14 September 2012

Public

Cross-submission in response to the Commerce Commission's Unbundled Bitstream Access Price Review Consultation discussion paper

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Chorus

EXECUTIVE SUMMARY

1. This is Chorus' cross-submission on the Commission's Unbundled Bitstream Access Price Review Consultation discussion paper (**Commission's discussion paper**).

2. The UFB network investment, the statutory direction of new section 18(2A), the move to cost-based UBA pricing, and the UCLL price review are a package. In this context of the transition to the UFB network, the UBA price is a balancing act in terms of creating the right incentives for the industry. If the industry focuses on investment in copper-based services, this will impact the transition to UFB.

3. When the Commission sets the UBA price, it will be a key influence on the incentives, efficiencies, innovation and competition in the provision of future telecommunications services, and ultimately success of the UFB initiative. We believe that the long term benefits of end-users are best served by fibre-based services.

4. It is helpful to identify early where there are areas of alignment across the industry, and where there are differences of view. In some cases, the framework for the Commission is clear in the IPP process. However, there will always be judgement calls for the Commission to make during the benchmarking process, particularly where there are different perspectives across the industry. The compass that helps guide the Commission through those matters of judgement is the purpose statement in section 18.

5. There is a level of alignment across the submissions on some of the matters the Commission should take into account when implementing the new cost-based UBA IPP. In particular submitters (including Chorus) generally agree that:

   5.1 the benchmarking exercise needs to consider similar services despite the omission of the words "similar services" in the IPP; and

   5.2 teledensity is not a sufficient comparability criterion.

6. However, there are a number of views that we disagree with - such as the arguments for relaxing the comparability criteria and for looking at prices that are not necessarily cost-based. The Commission is required to ensure that any benchmarking approach meets the requirements in the IPP – which include establishing comparability criteria, benchmarking forward-looking cost-based prices and selecting countries that reflect the comparability criteria.

7. In the rest of this submission we respond to some specific issues raised by submitters.

SUBMISSION

8. In this section we comment on some of the key points raised in the submissions on the Commission's discussion paper. We have set our responses under each of the Commission's original questions in the discussion paper.

Question 1: Do you agree with the Commission's view regarding the absence of "similar services" from the benchmarking for UBA?

Concept of similar services

9. There seems to be general alignment that the concept of "similar services" is inherent in benchmarking.

Similar does not mean identical

10. Telecom's view is that "similar" does not necessarily mean identical in every respect and adjustments can be made to address differences based on an understanding of technical and comparability criteria. TelstraClear takes the view that the Commission must benchmark against services that are "truly equivalent (i.e. services with genuinely similar technical and functional attributes to the UBA service)".

11. We agree with Telecom that "similar" does not mean "identical" to our UBA service from a technical perspective and adjustments can be made for any material differences. However, any exercise of judgement must be transparent, evidence-based and demonstrably consistent with the purpose of the Act.

Inclusion of naked and clothed UBA services in the benchmarking set

12. Vodafone suggests that where countries have a forward-looking cost-orientation for a regulated naked-DSL service and not for a "clothed" UBA service, then this in itself should not be considered a reason for excluding the jurisdiction from the benchmark. Rather, where the local loop service price is readily transparent, the forward-looking additional costs for UBA (minus the local loop price) in that jurisdiction should be identifiable and considered by the Commission. We agree with Vodafone that this approach is reasonable when benchmarking the UBA service and will assist in ensuring the widest benchmark set available for similar services that also meet the comparability requirement in the IPP.

Question 2: Given that both the UCLL price and the UBA price will be cost-based in future, are there any other considerations relevant to the relativity requirement?

13. Telecom's and TelstraClear's views on relativity are similar to our own. If both UCLL and UBA services are appropriately set on a cost-based approach, then presumptively those are the prices that encourage economically efficient investment between the two services. We would also highlight that in practice there will always be judgments to make in setting cost based prices. The Commission should make these judgement

calls in a transparent and evidence-based manner, and must consider whether the consequences will be consistent with the purpose of the Act.

