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Memorandum of advice

To	Tom Thursby, Lead Counsel – Competition and Regulatory Vodafone New Zealand
From	Malcolm Webb and Edward Willis
Date	29 April 2014
Subject	**UCLL and UBA Price Review – Selection of an appropriate MEA**

Introduction

1 The Commerce Commission is currently undertaking a pricing review determination in respect of the UCLL and UBA designated access services under the Telecommunications Act 2001 (the **Act**).[1] The Act mandates that the price for each of the services is to be determined by reference to a final pricing principle based on "TSLRIC" modelling.[2] The orthodox application of TSLRIC modelling is generally understood to require the selection of a modern equivalent asset (**MEA**) that could be used to supply the regulated service efficiently.

2 You have asked us for our opinion of the legal considerations that apply in respect of the Commission's selection of an appropriate MEA. In particular, you have asked us for our opinion on the reasoning set out in two legal opinions that have been made available to the Commission as part of its consultation process:

- a preliminary opinion provided by James Every-Palmer dated 12 March 2014, commissioned by the Commission; and
- an opinion provided by Chapman Tripp dated 11 April 2014, commissioned by Chorus.

3 We understand that our views may be put to the Commission as part of the formal consultation process.

Summary

4 In our view, there are a number of legal considerations that the Commission must take into account in its selection of an appropriate MEA. However, provided the Commission acts consistently with administrative law standards of reasonableness and fairness, there is very little constraining the Commission's discretion to determine the substantive outcome of the selection of an appropriate MEA.

1 The pricing review determination process is governed by the Telecommunications Act 2001, ss 42-52.

2 Telecommunications Act 2001, sch 1.

5 In this respect, we broadly prefer the analysis of Dr Every-Palmer over that of Chapman Tripp. In our view, Dr Every-Palmer's opinion reflects a more accurate and orthodox interpretation of the requirements derived from the legal framework. However, our reasoning appears to be based on a different set of considerations than those relied on by Dr Every-Palmer.

6 In particular, we do not consider that much turns on the interpretation of "the service" as used in the statutory definition of TSLRIC. The ability to "abstract" away from in-use technology for the purposes of modelling an efficient price is inherent in the TSLRIC concept and is not contingent on the precise statutory language employed in this context.

7 Importantly, this view does not compel a conclusion that "the service" is a pre-defined concept that requires a particular outcome in the exercise of the Commission's discretion in selecting an appropriate MEA. The process of abstracting away from the technology used to deliver the current services (however defined) that is required by the TSLRIC concept is a regulatory function where the exercise of discretion is wholly appropriate. In other words, regulatory discretion is an implicit and necessary part of the orthodox application of a TSLRIC pricing methodology.

8 In the absence of an express statutory intention or necessary implication, it is unlikely that the Commission's usual discretion will be restricted. For example, while the Commission may be minded to consider factors such as the extent to which the functionality provided by existing, in-use technology is relevant, that is a matter of judgement to be exercised in light of the relevant circumstances rather than a statutory (or other legal) requirement. Our view is the same regardless of whether TSRLIC is applied in respect of the total service, as in the case of UCLL, or only in respect of "additional costs", as in the case of UBA.

TSLRIC modelling inherently involves Commission discretion

9 The applicable final pricing principles for the UCLL and UBA services require the application of TSLRIC modelling in respect of the total service or the additional costs of the service respectively.

10 TSLRIC is defined in the Act in the following terms:

> ***TSLRIC**, in relation to a telecommunications service,—*
>
> *(a) means the forward-looking costs over the long run of the total quantity of the facilities and functions that are directly attributable to, or reasonably identified as incremental to, the service, taking into account the service provider's provision of other telecommunication services; and*
>
> *(b) includes a reasonable allocation of forward-looking common costs.*

11 An orthodox understanding of TSLRIC modelling, consistent with this statutory definition, is that the modelling exercise attempts to determine efficient, forward-looking costs of service supply. The usual approach is to posit a hypothetical network using equivalent modern

technology to supply the relevant service. The hypothetical network may take on elements of the existing network, requiring a number of judgements to be made. However, considering a hypothetical network ensures that the cost estimate derived from the model is:

- forward looking, because the model is not constrained by historical technology choices of the incumbent service provider; and
- efficient, because (to the extent deemed appropriate in the circumstances) the network is optimised.

