

18 October 2019

Tēnā koutou stakeholders,

**We seek your views on the report from our expert economic advisor, Dr Ingo Vogelsang, on the interpretation of the equivalence and non-discrimination obligations imposed on local fibre companies**

### **Purpose of this consultation**

1. The purpose of this letter is to inform stakeholders that the Commerce Commission (**the Commission**) engaged Dr Ingo Vogelsang (the **economic expert**) to provide expert economic advice (**the expert report**)<sup>1</sup> on the economic interpretation of the equivalence and non-discrimination obligations imposed on local fibre companies (**LFCs**).<sup>2</sup>
2. This letter provides the context for the expert report, summarises the expert report's key insights and outlines our questions for stakeholders.
3. We welcome stakeholder views on the contents of the expert report, and stakeholder responses to the questions posed in our letter below. Stakeholder submissions will be considered when we develop our guidance on equivalence and non-discrimination.

### **The context for the expert report**

4. The LFCs have each entered into Deeds of Open Access Undertaking (**Fibre Deeds**) under section 156AD of the Telecommunications Act 2001 (**Act**),<sup>3</sup> which require them to provide a point-to-multipoint layer 1 fibre access service (**PON Fibre Access Service**) from 1 January 2020 for UFB1.<sup>4</sup>
5. The Act gives the Commission a particular role in the context of the PON Fibre Access Service. Firstly, we are permitted to assess whether the LFCs' conduct complies with their obligations under the Fibre Deeds. Secondly, if we consider that a breach of the Fibre Deeds is likely to occur or has occurred, we will decide whether to bring enforcement action under the Act. When exercising our powers to enforce compliance with the Fibre Deeds, we consider the purposes outlined in section 156AC of the Act.

---

<sup>1</sup> The expert report, provided by Professor Ingo Vogelsang, on the economic interpretation of the equivalence and non-discrimination obligations imposed on local fibre companies is available on the project page, at <https://comcom.govt.nz/regulated-industries/telecommunications/projects/unbundled-layer-1-fibre-service>

<sup>2</sup> The LFCs comprise Chorus Limited, Enable Networks Limited, Northpower Fibre Limited, Northpower LFC2 Limited and Ultrafast Fibre Limited.

<sup>3</sup> All legislative references in this letter are to the Act, unless otherwise stated.

<sup>4</sup> Section 156AD(6)(a).

6. The Fibre Deeds require the LFCs to provide the PON Fibre Access Service on an equivalent and non-discriminatory basis (see clauses 5 and 6 of the Fibre Deeds). However, the Fibre Deeds cannot specify the price or non-price terms of the PON Fibre Access Service<sup>5</sup>, and the Commission is also not empowered to set standard terms (including a maximum price) for the PON Fibre Access Service<sup>6</sup>.
7. Given stakeholder concerns and the range of parties potentially involved in the enforcement of the Fibre Deeds, we believe that there would be clear public benefit in the Commission developing, in a transparent way, our views on what the equivalence and non-discrimination obligations in the Fibre Deeds (and other deeds) involve. We have begun developing guidance on our interpretation of these provisions.
8. We plan to publish the draft guidance in December 2019. Until we finalise the guidance, we do not expect to be in a position to form a view on whether a PON Fibre Access Service offer is likely in our view to comply with the obligations in the Fibre Deeds, let alone reach a decision on whether any enforcement action would be appropriate in relation to PON Fibre Access Service.

### Overview of the expert report and our questions

9. We asked the economic expert for analysis and advice on questions related to:
  - a. the interpretation of equivalence, as defined in section s 156AB;<sup>7</sup> in particular, as it applies to the level of the price for the unbundled product (PON Fibre Access Service); and
  - b. the interpretation of non-discrimination, as defined in section s 156AB,<sup>8</sup> as it applies to pricing practices.
10. The advice in the expert report is focussed on the interpretation of equivalence and non-discrimination in Part 4AA, being the provisions that relate to the Fibre Deeds. To the extent that the relevant definitions (and purposes) are substantively the same in other parts of the Act the advice in the expert report would also apply to other provisions in the Act.

---

<sup>5</sup> Section 156AD(5)(b).

