



Setting prices for service transaction charges for UBA and UCLL services

Cross submission | Commerce Commission

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Executive Summary

1. The Telecommunications Act 2001 (**Act**) provides for the following changes in prices on 1 December 2014:
 - a. A drop in UBA pricing from \$21.46 to \$10.92;
 - b. An increase in the UCLL price paid by UCLL operators such as Vodafone, CallPlus and Orcon from \$19.08 to \$23.46;
 - c. The introduction of new UBA transaction charges (which were previously recovered within the retail-minus UBA monthly charge).
2. Not surprisingly, Chorus has generated significant political and public interest in the first of these changes, but has put much less emphasis on the other two changes, which counter-act the first. In fact, Chorus' public narrative bemoaning the effect of the upcoming price changes, and the Commission's application of the Act, conveniently ignores them completely. That does not make them any less important.

Transaction charges require a robust model

3. Transaction charges are a material component of the UCLL and UBA STD pricing framework, and a material component of the total per-customer wholesale cost which is ultimately paid for by end-users. The same pricing principle – TSLRIC – applies for these charges as for the monthly recurring charges, the same pricing review process applies to them, and the s18 purpose applies to them.
4. All of that must translate into the same modelling process, effort and rigour. The Commission is required to undertake a rigorous bottom-up cost modelling of these charges in the same way it is doing for the monthly recurring charges.
5. Where there are insurmountable practical and time challenges that preclude this (and recognising that we are now only several weeks from the Commission's scheduled release of its draft determination) we have accepted the Commission may need to explore alternative approaches, such as efficiency adjustments as an interim measure.
6. Chorus seems to suggest the Commission can simply adopt its current practices and rates for these components of the STD price list, and be done with the exercise. That is clearly not an option.
7. Quite apart from the difficulties the Commission would have in reconciling this approach with the requirements of the Act, WIK notes several conceptual flaws in Chorus' existing pricing model which illustrate – even before the actual rates used by Chorus in its service company model are considered – why that model will be highly likely to contain inefficiencies.
8. In addition, we note our general unease with any model that uses Chorus-supplied information without clear independent cross-checks. Chorus' public narrative attacking the Commission's role in applying the legislated price changes has shifted almost 180° in its conclusions since it began and clearly illustrates the incentives Chorus is operating under. The shifting nature of this narrative should give the Commission significant pause in considering Chorus' proposal to simply accept its existing transaction charges and pricing framework.

Chorus on the UCLL monthly charge

- 1 June 2012 - *"The economic evidence supports a view that there should be little or no change to the UCLL price"*¹
- 7 October 2014 – 3 valuations leading to UCLL monthly prices of \$66, \$55 and \$33²

Chorus on the UBA monthly charge

- 30 October 2013: *There is no evidence, other than a troubled benchmarking approach, that supports a lower price [than \$21.46]*³
- 7 October – 3 valuations leading to UBA monthly prices of \$16, \$14, \$12.⁴

Transaction charges add a material uplift to the monthly UBA price

9. Finally, we note that Chorus indicated at its 1 October 2014 Dialogue update that the average UBA transaction cost will be approximately \$87 per connection using IPP charges. Assuming a customer lifetime of 30 months (and a notional WACC of 8% used for illustrative purposes only), this equates to a further \$3.23 per month on top of the monthly recurring UBA price, or an effective UBA IPP price of \$37.67 for connections sold from now on (\$14.15 after the UCLF charge is stripped out).
10. In fact, as WIK sets out in its advice there is a wide range of potential transaction cost combinations, some of which may (in the case of a VDSL customer for example) result in annualised per-month transaction charges of nearly equal value to the monthly recurring UBA charge. Retail service providers will pay Chorus \$44.44 for VDSL connections (which make up half of new broadband connections) from 1 December - \$10 more than the monthly recurring charge.

¹ Chorus submission in response to the revised draft determination on the benchmarking review for the Unbundled Copper Local Loop Service, 1 June 2012, p1.

² Chorus investor presentation, 7 October 2014.

³ Chorus Chairman's address, Chorus Annual General Meeting, 30 October 2013.

⁴ Chorus investor presentation, 7 October 2014.

Introduction

11. Thank you for the opportunity to comment on submissions received by the Commission relating to its service transaction charges consultation paper (**consultation paper**).
12. As WIK note in the attached report, transaction charges are an important element of regulated services and make up a substantive proportion of the costs of the service. In practice, Chorus' proposed transaction charges can represent up to \$10 per month on top of the proposed monthly charges.⁵ UBA connection charges, comprising the bulk of transaction charges, are currently built in to the monthly charge. Accordingly, the assessment of efficient costs for transaction charges deserve the same care and consideration as applied to monthly charges.
13. WIK strongly recommend that a bottom up approach should be taken to setting transaction charges. This is the only reliable way of ensuring that prices based on efficient costs are set and the Act's requirements are met. As a pragmatic way forward, recognising the time available, we've accepted that the Commission may – if faced with insurmountable practical and time challenges - adopt current charges as an interim approach with an efficiency adjustment. WIK advise in the attached report how the Commission might make this adjustment.
14. In this submission we respond to submissions relating to:
 - a. The scope of the FPP review. The Act requires the Commission to set an FPP price for the designated access service, not to undertake a review of only those prices set by an IPP methodology as Chorus propose;
 - b. The cost standard to be applied to the FPP. The submissions illustrate the stark choice faced by the Commission for assessing efficient costs; and
 - c. The cost categories against each of the transaction charges. Chorus' table illustrates the care that needs to be taken to defining the transactions and it is unclear what weight, if any, can be placed on the table.

