CallPlus Cross-submission on consultation on setting prices for service transaction charges for UBA and UCLL services

16th October 2014

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1. Summary

1.1 Thank you for the opportunity to cross-submit on the parties' submissions.

1.2 We rely upon the Wigley cross submissions and make the following additional points. In our submission, we outlined our concern about connection and wiring charges jumping from $145.05 today to $284.73 from 1 December, by a combination of price increases in Schedule 2 and the new $115 charge. This in turn enables Chorus to double the amortised charges to $10 per month, which is nearly as much as the underlying recurring charge for clothed UBA of $10.92.

1.3 That shows how important service charges are for the market and that they need close attention. We particularly draw attention to the Wigley submission on the implications of the connection and wiring charges for both implementing the IPP (as there is a major market failure problem before the FPP determination is issued) and for the FPP.

1.4 By one inappropriate backdoor or another, Chorus is seeking to increase the prices it imposes on RSPs and consumers. Wigleys cross-submission outlines why the latest attempt breaches the STD.

1.5 Continuing our summary:

Chorus' submissions should not be relied on

(a) Chorus continues to treat itself as if it is a "hypothetical efficient operator". It is not.

(b) Chorus continues to treat its actual costs as being equivalent to forward-looking TSLRIC costs. They are not.

(c) Submissions from Spark, Vodafone, WIK, Wigley and our own submissions detail some of the reasons why Chorus' transaction charges, even where set through competitive tender, should not be treated as being equivalent to efficient forward-looking costs.

(d) Chorus' claims about the "transparency" of its transaction charges should be seen in the context of what we have noted are "significant increase in costs" with "no real justification … other than looking to offset the IPP price changes and maintain Chorus' balance sheet".[1]

WIK's report, in particular, provides useful guidance to the approach the Commission should take to cost determination

(e) International experience indicates undertaking TSLRIC modelling for transaction charges is more straight-forward than for determining the monthly service charges for UBA and UCLL services.

[1] CallPlus, Submission on the Commerce Commission's Consultation Paper: setting prices for service transaction charges for UBA & UCLL, 9 October 2014, paragraphs 2 and 3.

(f) International experience indicates that if a top-down approach is taken to cost determination for transaction charges substantial (downward) efficiency adjustments would be required.

(g) Improvements in efficiency should be expected to more than offset any potential forecast in increased labour costs.

(h) As the Wigley cross-submission explains, bottom up is the only option.

Reasonable investor expectations only point to southbound prices

(i) "Reasonable investor expectations" are not being created by Chorus' investor briefings or submissions. These risk creating inflated and unrealistic investor expectations. Reasonable investor expectations, consistent with international experience, would be that transaction charges will be reduced as part of the FPP determinations.

1.6 The WIK report is particularly helpful and constructive for guiding the approach the Commission should take to determination of transaction charges except that, as explained by Wigleys, top down is not a viable or available option.

1.7 We turn now to the detail of our submission.

2. Chorus is not a hypothetical efficient operator and its actual costs are much higher than TSLRIC

2.1 Concern has previously expressed concern that "the approach the Commission will adopt to the TSLRIC determination will be too closely linked to Chorus' actual network and costs rather than the cost of a hypothetically efficient operator".[2] Chorus' submission, as with its preceding submissions, appear to be focussed on achieving this outcome.

2.2 In its submissions, Chorus states "It is consistent with TSLRIC to start with the service company charges, adjust for overheads and implement a mechanism to reflect changes in underlying cost inputs. This is our preferred approach"[3] That is, as Chorus well knows, inconsistent with TSLRIC. TSLRIC is NOT existing prices with mark-ups for overheads and cost inflation. Therefore, a top down methodology is fraught with danger when the incumbent makes these clearly incorrect statements.

2.3 There is a recurring theme of Chorus attempting to unjustifiably push up the cost determination for UBA and UCLL. The submissions in relation to transaction charges are an example. The claim made in Chorus' most recent Investor Relations Update that the replacement cost of its network is $16 billion and the TSLRIC prices should be $67p.m. for UCLL and $16p.m. for UBA is a major example of Chorus inflating costs.[4] That is the sort

[2] Wigley and Company, Submission on consultation paper outlining Commission's proposed view on regulatory framework and modelling approach for UBA and UCLL, August 2014, paragraph 35.
[3] Chorus, Submission in response to the Commerce Commission's consultation paper "Consultation on setting prices for service transaction charges for UBA and UCLL services (25 September 2014), 9 October 2014, page 5, response to question 4.
[4] Chorus, Chorus Institutional Investor Briefing, 7 October 2014.

of thing that was happening with Chorus' (as Telecom) TSO and PSTN TSLRIC cost calculations.