14. Telecom and TelstraClear both highlight that differences in the UCLL and UBA benchmark datasets may distort relativity.

15. TelstraClear favours the same dataset being used in both pricing processes (to the extent jurisdictions set forward-looking cost-based prices). As we noted in our submission, a UBA benchmark set that is similar to UCLL will give some comfort that the difference between the two benchmark prices captures relative service differences, rather than jurisdictional ones. Nevertheless, this objective must be balanced against the need to ensure that the benchmark set contains countries where the cost of providing bitstream services is not significantly different to the cost of providing the UBA service in New Zealand. Given that cost drivers of the UBA service differ to some extent from UCLL service cost drivers, the benchmark sets may not necessarily be identical.

16. Vodafone's view that relativity, in this context, is about incentivising further copper unbundling does not acknowledge fibre investment and its impact on the concept of relativity. Martin Cave's more recent thinking[1 and 2] in this area, updates the view on the ladder of investment in light of significant new fibre investment. Relativity needs to be considered in the context of section 18 and specifically the impact on UFB. As explained in our submissions on the Commission's UCLL re-benchmarking draft decision, if the industry focuses on investment in copper-based services, this will impact the transition to UFB.

17. Vodafone also states that retail-minus UBA pricing ensured that UBA access prices were higher than cost. We do not agree that simply by virtue of moving from retail-minus to cost-based pricing it should be assumed that the UBA price will decrease.

Question 3: What should the Commission consider in its section 18 analysis of the price review of the UBA service?

18. Telecom submitted that section 18 is often treated as nothing more and nothing less than an instruction to price regulated services at cost, however, they noted that other factors were also relevant to best giving effect to the purpose statement when setting cost-based prices such as ensuring:

    18.1 the regime and the services being regulated work as a coherent whole;

    18.2 the regulatory environment creates the right incentives in the industry in terms of investment choices; and

[1] Martin Cave*,* Snakes and ladders: Unbundling in a next generation world, Telecommunications Policy 34 (2010) pp 80–85

[2] Martin Cave, June 2012, Regulating the price of copper in New Zealand

18.3 the fundamental soundness of the sector, including Chorus' business case.

19. We agree that section 18 is relevant when the Commission is making any judgement calls in implementing the IPP. As with relativity, the Commission should focus on the consequences of any decisions it makes when setting cost based prices. There should never be a "robotic" interpretation of the IPP – the Commission should be applying section 18 to achieve pro-competitive outcomes that serve the long-term benefit of end-users.

20. TelstraClear notes in its submission that in reaching its decision under section 30R the Commission should:

20.1 first, identify and assess all factors that are potentially relevant to its decision; and

20.2 second, it should consider how such relevant factors ought to be weighted in order the reach its conclusions.

21. TelstraClear's view is that certain relevant factors were identified in statute (section 18(2) and section 18(2A), and relativity) but that these factors were not decisive and do not have any intrinsically greater weight than other factors. Weight given to any factor must also be reasonable in the context of setting a new forward-looking cost-based price.

22. We are unsure what other factors, beyond those in the Act, TelstraClear considers are relevant. However, it is clear that section 18 requires the Commission to consider Chorus' UFB investment.

Question 4: Do you agree with the use of tele-density criteria for determining comparability?

23. We have reservations about Telecom's proposed guiding principle that the IPP method should not be over-complicated. While simplicity is desirable where possible, it should not come at the expense of an accurate result. In particular, a preference for simplicity should not prevent the Commission from making appropriate adjustments to the benchmark prices to offset cost differences between New Zealand and the countries in the benchmark set.

24. Further, we would be concerned if Telecom's preference for a simple approach was interpreted to mean that the Commission's decision-making process could be unstructured or opaque. In our view, when the Commission exercises judgement, it is important that it does so transparently, uses supporting evidence and clearly explains why its judgement is consistent with the purpose of the Act.

25. Telecom's other submissions on the use of comparability criteria – including those relating to the tele-density criterion – are largely consistent with Chorus' views. We

share the view that "care should be taken to identify comparability criteria which clearly influence the long run cost of supplying similar services to UBA".

