16 December

InternetNZ
PO Box 11-881
Manners Street
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Attention: David Cormack, Communications Lead

Dear David

RE: UCLL FPP REVIEW - WHY THE ISSUE OF BACKDATING CREATES MORE RISK FOR CHORUS THAN FOR ACCESS SEEKERS

1. InternetNZ has asked us to provide legal advice on the Commerce Commission's (**Commission**) questions around whether the outcome of the Final Pricing Principle review (**FPP review**) of the UCLL service should be backdated. (This advice will also generally be applicable to the issue as to whether to backdate in the context of the UBA FPP review and the Commission's section 30R review of UCLFS charges.)

2. In conclusion, we are of the view that the legal risks arising from backdating are asymmetric, with Chorus facing more risk than Access Seekers.

3. In the scenario where Chorus is found to have been overcharging, the outcome produced should not have been permissive under the statutory pricing mechanism. Therefore there is a statutory basis for remediation, and presumption toward remediation.

4. In the contrasting scenario where an FPP process "discovers" that Chorus should have been allowed to charge a higher price for the UCLL service, no party has been pricing outside the statutory parameters, so the statutory driver for remediating is much weaker. The ability of Chorus to retrospectively vary its pricing to its Access Seeker customers is therefore essentially a commercial matter governed by the prevailing General Terms between the parties.

5. In our view the exposure of Access Seekers to backdating risk in the commercial context is limited because clause 15.1 of the STD General Terms for UCLL provides that Access Seekers are not under any obligation to pay Chorus for services unless Chorus first issues an invoice. Clause 15.12 then provides that Chorus may not issue an invoice for any service that has been supplied 100 days or more in the past. This combination of clauses raises a hard stop against Chorus being able to backdate beyond 100 days on a commercial basis.

6. We also consider that there are a range of other factors that would make a backdating decision against Access Seekers highly inappropriate or practically difficult to implement (during timeframes shorter than 100 days).

Observations on regulation under the Telecommunications Act 2001

7. Regulation to date has been concerned with the setting of maximum prices that Access Providers should be allowed to charge for a service. From time to time, Access Providers choose to charge below the statutory ceilings.

8. For example, in the past Telecom has offered discounts on regulated rates in exchange for term or volume commitments. Looking forward, it is possible that Chorus may choose to offer discounts on its copper services, rather than lose customers to competing LTE or LFC networks. Equally, if the relativity between the UBA service and the UCLL service were out of balance, it would be possible to envisage Chorus offering a commercial discounted variant of UBA as an alternative to customers having disproportionate incentives to unbundle.

9. It is this characteristic of regulation whereby pricing above the statutory maximum offends the regime, whereas pricing below the statutory maximum is not only permissive, but commercially rational in certain circumstances, that is a key factor in backdating being an asymmetric consideration.

10. We note that the Commission has made a similar observation at paragraph 43 of its "Process and issues paper for determining a TSLRIC price for Chorus' unbundled copper local loop service in accordance with the Final Pricing Principle" (**FPP Process Paper**).

More detail on how backdating would apply to Chorus

11. The purpose of an FPP review is to provide a more accurate determination of what the correct regulated price should always have been set at.

12. Therefore when an FPP process is completed, one theory of administrative law as applied to the regulatory decision making process is that the original price determined under the IPP becomes "void ab initio", i.e. treated as something that never existed and replaced with the FPP price from the very outset. This is essentially the approach the Court of Appeal applied in *Telecom New Zealand Limited v Commerce Commission and TelstrarClear Limited* (25 May 2006) **CA75/05,** see paragraph 44 of the judgment.

13. In the event that Chorus is then found to have been overcharging as against the true regulated rate (as discovered via the FPP), that outcome is one that never should have occurred under the statute. Thus reparation would naturally flow from that statutory transgression (albeit a transgression made accidentally). This then becomes a basis for a presumption that where overcharging occurs, the original decision is replaced and the overcharging between the determinations is undone via some backdating mechanism.

14. It is unlikely that the commercial terms of supply between the Access Seeker and Access Provider directly interfere with reparation arising from the backdating of the FPP because the backdating discussed above is an outcome driven by the Commission's exercise of its statutory power over Chorus, rather than by the commercial terms between Access Seekers and Chorus as Access Provider. To put

the same point slightly differently, the terms and conditions accompanying the STD cannot authorise that which the statute never allowed, therefore the commercial terms would not help Chorus. (To consolidate this point, Access Seekers would be able to pursue a statutory remedy under section 1560-156R if Chorus were to be found charging above its statutory cap, over and above the commercial position in the terms agreed between the parties.)