<sup>6</sup> Section 211. Note that regulations could be made under s 229 on the recommendation of the Minister, declaring an unbundled fibre service and setting a maximum, cost-based, price, which would apply to any parties subject to price-quality regulation under Part 6 of the Act. After 1 January 2025, the Commission could commence a price-quality review. One of the outcomes of the review might be a recommendation to the Minister on the content and scope of unbundling regulations to be made under s 229.

<sup>7</sup> Section 156AB defines equivalence as *'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'*.

<sup>8</sup> Section 156AB defines non-discrimination as *'non-discrimination, in relation to the supply of a relevant service, means that the service provider must not treat access seekers differently, or, where the service provider supplies itself with a relevant service, must not treat itself differently from other access seekers, except to the extent that a particular difference in treatment is objectively justifiable and does not harm, and is unlikely to harm, competition in any telecommunications market'*.

11. The expert report provides an economic interpretation of the equivalence obligation, including Equivalence of Prices (EOP) and Equivalence of Inputs (EOI), and the non-discrimination obligation. The expert report also elaborates on important related concepts and constraints. The key insights from the expert report and our questions are outlined below.

### Equivalence of Prices

12. The definition of 'equivalence' in s 156AB includes price along with the physical inputs, which means that LFCs are required to provide the upstream service (PON Fibre Access Service) to access seekers at the same price they charge internally their own downstream operations for this service. However, the LFCs do not charge internal prices for the inputs they supply to themselves and they are not required to do so by the Fibre Deeds. Therefore, the internal 'equivalent' price for the upstream service has to be imputed.
13. The expert report details that there are several pricing methods available, some linked to the economic concept of "opportunity costs",<sup>9</sup> others linked to the actual (resource) costs of the product supplied, that could satisfy EOP. Different pricing methods have both advantages and drawbacks in terms of promoting the different limbs of the purposes of Part 4AA, as stated in s 156AC.
14. The economic expert advises that EOP does not require a particular pricing methodology or structure; but it does entail certain restrictions on the pricing freedom of the service provider. In particular, to satisfy EOP, LFCs' own downstream operations have to be able to profitably supply the downstream product if faced with the upstream access price (ie, a form of 'no price squeeze' test has to be satisfied based, at least, on an 'equally efficient competitor' standard).
15. Further, for the purposes of establishing a 'safe harbour' for a price level that could be presumed to satisfy EOP, the economic expert suggests a (stricter) optional approach linking the upstream price (eg a PON Fibre Access Service price) to downstream costs and prices, and the upstream costs in the following way:

$$p_{\text{upstream}} \leq \min (\text{LRIC}_{\text{upstream}}, p_{\text{downstream}} - C_{\text{compdownstream}}),$$

where  $\text{LRIC}_{\text{upstream}}$  is the long run incremental cost of the upstream product,<sup>10</sup>  $C_{\text{compdownstream}}$  is the downstream cost of an efficient competitor<sup>11</sup> and  $p_{\text{downstream}}$  is the downstream price.

<sup>9</sup> This concept is linked to the efficient component pricing rule (ECPR) or so-called 'retail-minus' pricing.

<sup>10</sup> In this context, the economic expert also points out that building blocks methodology pricing is closely related to a top-down approach to LRIC pricing.

<sup>11</sup> The economic expert notes that international regulatory precedent often assumes that an 'efficient competitor' has approximately 20% share of the market.

16. The expert report outlines that the current context in New Zealand, where the network build-out is ongoing and thus, LFCs have an incentive to increase fibre take-up, may allow for some special circumstances which involve 'penetration pricing'<sup>12</sup> (in other words, downstream pricing below cost). The implications of downstream penetration pricing for the price of the upstream product might depend on the pricing methodology chosen and the optimal choice between these could depend on the policy intent:
- a. If a (resource) cost methodology is selected for the price of the upstream product, penetration pricing downstream would imply that there is no economic room for access seekers to compete in the downstream market (unless they choose penetration pricing themselves). In this scenario, there is likely to be no, or very little, take-up of the PON Fibre Access Service;
  - b. If a 'retail-minus' methodology is selected for the price of the upstream product, penetration pricing downstream is likely to imply prices below costs also for the upstream product. This scenario may impact negatively on the LFCs' incentives to invest.

