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### **Equivalence of inputs obligation: Implications for pricing of layer 1 services**

Dear Tom

#### **Introduction**

1. One of the topics raised by the *Telecommunications Act Review: Options Paper* (MBIE, July 2016) is the extent to which the “equivalence of inputs” (**EOI**) obligation contained in the Open Access Deeds of Undertaking for Fibre Services (**Fibre Open Access Deeds**) imposes pricing controls on layer 1 (that is, unbundled) UFB services.
2. The Options Paper notes (at p 51) that after December 2019, Chorus and the LFCs are required by the Fibre Open Access Deeds to offer unbundled access to dark fibre services on point-to-multipoint parts of the UFB network. The paper then records the view that: “The deeds do not impose any price controls on these services.”
3. However, the Options Paper appears to take a different view at other places. In particular, the paper:
  - a. notes that unbundling may provide an important incentive on UFB providers to innovate and improve service quality and that UFB providers would “face some broad pricing constraints” as a result of the layer 1 fibre product being offered on an EOI basis (at p 41); and
  - b. recommends “carving out” the proposed layer 2 anchor products from the EOI obligation under the Fibre Open Access Deeds because the prices of layer 2 anchor products might be capped at levels close to the expected layer 1 price in breach of that obligation (at pp 52 and 56).
4. In light of these comments, you have sought my advice as to:
  - a. whether the EOI obligation under the Fibre Open Access Deeds imposes a form of price control in relation to layer 1 UFB services; and

- b. the robustness of MBIE's proposal to carve out the proposed layer 2 anchor products from the EOI obligation.
5. I discuss each of these issues in turn below, but my views can be summarised as follows:
  - a. The EOI obligation requires the UFB provider to price the layer 1 service at a level which would allow the layer 2 services and prices to be replicated by an equally efficient rival, which creates a substantial constraint on the layer 1 price.
  - b. Carving out anchor layer 2 products from this comparison may undermine unbundling and create a significant bias against infrastructure competition.
  - c. The MBIE recommendation in favour of a carve out is not robust in that it fails to: recognise the potential undermining of unbundling; consider other more targeted approaches that are neutral as to the presence of unbundling; or attempt to weigh up the alternative options.

### **EOI obligation and pricing**

6. EOI is a regulatory tool designed to address the potential for a vertically integrated access provider to discriminate in favour of its own downstream business units.<sup>1</sup>
7. As a general concept, EOI requires a regulated access provider to provide access seekers with the same primary services, at the same prices and using the same processes as the access provider provides to itself. In this case, the primary service is the layer 1 unbundled fibre product.
8. The access provider must provide the access seekers and itself:
  - with the same primary service;
  - on the same timescales and on the same terms and conditions (including price); and
  - using the same systems and processes.
9. EOI is seen as a helpful regulatory construct as it:
  - generates better incentives for the access provider by forcing it to compete on equal terms with access seekers;
  - improves transparency and reduces information asymmetry;
  - facilitates compliance monitoring through increased transparency; and
  - requires less regulatory intervention than other types of bottleneck regulation.
10. As a term of art in the regulatory field, EOI would generally be understood as applying to price, as well as non-price, terms of supply for the primary service. However, the terms of the Telecommunications Act 2001 and the Fibre Open Access Deeds make it clear beyond any doubt that the EOI obligation imposed by the Fibre Open Access Deeds includes the price of the layer 1 unbundled fibre product.

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<sup>1</sup> The description of EOI in paragraphs [6]-[9] is based on *Commerce Commission Response to MED Discussion Document 'Regulatory Implications of Structural Separation'* (October 2010) at [58]-[60].

11. Section 156AD of the Act sets out the requirements for the UFB undertakings which include the provision of an unbundled fibre product on an equivalence basis from 1 January 2020. Equivalence is defined in section 156AB as follows (underlined emphasis added):

**equivalence**, in relation to the supply of a relevant service, means equivalence of supply of the service and access to the service provider’s network so that third-party access seekers are treated in the same way to the service provider’s own business operations, including in relation to pricing, procedures, operational support, supply of information, and other relevant matters

12. This statutory requirement is implemented in the Fibre Open Access Deeds for Chorus and the LFCs (Northpower, Enable and WEL Networks). Clause 6.3 in each Deed provides that where the UFB provider is required to provide a relevant unbundled layer 1 service, it must do so on an EOI basis, meaning (emphasis added):<sup>2</sup>

(a) [The UFB provider] must provide itself and the Access Seekers with the same Input Service;

(b) [The UFB provider] must deliver that Input Service to itself and the Access Seekers on the same timescales and on the same terms and conditions (including price and service levels);

(c) [The UFB provider] must deliver the Input Service to itself and the Access Seekers by means of the same systems and processes (including operational support processes);

(d) [The UFB provider] must provide its own business operations and the Access Seekers with the same Commercial Information about that Input Service, and those same systems and processes; and

(e) When providing that Input Service to itself, [the UFB provider] must use systems and processes that Access Seekers are able to use in the same way, and with the same degree of reliability and performance.

