chorus.

The long term rating remains unchanged at Baa2 (outlook stable).

The update states that Moody's expects to revise Chorus' current financial leverage tolerance threshold in 2021, following the Commerce Commission's final determination on the fibre price path for Chorus. This reflects Moody's expectation of declining UFB capital spending, reducing cash outflows and execution risks to place Chorus' risk profile more in line with other regulated utilities.

Moody's consider Vector the most comparable rated peer for Chorus, but note that Chorus' greater competition and technology risk suggest a tighter leverage tolerance threshold.

ENDS

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MOODY'S
INVESTORS SERVICE

ISSUER IN-DEPTH
5 August 2019

Rate this Research

RATINGS

Chorus Limited

Domicile	New Zealand
Long Term Rating	Baa2
Type	LT Issuer Rating - Fgn Curr
Outlook	Stable

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Chorus Limited

Transition to new regulatory framework will improve revenue predictability and stability

» **New regulation will reset regulatory framework applicable to Chorus, a credit positive.** In November 2018, the Telecommunications (New Regulatory Framework) Amendment Act was passed by the New Zealand Parliament. Under the new regulation, a utility-style building block model (BBM) commonly applied to regulated utilities will likely apply to fibre networks from 2022. We consider the new regulatory framework to be supportive of Chorus Limited's (Baa2 stable) credit profile because its revenue predictability and stability will improve. During the transition period before 2022, prices for copper and fibre anchor products will be capped at the 2019 level plus an annual CPI adjustment.

» **Chorus's revenue cap will be based on well-defined inputs, resulting in greater revenue predictability.** Once the new BBM is implemented, we expect Chorus will display a utility-like revenue profile, with most of the company's revenue subject to regulation. The new framework will feature a revenue cap, which will be calculated based on the company's allowable costs and returns to be determined by the New Zealand Commerce Commission (NZCC). This return-based framework provides good revenue predictability, underpinned by the NZCC's track record of consistency in applying the BBM to New Zealand's (Aaa stable) regulated utilities.

» **Price and revenue shocks are unlikely under the new framework.** The new framework contrasts with past regulation of copper networks, where a price for copper products was set initially based on benchmarking against prices for selected overseas networks. Given Chorus's unique position as a fixed-line wholesaler and differences between countries, this benchmarking process resulted in significant price and therefore revenue variation for Chorus.

» **We plan to expand Chorus's financial leverage tolerance threshold following NZCC's final determination.** Greater revenue predictability and stability should enable Chorus to operate with higher financial leverage at its current Baa2 rating. We expect to revise Chorus's current leverage tolerance threshold in 2021, following the NZCC's final determination on the fibre price path for Chorus. We expect to set the new leverage tolerance threshold based on a comparison against Vector Limited (Baa1 stable), the most comparable rated peer for Chorus.

New regulation will reset the regulatory framework applicable to Chorus, a credit positive

The New Zealand Parliament in November 2018 passed the Telecommunications (New Regulatory Framework) Amendment Act. Fibre access services will be regulated under the act, which is the same type of regulation in the Commerce Act that applies to electricity and gas distribution and transmission networks, as well as New Zealand's three international airports.

We regard this framework as fundamentally supportive and stable, and recognise that the regulator, New Zealand Commerce Commission (NZCC), has a track record of making consistent regulatory decisions. A key objective of the framework is that consumers receive fair quality and prices while investors receive a fair return and that, in the transition to the new regulatory model, revenue shocks will be minimised. Given the experience the NZCC has built up applying this type of regulatory model, we believe the new framework will not result in the same price shocks seen under the previous benchmarking regime.

Overview of Chorus revenue and new regulatory framework

Chorus's revenue can be split into three groups as follows:

1. Copper revenue (51% of first-half fiscal 2019 revenue (fiscal 2019 ended on 30 June 2019))

» Where fibre is available, the copper network will be deregulated

» Where fibre is not available, copper remains regulated and copper prices will be capped at the 2019 level plus an annual CPI adjustment

2. Fibre revenue (35% of first-half fiscal 2019 revenue)

» Subject to new regulatory framework

» An overall revenue cap (maximum allowable revenue) applies to the total revenue generated from fibre products.

» Anchor product revenue (expected to be 100/20 Mbps broadband, and voice): in addition to the overall revenue cap, a price cap (maximum price Chorus can charge for the product) will also apply. The price cap will be the contract prices immediately before implementation date plus an annual CPI adjustment.

» Non-anchor product revenue: no price cap applies, although demand for non-anchor products will be influenced by the price cap on anchor products. Revenue from these products are subject to the overall fibre revenue cap.