The scope of the FPP review

15. Chorus has proposed that the scope of the FPP review is limited to prices set through the IPP.

15 Chorus believes the appropriate approach for the Commission to take is to review prices for core transaction charges set in the IPP determinations, as the Commission has only applied the relevant IPP to core transaction charges. [...]
16. We disagree. The FPP is not a review of the IPP, it is a completely new process to establish an FPP based prices for the designated service.
17. Access seekers all support a broader review of regulated prices. As noted by Vodafone, the Act provides that “a party to the determination may apply for a review of that part of the determination that relates to the price to be paid for the service.” The application is not limited to a specific subset of prices.

⁵ Chorus propose to charge \$10 per month for VDSL to reflect connection costs.

18. Further, sections 49 and 52 set out the matters the Commission must include in the draft and final determinations respectively. These provisions require that a price review determination include “the price payable for the designated access service”.
19. Wigley Law adds to the analysis, noting that while the Commission did not address all the prices in the then existing Schedule 2, it has made a clear decision on all those prices even though not always expressly addressed. Attachment G (namely the new Sch 2) having recorded its decision. Further, it is unworkable for the Act to be interpreted so that only a subset of Schedule 2 is to be reviewed on the FPP. This would leave some prices in limbo.
20. We agree with the approach outlined by Wigley law on that point. If the Commission were not able to review all prices payable for a service, then there would be no way to apply the FPP approach to all prices now or in the future. Parts of the price would be left hanging.
21. In any event, a determination must be complete and contain all the terms on which an access seeker may purchase the service. If particular transaction charges are not provided during this FPP review then arguably a complete determination does not exist. It therefore makes sense that parties should be able to flag new or additional prices or services that are currently being supplied as part of the regulated service – even if those services or components are not today listed in the price list.
22. Chorus further propose that UCLFS connection charges should be reviewed as part of the UCLL FPP process. We disagree. The FPP review relates to prices payable for the UCLL designated service. In this case, the Commission has received applications to review the UCLL and UBA designated services and the Commission must determine the price payable for these services. However, it has not received an application for a UCLFS pricing review. Accordingly, we do not agree with Chorus that the Commission must review UCLFS prices as part of the UCLL FPP review. In any event, the Act and the provisions of the UCLFS STD clearly provide that UCLL prices automatically flow through to UCLFS.
23. Even if the applications could circumscribe the prices under review as Chorus suggest, the applications are framed broadly and capture all prices applicable to the designated access services. In the UCLL and UBA FPP Review applications:
 - a. Spark (then Telecom) applied for the review of the prices for the Designated Access Service, UCLL. We did not distinguish between core or sundry charges. We consider that whether a charge is core or sundry has little meaning and should bear no relevance to whether a charge is subject to FPP review or not.
 - b. In Spark’s UBA FPP application we applied for a review of the price for the designated access service, UBA; including transaction charges that take are specified as taking effect from 3 years after separation day.
 - c. Call Plus applied for the review of all prices in the Commission’s IPP determination.
 - d. In its UCLL FPP application, Chorus applied for the review of prices listed in the IPP determination; and
 - e. In Paragraph 6 of the Chorus’ UBA FPP application it stated that “(t)he specific prices for which a review is sought are those listed at Paragraph 7 and Attachments F and G of the Decision.” Attachment G of the Decision is the complete amended price list contained as Schedule 2 to the UBA STD. It includes all one off and recurring charges, core and sundry.

24. At the broadest level, the applications by Spark requires that the Commission review all possible and relevant prices for the designated access service. Even though certain or specified prices were mentioned by applicants, the scope of the application is certainly as broad as the designated access service.
25. As a result we consider that Chorus is wrong when it states that only core charges can be reviewed. We also think that the Commission would be wrong to narrow the scope of the FPP price review to only a subset of the designated access service. Our expectation was always that it's the prices for the designated service that require FPP review.
26. We also recognise that the IPP determination was made for the purpose of implementing the Amendment Act (pursuant to section 77 of that Act). But once the FPP Review is set in motion, the scope to review prices is no longer limited to those prices which must be reviewed for the purpose of implementing the Act. In fact, the review is broader.