13. The next matter to consider is how an unbundled layer 1 product must be priced to an access seeker in order to comply with the EOI pricing obligation in relation to a layer 2 anchor product. In terms of the application of clause 6.3:

a. I agree with MBIE that a commercial unbundled layer 1 service provided under the proposed new regulatory framework should become an Input Service under the Deeds (see *Options Paper*, footnote 26).

b. I consider that to comply with clause 6.3(a), the UFB provider would need to provide itself with this same layer 1 service in providing its layer 2 anchor products.

c. The price that the UFB provider provides the unbundled layer 1 service to itself must be one which would allow the UFB provider to earn at least a

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<sup>2</sup> This language is taken from the Chorus Deed. The LFCs’ Deeds are in materially the same terms.

normal profit on the layer 2 anchor products if it was receiving the layer 1 service from a third party.

- d. The UFB provider must make the commercial unbundled layer 1 service available to access seekers at the same price.
14. In other words, the key requirement is that there must be sufficient “economic space”<sup>3</sup> between the layer 1 and layer 2 prices such that an equally efficient access seeker purchasing the layer 1 service from the UFB provider will be able to compete against the UFB provider in respect of the layer 2 service or against other RSPs at retail. This concept is variously described as the “efficient component pricing rule (ECPR)”<sup>4</sup>, “economic replicability” or an “equally efficient rival” test.<sup>5</sup>
15. Given this economic space between the layer 1 and layer 2 price, an access seeker can make an efficient decision between:<sup>6</sup> (a) purchasing a layer 2 service to provide a retail service; or (b) purchasing an unbundled layer 1 service, investing in network infrastructure and developing its own layer 2 services to provide to other access seekers or end-users. This is the fundamental rationale for unbundling and the ladder of investment, and the idea of a staggered set of services would be undermined without this price gap.
16. The idea of there being sufficient economic space between the prices for a primary and a secondary service such that an equally efficient rival can purchase the primary (layer 1) service from the access provider but still compete with it in relation to the secondary (layer 2) service is well understood in the competition and regulatory fields. The equally efficient rival test finds expression in, for example, the test for a price or margin squeeze under section 36 of the Commerce Act 1986,<sup>7</sup> and the concept of “relativity” between the UCLL and UBA copper prices under the Telecommunications Act.<sup>8</sup>
17. Although the test does not entail a formula for determining the unbundled layer 1 price that can be applied mathematically and can be complex to apply in practice, it is an approach which the Commerce Commission and the courts are familiar with and are well able to apply in practice as demonstrated in the *Data Tails* litigation.<sup>9</sup>

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<sup>3</sup> See *Commerce Commission Response to MED Discussion Document ‘Regulatory Implications of Structural Separation’* (October 2010) at pp27-28.

<sup>4</sup> See *Telecom Corporation of New Zealand Limited v Commerce Commission* [2012] NZCA 27 (CA) at [64]-[73].

<sup>5</sup> See European Commission *Commission Recommendation of 11.9.2013 on consistent non-discrimination obligations and costing methodologies to promote competition and enhance the broadband investment environment* at pp10-12 & European Commission *Decision concerning Case SE/2015/1687: Wholesale local access provided at a fixed location in Sweden; Case SE/2015/1688: Wholesale central access provided at a fixed location for mass-market products in Sweden; Comments pursuant to Article 7(3) of Directive 2002/21/EC* (6 February 2015) at p8.

<sup>6</sup> Telecommunications (TSO, Broadband and Other Matters) Amendment Bill 2011 (250-2) at p3 and *Commerce Commission Response to MED Discussion Document ‘Regulatory Implications of Structural Separation’* (October 2010) at p9.

<sup>7</sup> A margin (or price) squeeze occurs when a dominant vertically integrated supplier sets a price in the downstream market which is too low (or a price in the upstream market which is too high), such that equally or more efficient competitors are prevented from profitably operating in the downstream market. See *Telecom Corporation of New Zealand Limited v Commerce Commission* [2012] NZCA 27 (CA) at [2].

<sup>8</sup> Commerce Commission *Final pricing review determination for Chorus’ unbundled copper local loop service* [2015] NZCC 37, [689]-[708] and Commerce Commission *Final pricing review determination for Chorus’ unbundled bitstream access service* [2015] NZCC 38, [551]-[555]

<sup>9</sup> See *Telecom Corporation of New Zealand Limited v Commerce Commission* [2012] NZCA 27 (CA).

18. Accordingly, I consider the EOI obligation creates a substantial constraint on that price. Whether this is called a form of “price control” is probably a matter of semantics; the key point is that the UFB provider is required by the EOI obligation to price the layer 1 service at a level which would allow the layer 2 service to be replicated at a competitive price by an efficient rival.