2.4 The position Chorus takes to transaction charges effectively requires the Commission to treat Chorus as an efficient service provider, and its actual costs to be the same as TSLRIC prices. The principal basis for this position appears to be that transaction charges were determined by competitive tender.

2.5 We agree with Spark, which shares our concerns, that "*The Commission is not tasked with calculating the cost to Chorus of transaction charges, or the cost of transaction charges on Chorus' actual network. It is tasked with calculating the efficient transaction costs for an efficient operator's network. The difference will represent the efficiency enhancements an efficient operator using modern technologies would enjoy*."[5]

2.6 Previous Spark and Vodafone submissions detailed why Chorus' actual costs are substantially above the costs of a hypothetical efficient operator. (Chorus did not respond to, or dispute, these submissions in its Transaction Charges submission.) These submissions are further reinforced by the Spark, Vodafone and WIK in their responses to the Transaction Charges Consultation.

2.7 Spark correctly notes "the pass-through model adopted by Chorus, and the unavoidable link between this model and Chorus's actual network" precludes the Commission from treating Chorus' actual costs as being the same as that of a hypothetical efficient operator.[6]

2.8 Similarly, the WIK submission describes well why Chorus' transaction charges should not be assumed to represent the TSLRIC costs, or the costs of a hypothetical efficient operator:[7]

(a) Contractors provide the transaction services as defined and in the process structure as prescribed by Chorus. These processes must not necessarily be efficient.

(b) Chorus does not have proper incentives to minimize the cost of service provision through contractors.

(c) Chorus has a strong incentive to allocate more costs to regulated than to unregulated transaction services as co would be justified from a TSLRIC perspective.

(d) The Commission intends to set prices in the FPP for a five year regulatory period. Costs identified on the basis of contracts of today (or even yesterday) do not properly reflect the relevant cost in five years time."

2.9 WIK elaborates on these points by noting:[8]

> Even if the service companies provide the services Chorus is requesting from them efficiently, the resulting costs may not be efficient. This outcome can occur if the

[5] Spark, Setting prices for service transaction charges for UBA and UCLL services, 9 October 2014, paragraph 3.
[6] Spark, Setting prices for service transaction charges for UBA and UCLL services, 9 October 2014, paragraph 3.
[7] WIK, Report for Spark and Vodafone NZ, Submission In response to the Commerce Commission's Consultation on setting prices for service transaction charges for UBA and UCLL services (25 September 2014), 8 October 2014, paragraph 19.
[8] WIK, Report for Spark and Vodafone NZ, Submission In response to the Commerce Commission's Consultation on setting prices for service transaction charges for UBA and UCLL services (25 September 2014), 8 October 2014, paragraph 20.

> underlying transaction process is not defined and structured efficiently. The overall efficiency of transaction services very much depends on the degree of automation of the processes, the use of appropriate IT systems and the proper interfaces. In Germany for instance the costs of ordering processes have been reduced by a factor of three over time and the corresponding transaction charges today are now only a fraction of what they had been some years ago.

2.10 As we said in our submissions:[9]

> Commercial negotiations across a range of services rarely reflect the cost of the underlying individual services, rather they are a bundle with 'overs and unders'. For the Commission to take the individual charges as an indication of the cost of the service would be flawed in our opinion.

2.11 Vodafone provide two examples of why the transaction charges should be lower:[10]

- the $15.85 charge for a UBA installation which does not require a site-visit is significantly overstated. Efficiently provided, this service is a record change only which should be automated. As such, the plan change (no port change required) charge of $4.71 is a more appropriate starting point for UBA installations which do not require a site visit.
- the installation charges which require a site visit (particularly to an exchange or cabinet) are unlikely to adequately reflect the efficiency gains of "batching" that a hypothetically efficient nation-wide access provide can deliver.

2.12 Also, as we said:[11]

a) Interleaving – the IPP has a charge of $15.85. This could have a critical impact on RSPs. CallPlus offers interleaving on/off as an option for consumers. Furthermore it extensively uses this capability for fault diagnostics. CallPlus offers this feature to our Wholesale customers using our own LLU services. CallPlus Wholesale customers are able to change interleaving on or off via an on-line portal in real time. There is no charge levied for this service and there are little or no costs incurred by CallPlus.

b) Charges with no port change – these charges look high at $15.85 for what is essentially a change in internal records or a simple plan change. If you compare this charge with, for example, the average cost of handling a customer call in a call centre – involving real time, person to person interaction – it is well above the cost of the average call. CallPlus would suggest a good 'benchmark' may be the porting fee, the cost charged by service providers porting away numbers. This is a well-established industry charge which following a review reduced to $5.94 based on a cost assessment by Spark and Vodafone plus a mark-up.