The Cost standard

27. Chorus argue that the Commission should base its assessment on costs faced by Chorus, plus a margin. This seeks to reflect the real world costs which are Chorus' reality in its current circumstances. However, Chorus' approach will not result in efficient costs except by accident.
28. As WIK note in the attached report, Chorus' proposed approach will not reliably identify the efficient costs required by the TSLRIC approach. A TSLRIC approach seeks to identify the efficient costs of efficiently structured transaction processes. However, Chorus is just requesting compensation of its actually occurring costs. As set out in WIK's previous report, there are a number of reasons why current transaction charges will not be efficient and the incentive structures do not promote efficient costs.
29. Accordingly, Chorus' proposed approach will inevitably overstate the efficient costs of transaction services. For that reason, WIK recommend that the Commission undertake a bottom up cost exercise to identify efficient transaction costs.
30. Chorus' proposed approach to transaction charges is directly contrary to that taken by it in relation to the calculation of the monthly recurring charge and illustrates the wider decision faced by the Commission. On one hand, Chorus has proposed that the FPP exercise be based on its current network design and costs. It then claims that the TSLRIC methodology requires the Commission to value the assets required to deliver the service at replacement cost, as at today. As set out in our previous submissions, Chorus' proposed approach will inevitably incorporate current and path dependent inefficiencies and result in inefficient prices. Chorus noted at the recent investor day that its proposed approach would value the network at up to \$16Bn. Far from reflecting Chorus' reality, the proposed approach would identify costs far in excess of Chorus' actual forward looking costs – i.e. the expected actual cost to maintain and enhance the existing network over time - and constitute a significant wealth transfer from consumers to Chorus. The Commission and Courts have not been prepared to accept such transfers to date.
31. Conversely, access seekers propose that the Commission establish efficient forward looking costs by looking to the costs that would be incurred by a hypothetical efficient provider. It's these costs that reflect the outcomes we would expect to see from a competitive market, and provide the efficient investment, innovation and consumption signals required by the Act. Accordingly, efficient forward looking costs are those provided by an efficient provider focused on deploying the lowest cost technologies, making the most of sharing and asset re-use opportunities wherever they lie.

32. The Commission faces a clear choice. We do not believe the Commission can seek to split the difference as, by moving from the assessment of an efficient providers costs to incorporate inefficient Chorus' costs, it must depart from the efficient forward looking costs required by the Act. Therefore, we believe the Commission must seek to identify the costs of an efficient provider. While Chorus might provide useful data for assessing those costs, it should not be considered as more than a possible starting point amongst alternatives available to the Commission (from which efficiency and other adjustments will need to be made), or have any greater weight than other viable options or sources. A FPP process that starts with Chorus design and inputs would result in inefficient prices that would inevitably be unlikely to comply with the FPP.
33. It is for this reason that we believe the FPP model should focus on the costs of an efficient provider – taking a fresh look at identifying the efficient network and costs. As set out previously, we believe this is analogous to a counterfactual analysis undertaken by economists and in competition law. This is where an authority, rather than modify the factual, seeks to identify the circumstances (costs) that would prevail if not for the path dependent and competitive conditions that prevail.

Chorus cost appendix

34. Chorus also provides an exhaustive list of all possible process activities Chorus may need to undertake to provision service. While a useful detailed list of activities, it may suggest that transaction activity is more complex than what it is in practice. For example, the creation of a work package has been blown into many individual component activities whereas, in reality, it is just a sequence of consecutive steps.
35. In any case, as set out above transaction charges should be determined through a robust bottom up costing exercise. While the table might provide some useful information for that exercise, the Commission should be cautious drawing any conclusions from the table itself.
36. In the limited time available to consider the table, we consider that on the face of it, the table likely overstates the work and level of activities that would be relevant for efficient transaction charges:
- a. Decommissioning of logical/physical inventory, which is a cost of doing business as a network operator and should not be included in the chargeable activity list;
 - b. Confirmation of correct plant allocation, which is merely verification of Chorus' own records and thus should not be chargeable;
 - c. Breakdown of intacts and rearrangement of pair gain customers, which is a Chorus network management activity and thus should not be chargeable;
 - d. Installation of a splitter (customer owned equipment) in the ETP, which we would not seek in today's environment;
 - e. An ethernet adapter as part of a modem configuration job. We are not aware these have been installed for some time.
37. Further, the table includes activities that we would not expect to be charged to access seekers. For example, the UBA service transactions includes:
- a. Decommissioning of logical/physical inventory is a cost of doing business and should not be included in the chargeable activity list;

- b. Confirmation of correct plant allocation is merely verification of Chorus' own records and thus should not be chargeable;
 - c. Breakdown of intacts and rearrangement of pair gain customers is a Chorus network management activity and thus should not be chargeable;
 - d. In today's environment we would not be looking to have the splitter (customer owned equipment) installed in the ETP;
 - e. An ethernet adapter as part of a modem configuration job where we are not aware it has been installed for some time.
38. Therefore, it is difficult to determine how much weight, if any, the Commission can place on the information provided by Chorus as it currently stands.

END

Attachment: WIK report

Provided as a separate document.