15. To recap, we believe that the Court of Appeal Judgment stands for a proposition that the original determination (the Initial Pricing Principle (**IPP**) determination) can simply be supplanted with the FPP determination from the date of the IPP determination, and the Commission can order remediation of any overcharging by the Access Provider that occurred between the IPP and FPP determinations on the basis that Chorus would have been acting outside of its true regulated envelope.

16. Although, we believe that there is a strong presumption that the Commission require Chorus to return the product of any overcharging for the reasons given above, our view is that the Commission could either soften the approach or limit the scope of backdating if there were compelling reasons (taking into account the section 18 purpose statement of the Commerce Act 1986) to do so.

17. Indeed it would be a very strange outcome for the Commission to have the freedom to refrain from fully applying an IPP for a regulated service from the outset (which is what occurs whenever the Commission uses a glide path instead of applying a full IPP from day 1) and yet no power to do anything other than fully backdate after an FPP.

18. In further support of our view, we also note that the enforcement provisions that apply where an Access Provider breaches its pricing obligations (sections 156O to 156R of the Act) are intentionally not drafted as offense provisions and also provide the Commission, parties and the Courts with discretion as to the remedies that could be pursued or awarded. In our view, if the enforcement provisions for an overt breach of price cap include a thread of discretion and commercial pragmatism in terms of response, then it also follows that discretion and pragmatism should be present where the Commission has to respond to a scenario of "innocent" overcharging by the Access Provider.

19. We note that the Commission also observes at Paragraph 41 of its FPP Process Paper that the High Court has found that the Commission had discretion to set an alternate start date for the revised pricing to apply from if it wished to, which is consistent with our views as to the Commission's discretion. (However, this is ultimately only obiter dicter at this stage, rather than a binding decision.)

20. When considering whether there is a case to soften a full force approach to backdating, the Commission would have to find policy reasons, consistent with the section 18 purpose statement, sufficient to overcome the following points:

    (a) The outcome of the FPP review would reflect a more efficient price than the original IPP price, therefore the assumption would be that the more efficient price would prevail. (We note that this reasoning is embedded in the Court of Appeal's decision.)

(b) Our view is that there will be a general assumption that Access Providers would be capable of setting contingencies aside in order to be able to manage a backdating outcome. This is for two reasons:

(i) Access Providers would have the best cost information available to understand the true costs of their service and thus anticipate outcomes of a review.

(ii) Further, all they would normally have to do to accrue a contingency fund is to not dissipate the excess returns that had accrued since the original determination was made in order to meet a backdate obligation. We note that the Court of Appeal Judgment observes at paragraph 29:

…large corporations employ sophisticated financial mechanisms for reserving against such adverse contingencies… [Paragraph 29]

(c) In this instance, it is relevant that Chorus is driving the FPP review and is creating further uncertainty for the sector as a whole. Chorus should therefore only be taking this review if it is sure of the merits of its case. Therefore if it transpires that the review that Chorus itself is driving ends up cutting against Chorus itself, it is appropriate that it be exposed to the greatest fallout.

(d) From the time of Separation there has been a three year transition period before UCLL and UBA pricing changes were fully implemented. This is significant for three reasons:

(i) We know for a fact that Chorus will have been overall earning excess returns over the three year period, which better places it to meet a backdating outcome;

(ii) The Act is relatively specific in terms of seeking the new pricing regime to take effect as of three years from Separation Day (and the opportunity for alternate pricing was over the proceeding three years), that start date is cut across if backdating is not applied; and

(iii) We are still a year away from the most significant pricing changes to take effect , therefore Chorus is particularly on notice that it needs to set contingencies aside.

(e) The period for which the determination stands will be relevant. In the Court of Appeal decision there would have been little if any ability to pass on the fruits of the pricing correction if backdating had not been applied, owing to the limitation of the period during which the pricing determination stood. In this case, there would have to be a sufficient forward looking timeframe for the FPP outcome to stand for the review to be meaningful if backdating is not applied.

21. Overall, our view is that there would be a strong presumption that backdating would apply if the decision went against Chorus, but there is discretion to consider whether

there are arguments that are compelling enough to soften the approach, notwithstanding the good policy reasons not to soften the approach.

More detail on why backdating is problematic as against Access Seekers

22. The Commission's basis for requiring Chorus to remediate in the event that an FPP discovers that Chorus has been overcharging turns on three things that do not apply to Access Seekers when the situation is reversed:

    (a) As noted above, no one has breached the statutory price cap for services at any point in an under charge scenario so the statutory basis for remediation is missing and no statutory remedies would be available under sections 1560 to 156R. Instead, there has just been a mistake within the statutory envelope as to how far Chorus' pricing can go. The ability to go back on pricing in that scenario will be governed by the commercial arrangements between the parties, not by statutory mechanisms.