26. Vodafone's view that the comparability criteria should not be rigorously applied are inconsistent with the requirements of the IPP. Comparability is a distinct step in the IPP. It is important that the Commission apply the criteria properly, in order to establish a robust estimate of the forward-looking cost of providing the UBA service in New Zealand.

27. Further, Vodafone's submissions may reflect a view that the additional costs of UBA are limited to electronics, which is incorrect. It overlooks significant cost components including trenching costs for backhaul, for which "the costs of network roll-out" are an important cost driver (see discussion below under: *Interpretation of the words "additional costs"*). Further, even with respect to electronics, cost-based comparability criteria remain important. As Telecom noted in its submission, the unit cost of equipment is affected by the scale of purchases, so scale-related criteria including total country population and size of the access provider are relevant. The resulting UBA price would fail to be cost-reflective if Vodafone's submissions were accepted.

28. We agree with TelstraClear that the Commission's approach to comparability in the UBA context should be analytically consistent with its approach in the UCLL review. However, it would be wrong to conclude on this basis that the Commission should use the same criteria to define the UBA benchmark set as it used to define the UCLL benchmark set. This is because UCLL and UBA are different services, which use different cost inputs, or in some cases the same cost inputs in different proportions. The cost drivers, and *ipso facto* the comparability criteria, differ between the two services.

29. As noted in our submission on the Commission's discussion paper, if the benchmark set was similar to the UCLL set, this would facilitate the Commission's consideration of the relativity issue. However, this consideration is secondary. The Commission must ensure that the benchmark set contains cost-reflective prices. If the Commission assumed that the comparability criteria for UBA must be the same as those used for UCLL, the risk is that the UBA benchmark set would contain inappropriate comparators, and the resulting UBA price would not be cost-reflective.

Question 5: Are there any other comparability criteria that could and/or should be used?

30. Telecom's submission that the Commission should examine the various cost drivers for UBA and UCLL, and determine the comparability criteria on that basis, is consistent with Chorus' views.

31. We agree with Vodafone's suggestion that fixed broadband penetration per population is more relevant that tele-density. However, the *absolute* number of broadband subscribers is likely to be an even more relevant cost driver, since it is related to the scale of purchases (and therefore unit cost), as Telecom has noted.

Question 6: If comparable countries that meet the comparability criteria are limited, what other information should the Commission gather in order to establish a price for the UBA service?

32. We note Telecom's suggestion that the Commission could survey price relativity between UCLL and UBA around the world and use the result to scale up the NZ UCLL price. We think that the suggested technique could be a useful approach.

33. We disagree with Telecom's suggestion that UCLL and UBA prices could be included in the survey *regardless of how those prices are determined*. To include non cost-based prices in the survey would introduce distortion and render the results of the survey useless even as a cross-check. If it is to be consistent with the IPP, the Commission's benchmarking exercise must be limited to forward-looking cost-based prices.

Question 7: What key cost drivers do you think need to be taken into consideration when benchmarking the UBA service variants?

34. Vodafone has suggested that the Commission look at the replacement costs of equivalent active equipment comprising the UBA service, such as DSLAMs, commercial fibre, dark fibre and other types of backhaul services. Given that under the IPP the Commission is benchmarking the cost-based UBA price we do not think it is relevant to look at the replacement costs of equipment.

35. Vodafone also states that any forward-looking price will be likely to overstate the forward-looking costs given the rate of technology development or increased obsolescence in ADSL technology. It is generally true that as technology matures and gains wider uptake the price falls. However, Vodafone's statement is too simplistic and assumes some kind of linear cost decline. This is not generally the case in the telecommunications equipment market. Purchasing 'mature' equipment at lower prices means a shorter pay-back period, as new technologies become available and demand changes e.g. 100Mb equipment could be a similar price to 10Gb (different ends of their respective lifecycles) – 1Gb, the current industry standard being much cheaper.