Q1. What is your view on the implications of potential penetration pricing (downstream pricing below cost) for the EOP obligation on the PON Fibre Access Service?

Q2. What are your views on each of the following conclusions in the expert report?

- a) The EOP obligation does not require a particular pricing methodology or structure, but it does entail certain restrictions on the pricing freedom of the service provider.
- b) The EOP obligation requires that the LFCs' own downstream operations can profitably supply the downstream product if faced with the upstream access price (ie, a form of 'no price squeeze' test has to be satisfied based, at least, on an 'equally efficient competitor' standard).
- c) There is an optional approach to establish a 'safe harbour' price level for the upstream price, based on the formula provided in paragraph 15 which, if demonstrated to hold, would be presumed to satisfy the EOP obligation.

### Equivalence of Inputs

17. The expert report outlines that EOI concerns the relationship between inputs used by the regulated firm for generating its own downstream services and the inputs provided to an access seeker. Based on the definition in the Act, to satisfy EOI all inputs have to be provided to access seekers on exactly the same terms (including timeliness and quality of provision) as the terms that an LFC offers its own downstream business operations.

<sup>12</sup> We did not ask the economic expert to consider the specific implications of Part 6 of the regime and the Crown Infrastructure Partners contracts in his advice.

## Non-Discrimination

18. The expert report outlines that when applied to prices, non-discrimination concerns the price structure offered by an LFC to various access seekers (as well as their own downstream operations). The economic expert concludes that all pricing structures that in effect result in different unit prices being offered to access seekers (or the LFCs' own downstream operations), including component pricing, discount structures, etc., are a form of price discrimination. Equally, a single price schedule offered to all access seekers can be discriminatory if such a schedule has different impact on different access seekers or is not functionally available to all access seekers.
19. The expert report interprets the non-discrimination obligation in the Fibre Deeds to mean that all pricing practices that have different impact on different access seekers (or affect access seekers differently from an LFC) will fail the non-discrimination obligation unless they qualify for the dual exemption of being objectively justifiable and not harming, or not being likely to harm, competition. For prices to automatically satisfy the non-discrimination obligation, they would have to be linear or near-linear (meaning a single price per unit or a de minimis deviation from a single price).
20. The economic expert points out that price discrimination can be efficient and thus, there could be grounds for considering certain forms of price discrimination objectively justifiable. However, before it qualifies for an exemption, any form of price discrimination would still have to be evaluated against the requirement that it does not harm competition. For example, pricing practices that are likely to favour large access seekers (such as those with a large fixed component) may be presumed to fail the non-discrimination obligation since they are likely to harm competition in the long term.

Q3. What are your views on each of the following conclusions in the expert report?

- a) Any price structure that deviates from a single price per unit (aside from de minimis deviations) or that impacts different access seekers differently (from each other or an LFC's own downstream operations) can be considered to fail the non-discrimination obligation unless it qualifies for the exemption in the relevant provision of the Fibre Deeds.
- b) Pricing practices that are likely to favour large access seekers can be presumed to fail the non-discrimination obligation, since they are likely to harm competition.

**We welcome your feedback**

21. This letter has outlined key insights from the expert report and has asked three questions related to those key insights. While we understand that this is a complex topic we encourage stakeholders to provide their views on the questions listed above and the expert report.
22. Please email your submissions to Michael Callan, c/o [regulation.branch@comcom.govt.nz](mailto:regulation.branch@comcom.govt.nz) by **5pm on 18 November 2019**, with 'Submission on Telco application of equivalence and non-discrimination obligations' in the subject line.
23. We anticipate that there may be important information of relevance to this consultation that is commercially sensitive. If you wish to provide commercially sensitive information in your submission, we request that you provide both a public and a confidential version of your submission:
  - a. please provide a clearly labelled "confidential version" and "public version" of your submission. This is because we intend to publish all public versions on our website; and
  - b. where a confidential version of your submission is provided, please ensure that you clearly and specifically identify all information you consider to be confidential.
24. Stakeholder views will be considered when we develop our guidance on equivalence and non-discrimination. We plan to publish the draft guidance for consultation in December 2019.

Nāku, nā

A handwritten signature in black ink, appearing to read 'Stephen Gale', with a large, stylized initial 'S' and 'G'.

Stephen Gale  
Telecommunications Commissioner