    (b) The Commission does not have the same relationship with Access Seekers as it does with Access Providers. More specifically, the Commission has a mandate to direct the affairs of an Access Provider because the Commission directly regulates the services that it provides. Further the Commission only acquires the mandate to regulate conduct of an Access Provider because its affairs are found (after a lengthy process) to be insufficiently constrained by competitive forces. In contrast, Access Seekers, are not directly regulated by the Commission, their conduct is generally constrained by the market instead and through the Access Provider's General Terms. Access Seekers are normally the first instance beneficiaries of regulation. Therefore it would be very unusual, if not problematic for the Commission to exert regulatory force over these unregulated businesses. It is clear that the commercial terms are there to govern the exposure of Access Seekers, rather than direct regulatory powers.

    (c) As noted above, there will be an initial assumption that Access Providers would be well placed to set aside contingencies to deal with backdating because they have good cost information and will be operating within markets that do not quickly force them to surrender benefits they get from being able to overcharge to consumers. This situation would be reversed for Access Seekers. They do not have the same level of cost information and at some point in time it is likely that they will be forced to pass on the benefits of any undercharging in order to retain market share. (There may be some time lag between large Access Seekers passing on benefits. However small Access Seekers will likely quickly pass on benefits to win share and the larger providers will be forced to follow suit when the loss of share from their higher pricing outweighs the value of hanging on to any benefits of undercharging. We are seeing this dynamic play out exactly with Orcon and Call Plus already promising to pass through benefits of the Commission's recent UBA determination, while Vodafone and Telecom are not promising to immediately pass benefits through, but will no doubt be forced to respond when Orcon and Call Plus' lower pricing begins to take its toll on them.)

23. If for the reasons given above, ifit is accepted that the exposure of Access Seekers to backdating is driven by the commercial terms of supply, rather than by statutory power, it then becomes clear that it is highly problematic to apply backdating against Access Seekers.

24. Clause 15 of the General Terms of the UCLL STD provides the following:

"*Chorus will invoice the Access Seeker for all Charges*" [clause 15.1]; and

"*…no Charge may be invoiced 100 days or more after the date the UCLL Service to which the Charge relates was supplied"* [clause 15.12]

25. These terms essentially create a hard stop on Chorus from being able to reach back more than 100 days for services that have already been supplied.

26. Even for services that occurred within 100 days there is no straight forward path to recovery:

(a) Where Chorus has supplied services, issued an invoice for services and received payment for services it would be a commercially hard argument for Chorus to prove that the payment supplied did not constitute full and final settlement. This is especially as the General Terms do not expressly provide a basis on which Chorus can change pricing after the event.

(b) It is likely that Access Seekers would have made choices as to whether to take services from Chorus based on what the charges were purported to be, therefore allowing Chorus to then revisit those charges would raise issues under the Fair Trading Act 1986.

(c) Finally, we note for completeness that the General Terms do not expressly provide any avenue for Chorus to directly dispute its own invoices. Under the General Terms it only expressly contemplates an Access Seeker initiating an invoice dispute. This raises an interesting question as to what Chorus can actually do in the event that it finds anything in its own billing that it wishes to revisit.

27. Overall, setting aside any policy issues, the Commission backdating pricing against the interests of Access Seekers seems deeply problematic at a purely practical level, because the Access Seekers are not directly within the reach of the Commission, and because no one would have breached the statute if Chorus just mistakenly was charging less than it could have done for services.

28. However, when policy considerations are factored in, it is clear that there are also strong policy reasons in support of this asymmetry of risk to backdating as between Access Seekers and Access Providers:

(a) For the reasons given above, in the normal course of events, Access Providers are much better placed to put contingencies aside because they have better cost information and their businesses are not as susceptible to competitive pressures; and

(b) It is much easier in general for an Access Provider to adjust its prices downward to meet the efficient level in a market, than it is for Access Seekers to raise prices for their end users in a competitive market, if the input price they face goes up. The asymmetric backdating risk therefore simply reflects that difference.

(c) Finally, it is worth noting that the exposure of Access Seekers will have been limited under the General Terms of the STD for good reason. If the Commission were to backdate beyond the limitations of the General Terms, it would be cutting across an agreed basis of engagement that the Commission itself set up. This would be an inappropriate outcome.

Yours faithfully

LOWNDES ASSOCIATES

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