Question 8: Do you consider there is any other appropriate approach for determining the price of the UBA variants?

36. We have no further comments at this stage.

Question 9: Do you agree that the Commission's proposal for adopting the UCLL STD core charges for the comparable UBA core charges is appropriate for the purpose of the UBA price review?

37. Telecom's position is that UBA connections and transfer charges should reflect the nature and costs of the activity. This is consistent with our approach of recovery of service company charges. The current pass through of service company charges referred to by Telecom is just that, based on the service ordered by our customer.

38. Chorus awarded service company contracts following a robust and competitive tender process in 2009. These contracts include regular price and service code reviews.

39. Telecom's view is that it is important to properly classify the type of costs incurred. We agree that costs do need to be properly classified. But we don't think unnecessary complexity should be added to the to the current service company charges. As noted in our submission, we are only seeking to recover the cost we incur from a service company for services ordered plus a reasonable margin to cover our own associated back office costs and common costs. As customer requirements inevitably vary our service companies need to have some degree of flexibility and having a rigid classification would be counter productive to this.

40. Telecom appears concerned about bulk transfers. The UCLL STD currently provides a price for bulk transfers as Telecom refers to. It is a sundry "price on application" charge which reflects underlying costs. We believe there is a similar sundry charge in the current UBA STD that would cover bulk transfers that is also price on application. However, the focus of the Commission's discussion paper is on benchmarking of the core charges.

Other matters raised in submissions

The ability to move to an FPP under this section 30R review

41. TelstraClear submits that one reading of section 30R is that it confers on the Commission a broad power to make any changes to the UBA STD that it considers necessary, including setting the UBA service price using the relevant FPP on its own initiative if the Commission considers it appropriate.

42. Standard statutory interpretation requires section 30R to be considered in the overall context of the Act – it cannot be considered in isolation. It is clear from the other provisions in the Act that the Commission is to implement the IPP and only if an application is made by a party to the determination is the FPP relevant.[3]

Interpretation of the words "additional costs"

43. Vodafone has submitted that the "additional costs" incurred in providing the UBA service, as referred to in the applicable pricing principles, refer to "active assets" used for providing broadband services as opposed to the passive infrastructure comprising the unbundled copper local loop network. From the table on page 6 of its submission "active equipment" does not include copper or fibre.[4]

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[3] See section 42 and section and the service description of the UBA service in Schedule 1 of the Telecommunications Act and section 78 of the Telecommunications (Amendment) Act 2011.

[4] Vodafone's position on additional costs is not completely clear from its submission. However, we think it is important to clarify any potential disagreement over this issue. It appears that Vodafone may not consider *trenching costs* for backhaul to be included in the additional costs of UBA. This is an important oversight.

44. As we noted in our submission dated 24 August 2012, the additional costs of providing the UBA service include the following elements, of which electronics is only one component:

44.1 Backhaul – a share of trenching costs and the fibre feeder component which reflects the significant FTTN investment made by Chorus over the last 5 years;

44.2 Co-location – space and power;

44.3 DSLAM – shelf and linecards; and

44.4 Switches – 7450 (BUBA and EUBA over Ethernet) or LAC (BUBA over ATM and Ethernet).

Benchmarking information in Vodafone's table is out of date

45. We do not propose to respond in detail on the benchmarking put forward in submissions, as the focus of the Commission's discussion paper appears to be on the methodology to be applied in implementing the IPP. However, we note that the table on page 5 of Vodafone's submission is out of date.

46. For example, the benchmarking exercise uses blended exchange rates from the Commerce Commission's Excel Spreadsheet from 21 September 2011 (World Bank PPP rates from 2009, and 10 year average exchange rate up to 30/06/2011), when more up to date data is available.

47. In addition, the benchmarking exercise has referenced pricing decisions from previous years, while 2012 reference offers are available on most incumbents' websites.

Competition test

48. Telecom noted that the IPP is subject to a competition test so the price will only apply in future in non-competitive areas. We think there is value in understanding now how the competition assessment will be applied, including whether this would impact on pricing.