3. Other revenue (14% of first-half fiscal 2019 revenue)

» Includes field service revenues and infrastructure revenues

» Not subject to regulation

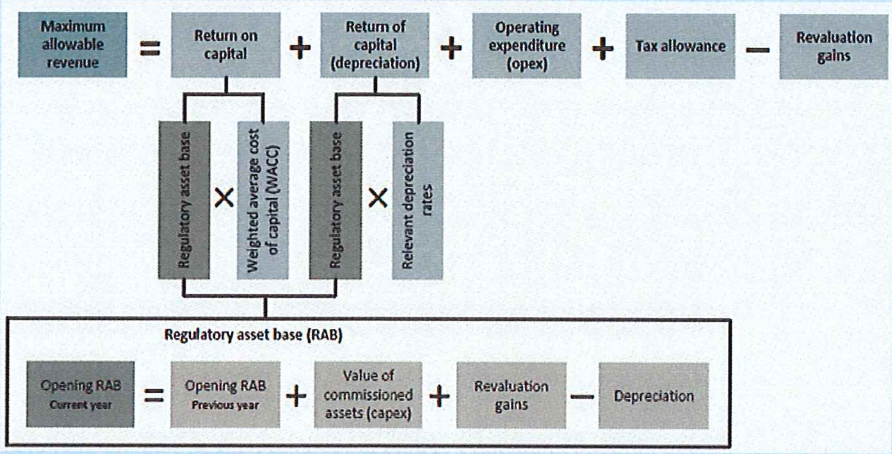
Given growing demand for data and the continued strong uptake of fibre in New Zealand, we expect revenue earned from fibre to account for around 80% of Chorus's total revenue by fiscal 2025. As a result, the majority of Chorus's revenue will be subject to the new regulatory framework.

While the use of BBM is not explicitly prescribed by regulation, NZCC has said that its preliminary view is that the BBM approach with a regulated asset base would likely give the best effect to the objectives of the act.

Under the new regulation, the NZCC is required to develop upfront Input Methodologies that will set the rules and processes that apply to the regulation of fibre services. This will provide increased transparency and predictability. The NZCC is expected to finalise the Input Methodologies by June 2020.

Key features of the building block model (BBM) framework

The BBM approach is a return-based approach to calculating the revenue cap (maximum allowable revenue) based on delivering the regulated services over the regulatory period. Under the BBM, the NZCC will calculate the value of the network that is used to supply the regulated services; this forms the regulated asset base (RAB). The RAB, along with the supplier's other costs as well as an allowed return, will be used as a basis for calculating the allowed revenue or prices (see diagram below).



Source: NZCC

We expect the new regulatory framework to provide greater revenue predictability and stability

Once the new BBM is implemented, we expect Chorus to display a utility-like revenue profile, with most of its revenue subject to regulation. The new framework will feature a revenue cap, which will be calculated based on the company's costs and an allowed return to be determined by the NZCC. This provides good revenue predictability over the regulatory period.

In addition, we expect that the new regulatory framework will reduce uncertainty over regulatory resets, compared with the past regulatory framework for copper networks, where a price cap for copper products was in the first instance set based on benchmarking against prices in selected comparator countries.

The NZCC lowered copper prices in New Zealand substantially following the November 2013 ruling, which was based on much lower prices in Sweden and Denmark, the countries selected as the comparator benchmarks. However, given Chorus's unique position as a fixed-line wholesaler and differences between the countries, this meant the benchmarked prices did not necessarily reflect New Zealand-specific factors. For example, the dispersed New Zealand population was a significant cost factor and networks in New Zealand were more expensive than in Europe because of greater line length per customer and trenching costs, which were much higher than Sweden's. The NZCC ruling impacted around 1.1 million of Chorus's copper lines, and resulted in an annualised EBITDA loss for Chorus of NZD142 million, which represented around 20% of total EBITDA.

Included in the old regulation was a clause that allowed Chorus to invoke the second phase of the regime that required the NZCC to undertake an economic cost model of Total Service Long Run Incremental Cost (TSLRIC) to determine prices, if benchmarked pricing outcomes were viewed by Chorus as suboptimal. This option was exercised following the NZCC initial pricing principle ruling in 2013. Although this led to copper prices and revenues being restored almost to the original level, the process took two years to complete and the NZCC provided for no backdating to compensate for the preceding years' revenue losses. As a result, Chorus's revenue and EBITDA declined considerably in fiscal 2015 and 2016, but recovered in fiscal 2017 following the TSLRIC-based final pricing determination. We do not expect similar revenue volatility under the new regulatory framework.