**MBIE’s proposal to carve out the proposed layer 2 anchor products from the EOI obligation**

19. MBIE notes in the *Options Paper* that the proposed prices for the layer 2 anchor products may be close to the expected layer 1 price (for example, due to price smoothing of the anchor products and the setting of prices to reflect quality), such that the EOI obligation would be breached (at page 56). Given “the policy significance of these anchor products”, MBIE proposes that this conflict be resolved by “carving out” the proposed layer 2 anchor products from the EOI obligation. I take the expected layer 1 price to be a reference to a cost-based price and assume that by carving out the proposed layer 2 anchor products MBIE envisages that the UFB provider would be excluded from complying with the price aspects of EOI to the extent that the layer 2 anchor products would imply a lower layer 1 price.
20. While the Fibre Open Access Deeds could be amended (or overridden by legislation) to this effect, in my view the *Options Paper* does not undertake a sufficient analysis to justify the conclusion that this *should* occur.
21. The issue which is not discussed in the *Options Paper* is the impact of such a carve out on potential fibre unbundlers. That is, if the layer 1 price does not guarantee that an equally efficient access seeker can create a service that can be priced competitively against the layer 2 anchor products, then an unbundler would always be at risk of being undercut.
22. At the extreme, layer 1 unbundling may not occur at all as a result of the carve out, particularly if the anchor products cover “a typical broadband user’s needs”.<sup>10</sup>
23. The *Options Paper* also, as a result, does not consider the potential adverse implications for end-users if the carve out undermines unbundling, in terms of the loss of innovation and the absence of constraint on monopoly pricing for higher specification services. The Commerce Commission has described equivalence as “the only effective way of achieving competition between network components where the access provider is vertically integrated” and noted that the benefits to competition are potentially “immense”.<sup>11</sup> While these observations were made in the context of the copper network, in my view it would be a brave prediction that ruled out similar benefits in respect of fibre.

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<sup>10</sup> *Options Paper* at p10.

<sup>11</sup> See *Commerce Commission Response to MED Discussion Document ‘Regulatory Implications of Structural Separation’* (October 2010) at p19.

24. As the Network Strategies report dated 2 September 2016 notes, the proposed carve-out:<sup>12</sup>

... implies that Chorus will be unable to offer dark fibre to access seekers on the same terms as internally. As such the conditions for the proposed 15/1 anchor product will distort service providers' decisions between offering services based on layer 1 or layer 2 inputs, which will in turn have an adverse impact on innovation and the long term benefit of end-users.

25. The *Options Paper* also fails to consider other less restrictive means of resolving the tension described above. As Network Strategies note:<sup>13</sup>

As inclusion of a low-priced 15/1 anchor product within the proposed pricing framework is likely to have a significant distortionary impact we recommend a more targeted approach to meeting affordability objectives for the affected rural market segment. The target end-users should be closely identified, any subsidy should be transparent and a means of funding identified that is more efficient than the current proposal. This may involve specific funding from Government on either the supply or demand side.

If there are some income-constrained individuals or households unable to subscribe to a fixed broadband service then the most effective means of encouraging uptake for this market segment would be through a targeted grant or voucher scheme. Our market analysis indicates that, given current trends, by 2020 those without broadband subscriptions will be a very small group consisting of individuals who simply do not see the need for fixed broadband.

26. That is, by carefully identifying the policy goal, it should be possible to address that issue in a way that is neutral as between the UFB provider supplying the layer 2 service to the RSP, or the fibre being unbundled and the UFB provider supplying the layer 1 service only.

27. I also note that this debate took place and was resolved in 2011.<sup>14</sup> In 2011 it was recognised that the ability of UFB providers to encourage uptake through price discrimination would be constrained if they were required to unbundle and meet EOI requirements from the beginning of operation. On the other hand, it was also recognised that unbundling with EOI protection was also important for the long term interests of end users. This was one of the primary reasons for requiring UFB providers to build their networks in a way that enabled future unbundling, but deferring the obligation to provide unbundled services until 2020.

28. In these circumstances, I would expect a robust policy process to:

- a. expressly recognise that a previous policy resolution was being revisited;
- b. investigate the potential impact of the carve out on unbundling; and

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<sup>12</sup> Network Strategies *Price regulation at Layer 1: Options paper for the Telecommunications Act 2001 Review* (2 September 2016), p12.

<sup>13</sup> Network Strategies *Price regulation at Layer 1: Options paper for the Telecommunications Act 2001 Review* (2 September 2016), p57.

<sup>14</sup> *Officials' Report on the Telecommunications (TSO, Broadband, and Other Matters) Amendment Bill – Part One* (1 April 2011), pp7-9.

- c. investigate other more targeted ways of addressing the policy goal behind the “entry level” anchor product without jeopardising fibre unbundling.

Yours sincerely



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