[9] CallPlus, Submission on the Commerce Commission's Consultation Paper: setting prices for service transaction charges for UBA & UCLL, 9 October 2014, paragraph 11.
[10] Vodafone, Submission on consultation paper on setting prices for the service transaction charges for UBA and UCLL services, 9 October 2014, page 1.
[11] CallPlus, Submission on the Commerce Commission's Consultation Paper: setting prices for service transaction charges for UBA & UCLL, 9 October 2014, paragraph 12.

3. There are transparency issues with Chorus' recent behaviour

3.1 Chorus claims in its submission that "Service company charges … were set in 2009 in a transparent manner".[12]

3.2 A problem though, is, as stated in our submissions:

> "In recent weeks Chorus in addition to the doubling of the amortised connection and wiring fee service for VDSL has clearly signalled its intention to increase transaction charges to RSP's - with unprecedented price increases with little empirical justification. In the last few weeks alone we have had three examples …"[13]

> "Given the recent developments there is a real risk that escalating transaction charges which will create barriers to switching, inhibiting competition, and causing some significant confusion and issues for end users".[14]

4. A bottom-up approach should be undertaken for the TSLRIC determination

4.1 We remain of the view that a bottom-up TSLRIC approach to transaction charge determination is correct. As Wigleys submitted:

> "We do not understand why transaction charges fit uncomfortably in the TSLRIC model ... First, there is no choice but for them to fit into TSLRIC, because that is what the Act requires. Standard statutory interpretation requires a solution to ensure TSLRIC workably applies ... Second, they fit comfortably anyway. The TSLRIC definition exactly fits one off charges such as for labour, truck rolls and so on. We cannot see any way why this is any more challenging than determining monthly charges."[15]

4.2 Our position is supported by WIK which argues that determining the TSLRIC price for transaction charges is more straightforward than for the UCLL and UBA recurring services:[16]

> The TSLRIC cost standard has from an economic perspective the same justification and meaning for service transaction charges as it has for service recurring charges. Although the cost structure of transaction services differs a lot from that of the UCLL and UBA recurring services this does not give reason to assume that the TSLRIC cost standard would not be appropriate or not applicable. Transaction services are much more characterized by labour costs than by capital cost compared to the UCLL and UBA

[12] Chorus, Submission in response to the Commerce Commission's consultation paper "Consultation on setting prices for service transaction charges for UBA and UCLL services (25 September 2014), 9 October 2014, paragraph 37.
[13] CallPlus, Submission on the Commerce Commission's Consultation Paper: setting prices for service transaction charges for UBA & UCLL, 9 October 2014, paragraph 7.
[14] CallPlus, Submission on the Commerce Commission's Consultation Paper: setting prices for service transaction charges for UBA & UCLL, 9 October 2014, paragraph 5.
[15] Wigley and Company, Submission on consultation on setting prices for service transaction charges for UBA and UCLL services, 9 October 2014, paragraphs 5.1 – 5.3.
[16] WIK, Report for Spark and Vodafone NZ, Submission In response to the Commerce Commission's Consultation on setting prices for service transaction charges for UBA and UCLL services (25 September 2014), 8 October 2014, paragraph 14.

> recurring services. Also the degree of directly attributable costs is significantly larger and correspondingly the degree of shared cost is lower for transaction services than it is for the recurring services. For this reason it is conceptually and practically much easier to apply TSLRIC costing and pricing principles for transaction services than it is for the recurring services. Therefore we do not share the Commission's concerns of applying the TSLRIC methodology to service transaction charges as, expressed in para 31 of its Consultation paper. The TSLRIC methodology fits comfortably for being applied to transaction charges. [emphasis added]

4.3 A bottom-up TSLRIC modelling approach would help ensure costs are only accounted for once (no double-dipping) and mitigate the concern that:

> "The biggest risk with consideration of transaction charges, particularly if they are considered remotely from the TSLRIC modelling process for UCLL and UBA, is the prospect of additional transaction charges resulting in an undue uplift in the revenue Chorus is able to extract for UCLL and UBA services."[17]

4.4 But in the end, as Wigleys submit, only bottom up is available to the Commission.

5. If a top-down approach is taken there would need to be substantial efficiency adjustments to avoid inflating prices

5.1 "Regardless of whether the Commission accepts our views on bottom-up modelling, Chorus' transaction charges should not be based solely on service company contracts. This would result in transaction charges based on actual cost rather than TSLRIC or the costs of a hypothetical efficient service provider".[18]

5.2 We share WIK's concern that:[19]

> Relying on Chorus service companies' costs would not lead to determine the efficient costs of transaction services. The Commission should not rely on this topdown approach.
>
> We are generally skeptical to determine regulated prices on the basis of a topdown approach which solely relies on the cost data provided by the regulated firm. The information asymmetry inherent in this approach generally generates a biased to inflate costs away from the relevant efficient costs.