12 The Act mandates a particular approach to cost estimation. If there had been an intention that cost estimation would necessarily proceed with reference to existing service supply, we would have expected an alternative final pricing principle to have been provided for. By mandating a TSLRIC approach to cost estimation, the legislation employs a technical concept specific to the regulation of telecommunications services. We draw two broad conclusions from this:

- As the expert regulator, the Commission is best placed to exercise judgement as to the appropriate application of TSLRIC in all the circumstances.
- If there was an intention to restrict the Commission's usual discretion in such matters, this would likely have been made express in either the definition of TSLRIC (if the restrictions were intended to apply generally) or in the detailed service descriptions (including the statement of the final pricing principle) that are set out in Schedule 1 to the Act.

13 Applying TSLRIC modelling is a standard regulatory task involving the usual discretion and judgement that is associated with the discharge of the functions of an independent economic regulator. If this usual scope for discretion was intended to be limited in some way, we would expect unambiguous statutory language setting out those restrictions. We have reviewed the Act, but have not identified any restriction that would apply on the basis of express statutory language or necessary implication.[3]

MEA selection not constrained by statutory framework

14 The selection of an appropriate MEA as part of TSLRIC modelling is, in our view, one of the matters in respect of which the Commission must exercise its discretion in order to properly perform its functions under the Act. On an orthodox approach to statutory interpretation, there is nothing to indicate that the substance of the Commission's selection of an MEA is constrained in any particular way by the statutory framework within which the Commission is required to operate.

3 For completeness, we note that the Commission is required as a matter of statute to best give effect to s 18 of the Act whenever it exercises a statutory discretion: Telecommunications Act 2001, s 19. Whether the selection of a particular MEA best satisfies s 18 cannot be assumed *ex ante*, and must be demonstrated as the result of full analysis. We have not undertaken analysis to determine whether s 18 compels the adoption of a particular MEA in this case.

15 In this respect, we broadly agree with the reasoning set out in paragraphs 16(a)-(c) of Dr Every-Palmer's opinion. That reasoning emphasises the nature of orthodox TSLRIC modelling and the regulatory discretion involved in a manner that in consistent with our analysis above. We consider that this understanding of the approach to be employed in respect of TSLRIC modelling supports the conclusion reached in Dr Every-Palmer's opinion that "the Courts would be likely to find that Parliament intended to leave decisions about the extent of abstraction in ... the degree of optimisation of the MEA to the Commission".[4]

16 Of course, there are a number of legal considerations that the Commission must take into account in its selection of an appropriate MEA. However, provided the Commission acts consistently with administrative law standards of reasonableness and fairness, there is very little constraining the Commission's discretion in a way that would dictate the substantive outcome of the selection of an appropriate MEA as a matter of law.

17 Dr Every-Palmer's opinion lists a number of factors that would reasonably be expected to bear on the Commission's exercise of discretion in paragraph 20. We agree that each of these factors is likely to amount to a relevant consideration in the administrative law sense. To that extent, the Commission is likely to be required to demonstrate that it has turned its mind to these factors. The weight to be given to each of these factors in the context of selecting an appropriate MEA is a matter of judgement for the Commission, acting fairly and reasonably. None go as far as to require a particular substantive outcome.

18 In addition, we agree with Dr Every-Palmer's view that the TSO is of limited relevance to determining the appropriate MEA for the reasons set out in paragraph 39 of that opinion.

19 Our view is the same in respect of the application of TSLRIC under the final pricing principle for both the UCLL and UBA regulated services. In particular, we do not consider that the reference to "additional costs" in the final pricing principle for the UBA regulated service gives rise to a specific statutory requirement to consider the actual costs of service supply based on current, in-use technology. In our view, the reference to "additional costs" goes to the question of scope, rather than the question of process. Specifically, it determines the elements of the service in respect of which the Commission is required to determine a cost estimate. The relevant point is that each cost estimation process requires application of the TSLRIC concept, regardless of whether TSLRIC applies in respect of a stand-alone layer 1 service (UCLL) or the additional components of a layer 2 service (UBA), or both.[5]

20 We appreciate that there may be a perception of analytical complexity in determining "additional costs" as between UCLL and UBA if the network assets assumed for the purposes of cost modelling are not the current, in-use copper assets. To the extent that this does amount to a difficulty in practice, we note that it does not displace the clear statutory requirement to apply TSLRIC modelling and the forward-looking, efficient network assumptions that concept necessarily implies. Provided it acts in accordance with this

4 James Every-Palmer "FPP determination: Issues re service description and the modern equivalent asset" Opinion to Commerce Commission (12 March 2014) at paragraph [18].

5 In principle, the regulatory discretion afforded by the application of TSLRIC in this context would extend to the issue of whether the same MEA ought to be applied consistently across the UCLL and UBA services.

statutory requirement, the question of how to best manage any practical difficulties is ultimately a matter for the Commission.