Another supportive feature of the new regulation is the expected inclusion of a wash-up mechanism, which will apply to any over or under recovery of revenue during the previous regulatory period. The objective of a wash-up mechanism is to minimise price shocks to consumers or undue financial hardship to suppliers. If Chorus does not earn revenue up to the revenue cap within a regulatory period, the revenue shortfall can be recovered in the following regulatory period through the ability to increase prices. Therefore, this provides a degree of buffer against demand fluctuations and has the effect of smoothing Chorus's revenue over the longer term.

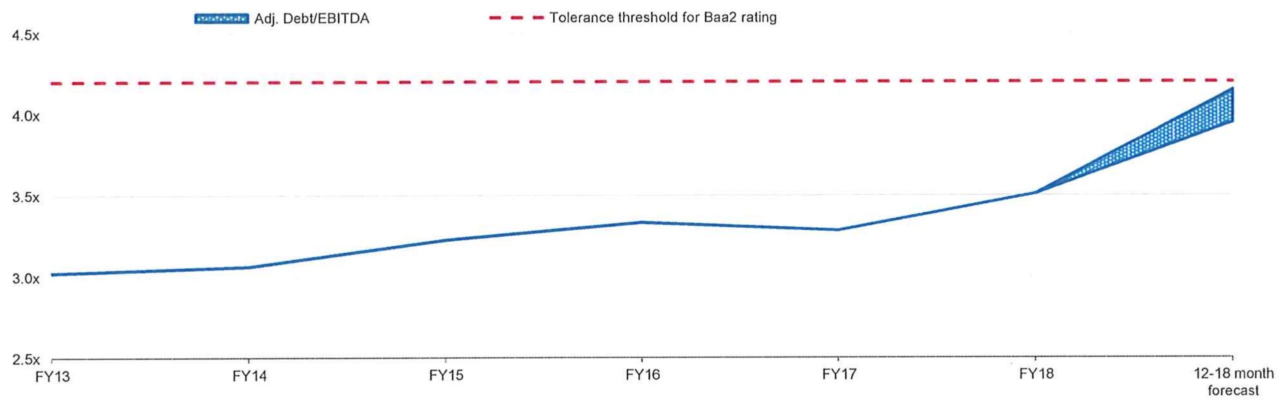
While the inclusion of a wash-up mechanism would be credit positive for Chorus, the exact details of how this mechanism will work is still to be determined by the NZCC. Also, the mechanism will feature a delay in recovery of revenue shortfalls since the recovery would be made in the following regulatory period. This is less protective than the true-up mechanisms typically found in regulatory regimes in Australia, which allow for quicker recovery of revenue shortfalls within the same regulatory period.

We plan to expand the financial leverage tolerance threshold for Chorus following NZCC's determination of the fibre price path

With greater revenue predictability and stability, we believe Chorus should be able to operate with higher financial leverage at a given rating level, similar to other regulated utilities. We expect to increase Chorus's leverage tolerance threshold from the current limit of 4.2x after the NZCC makes a final decision in 2021 on the fibre price path it will apply to Chorus. We expect greater clarity around the details of the new fibre regulation closer to that decision.

Exhibit 1

Chorus's financial leverage and current leverage threshold for the Baa2 rating



Moody's forecasts are Moody's opinion and do not represent the views of the issuer.
Sources: Moody's Investors Service, Moody's Financial Metrics

The new threshold will be based on a benchmarking exercise against New Zealand electricity and gas distribution company Vector Limited (Baa1 stable), which we consider to be the most comparable Moody's rated peer for Chorus.

A comparison of the companies shows that Chorus's business risk is higher than Vector's because of greater competition and technology risk. Vector operates a monopoly in electricity and gas distribution in the Auckland region, with lower rates of technology substitution. Given Chorus's higher business risk, we anticipate that the company's tolerance threshold should be tighter than Vector's at a given rating level.

Chorus's high capital spending reflects its mandate for the ultra-fast broadband (UFB) network rollout in New Zealand. The increased funding requirement for the rollout has resulted in elevated financial leverage relative to our current leverage threshold. We expect the company's capital spending to decline substantially by the end of fiscal 2021 with the expected completion of the UFB1 rollout and the majority of the UFB2/2+ rollout. This anticipated normalisation in capital spending would reduce cash outflows and execution risks, and place Chorus's risk profile more in line with other regulated utilities in this regard.

Moody's related publications

Credit opinion

» Chorus Limited: Update

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

REPORT NUMBER 1177999

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