5.3 If the Commission decides to adopt a top-down approach to the cost determination for transaction charges we agree with WIK that:

(a) "… the starting point of the new transaction charges would be the previous transaction charges."

[17] Wigley and Company, Submission on consultation on setting prices for service transaction charges for UBA and UCLL services, 9 October 2014, paragraph 3.1
[18] Wigley and Company, Submission on consultation on setting prices for service transaction charges for UBA and UCLL services, 9 October 2014, paragraph 6.3.
[19] WIK, Report for Spark and Vodafone NZ, Submission In response to the Commerce Commission's Consultation on setting prices for service transaction charges for UBA and UCLL services (25 September 2014), 8 October 2014, paragraph 33.

(b) "They would be reduced by a factor representing efficiency gains over time and to reduce cost inefficiencies contained in the current charges."

(c) "Such an efficiency factor could be developed from international benchmarks."[20] "The European regulatory practice and its identification of efficiency potential in comparison to cost documents of incumbents shows, that relying on incumbents cost data is not adequate to identify efficient costs".[21]

(d) "… the efficiency of providing the services may and should increase over time too. ….These efficiency improvements can easily dominate any increase in labour costs. It is for this reason that in many European countries transaction charges decrease over time."[22]

(e) "… a top-down approach – if applied at all – needs to rely on independent cross checks of the data provided by Chorus conducted by the Commission."[23]

5.4 Again, the WIK report provides useful guidance, including based on European experience, on how to determine the efficiency adjustment for a top-down approach to cost determination for transaction charges.

6. Don't provide Chorus with opportunities to double dip

6.1 We share WIK's concern about the risk of double-dipping:[24]

> In para 40 of its Consultation the Commission seems to follow Chorus' request to allow for an appropriate margin for Chorus internal cost on-top of the prices that the service companies charge Chorus. This approach runs the risk that RSPs are subject to a double marginalization of Chorus' service companies and Chorus itself. In case Chorus faces its own cost in addition to the cost of its outsourcing partners, such costs should be identified and they have to be compensated for if they efficiently occur. The Commission, however, should not allow for a general margin for Chorus on-top of the service companies' prices. This would lead to an unjustified double-recovery of overhead costs.

6.2 Chorus' submission advocates the inclusion of a mark up for overheads in its transaction and "sundry" charges e.g.:[25]

> Sundry charges were set on a cost recovery basis. Where Chorus uses the service companies, the sundry charges are based on the service company input and recovery

[20] WIK, Report for Spark and Vodafone NZ, Submission In response to the Commerce Commission's Consultation on setting prices for service transaction charges for UBA and UCLL services (25 September 2014), 8 October 2014, paragraphs 24 and 25.
[21] WIK, Report for Spark and Vodafone NZ, Submission In response to the Commerce Commission's Consultation on setting prices for service transaction charges for UBA and UCLL services (25 September 2014), 8 October 2014, page 2.
[22] WIK, Report for Spark and Vodafone NZ, Submission In response to the Commerce Commission's Consultation on setting prices for service transaction charges for UBA and UCLL services (25 September 2014), 8 October 2014, paragraph 23.
[23] WIK, Report for Spark and Vodafone NZ, Submission In response to the Commerce Commission's Consultation on setting prices for service transaction charges for UBA and UCLL services (25 September 2014), 8 October 2014, paragraph 30.
[24] WIK, Report for Spark and Vodafone NZ, Submission In response to the Commerce Commission's Consultation on setting prices for service transaction charges for UBA and UCLL services (25 September 2014), 8 October 2014, paragraph 32.
[25] Chorus, Submission in response to the Commerce Commission's consultation paper "Consultation on setting prices for service transaction charges for UBA and UCLL services (25 September 2014), 9 October 2014, paragraph 17.

of relevant overheads, with price change mechanisms to reflect changes in the underlying costs.

6.3 A risk that could arise, particularly, if the costs for transaction charges and for UBA/UCLL are calculated separately is that they provide duplicating mark-ups for overheads and common costs.