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Commerce Commission
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2 December 2013

Dear Stephen

Chorus Application for Final Pricing Principle Review for Unbundled Bitstream Access

We enclose Chorus' notice of application under section 78 of the Telecommunications (TSO, Broadband, and Other Matters) Amendment Act 2011 and section 42 of the Telecommunications Act 2001 (**Act**) for a pricing review determination of Chorus' unbundled bitstream access service (**UBA**). This application relates to Decision [2013] NZCC 20, which applied the initial pricing principle (**IPP**) of benchmarking (**UBA IPP Determination**).

Chorus and other parties also applied for a final pricing review (**FPP**) determination of the Commission's initial unbundled copper local loop (**UCLL**) determination in February.

While Chorus appreciates that the Act requires the Commission to follow a two stage process of benchmarking followed by TSLRIC cost modelling Chorus does not consider that benchmarking is a robust pricing principle. Nor does Chorus consider that the benchmarked prices for UCLL and UBA adequately reflect Chorus' costs of providing these services in New Zealand.

We also do not think that what has played out is what was intended.

First time TSLRIC

Working within the Act, the FPP applications mean that TSLRIC network cost modelling is required to determine the final prices. This is clearly a different exercise to benchmarking countries that bear no relation to New Zealand.

The framework the Commission is operating in means that it looks service-by-service in two steps. This means there is the potential for a mixture of benchmarked determinations and cost modelled determinations and for new processes to be opened up for other services on the network. For this reason, we encourage the Commission to set out its preliminary views on how it intends to approach this exercise within the framework very transparently and early to enable an informed consultation, rather than leaving it to "evolve".

While we appreciate that informed consultation is essential, the evolution of the IPP processes and the uncertainty around how the Commission would approach matters eroded around \$670 million of shareholder value in Chorus. Chorus expects TSLRIC modelling is likely to result in the UBA price being higher than the UBA IPP and that Layer 1 prices will increase significantly. This, coupled with backdating of the final decisions, means this is not just a Chorus issue.

We set out below some preliminary views on matters that will need to be addressed.

Scope of the modelling exercise

We think that the Commission will have to model Chorus' full unbundled copper local loop network, for the reasons explained below.

The Commission determined the updated price for UCLFS in the UCLL benchmarking decision (Decision No NZCC 37, see for example paragraph 320). Chorus is therefore proceeding on the basis that the Commission must consider a TSLRIC model that recognises the interplay of pricing and overlapping infrastructure of the UCLFS service as part of the UCLL review.

As the Commission has acknowledged before, any updated price for the UCLL service may not be appropriate for the UCLFS service, given that the UCLFS service is provided over the entire copper local loop (i.e. both cabinetised and non-cabinetised lines). The UCLL service is only delivered over non-cabinetised lines. In a cost modelling context, this is likely to raise questions again as to whether the geographically averaged price for the UCLL service is the appropriate price for the UCLFS service. In order to calculate the price for the UCLFS service, the Commission's TSLRIC model will need to reflect the costs associated with both cabinetised and non-cabinetised lines.

Chorus also expects that the Commission will address the interface between Chorus' sub-loop UCLL services and UCLL given that in the UCLL benchmarking decision the Commission also updated the price of the sub-loop service standard terms determination.

The same is true for the UBA service, which is priced on a nationally averaged basis and provided over cabinetised and non cabinetised lines. Chorus' sub-loop co-location and sub-loop backhaul services are used to deliver the UBA service.

Quality, coherency and timing considerations

It is essential that the Commission considers the range of services that are provided over Chorus' unbundled copper local loop in an integrated way when embarking on the FPP processes. The Commission will need to develop a model that recognises and pays proper attention to the complexity of the framework and the overall economics of the network. This may be difficult, but it would be untenable for Chorus if the review process for each service was considered in isolation over a number of years with separate but overlapping and/or incoherent economic models.

As the Government stated in its current review discussion document, "*the process of setting prices based on long-run forward-looking costs using costs models can be very time consuming (usually several years) because complex modelling and extensive consultation are involved*".

This is already illustrated by the fact that it has been ten months since the FPP applications for UCLL were made, and the Commission is yet to release its initial scoping and issues discussion paper. The Commission's forecast timetable will not see the final determination being made until late 2015 (almost three years after the application for review was submitted).

The uncertainty caused by delay is already very hard to manage commercially, but it would be further exacerbated if the process was carried out in a piecemeal way. Careful consideration of the quality of outcomes and timeliness of these processes is going to be essential because the risks of error and impact on the industry are considerable.

Backdating of FPP outcomes

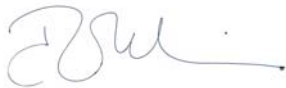
The 2006 Court of Appeal decision in *Telecom v Commerce Commission and TelstraClear* held that final price review determination prices should "relate back" (in the Court of Appeal's language) to the date of the initial price determination. These were declaratory proceedings as to whether backdating was contemplated as between the IPP and the FPP determinations:

[44] In our view Harrison J was right to uphold the contention by the Commission and TelstraClear that a price review determination relates back to the date of the initial determination. That is consistent with the substitutionary nature of reviewing or appellate decisions which vary an original decision. The alternative view implies a potential for negating the efficacy of the review process which the Act has established in order to serve the s 18 purpose. Moreover, the obvious function of the price determination regime is to fix the price for a period of time relevant to the application, not to fix the price for part of that time and another price for another part. We consider that the s 18 purpose is better served by substituting the revised price for the initial price *ab initio* rather than only after a period of relatively less efficient pricing. None of the arguments advanced on behalf of Telecom has persuaded us to the contrary.

Given the Court of Appeal's views and the Commission's early indications that it may not be able to complete FPP determinations prior to 1 December 2014, the Commission should provide its preliminary views on the substitutionary effect of FPP determinations upfront for consultation.

We look forward to engaging with the Commission and the industry on the FPP processes.

Yours faithfully



Anna Moodie

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cc Simon Thomson

cc John Gandy