Misplaced emphasis on "service"

21 Both the Every-Palmer opinion and the Chapman Tripp opinion advance arguments that the scope of the Commission's discretion with respect to the application of the TSLRIC process is dictated by the correct interpretation of the word "service" in the statutory definition of TSLRIC. In line with our analysis above, we consider that this emphasis on the use of the word "service" is misplaced and does not bear directly on the issue of the selection of an MEA.

22 We agree with the Chapman Tripp opinion that "the service" is defined by the service description in the Act as applied by the Commission's standard terms determination. Further, we agree that it is not possible for the MEA or the TSLRIC modelling process to redefine the service. In this respect, therefore, we appear to disagree with Dr Every-Palmer's opinion that the best interpretation of "the service" is "a more abstract description of the regulated service that is technology neutral and captures its core functionality".[6]

23 However, we are of the view that not much turns on this interpretation. Our analysis above lends support to the conclusion that the Commission has discretion to select an appropriate MEA based on the nature of TSLRIC modelling, which necessarily requires some degree of abstraction and consideration of hypothetical alternatives, rather than the legal definition of "the service". In fact, if the Commission considered itself constrained by a particular interpretation of "the service" so that it was unable to apply TSLRIC modelling in the usual way, in our view this risks misapplying the relevant final pricing principle.

24 In this sense, while we agree with what we apprehend the analysis in the Every-Palmer opinion to be, we find it more helpful to express the analysis in slightly different terms. The MEA must capture the relevant functionality of the service in a technology neutral sense, but there is no case to be made for "abstracting" away from the service as defined in statute. To the extent that any abstraction is required, this is not a function of the way "the service" is defined, but the approach required by application of the TSLRIC modelling in accordance with the final pricing principle.

25 The reasoning offered in support of the abstracted definition of service in paragraphs 16(a)-(h) of Dr Every-Palmer's opinion based on "contextual and purposive indicators" relates better to the understanding of the application of the TSLRIC process, rather than the definition of "the service". The focus on "the service" as apparently dispositive of the issue is, in our view, misplaced.

6 James Every-Palmer "FPP determination: Issues re service description and the modern equivalent asset" Opinion to Commerce Commission (12 March 2014) at paragraph [13].

Chapman Tripp specific propositions regarding functionality

26 The Chapman Tripp opinion advances a number of specific propositions concerning the legal framework within which the Commission is required to operate. For current purposes, we highlight two of those propositions, which we apprehend are intended to demonstrate that the Commission's selection of an appropriate MEA is constrained by reference to the existing, in-use technology as a matter of statutory interpretation:

> *(J) The Act reflects a legislative intent or expectation that, at the time of a [price review determination] access seekers would already be utilising the designated access services as defined in the Schedule 1 service description and the STD, and have reflected and relied on aspects of the functionality of that (described) service in their own (retail) services.*
>
> *(K) Conversely, while there may well be some abstraction of service functionality involved in a TSLRIC analysis, it cannot have been a legislative intent that the service to be the subject of the [price review determination] exercise would be one which (in the relevant hypothesis) was inconsistent with, or assumed away, such functionality.*

27 We apprehend that the argument being advanced is that because "the service" is defined by the service description in the Act as applied by the Commission's standard terms determination, there is a statutory requirement that the hypothetical MEA replicate the total suite of functionality of the current, in-use technology.

28 On the basis of our analysis above, we cannot accept these propositions in the terms on which they are advanced, nor the broader conclusion that a statutory requirement follows if a particular definition of "the service" is adopted. The task envisaged by TSLRIC modelling abstracts away from the currently provided technology while preserving that technology's relevant functionality. That relevant functionality is not defined in the Act. There is nothing in the Chapman Tripp analysis that suggests determining the scope of that relevant functionality is not an exercise of discretion on the part of the Commission as part of the standard TSLRIC process, having regard to the (non-exhaustive) relevant considerations identified in Dr Every-Palmer's opinion. In this respect, the approach the Commission has proposed in its relevant consultation documents to date appear to us to be orthodox and consistent with the statutory framework.

29 Further, we note that a consequence of the analysis in the Chapman Tripp opinion is that "the service" is in effect defined with reference to Chorus' historical technology choices. There is no indication in the statutory framework that the service description in the Act as applied by the Commission's standard terms determination is intended to be redefined for the purposes of the application of the final pricing principle in this way. This consequence is also inconsistent with the view expressed in the Chapman Tripp opinion that "the service" is

defined by the service description in the Act as applied by the Commission's standard terms determination.[7]

30 The only situation where the broader legal framework requires a specific outcome, in our view, would be where the factual circumstances elevate the existing particular functionality of the current in-use technology to be a mandatory relevant consideration in respect of which the Commission is required to place heavy weight. However, this argument is not obvious, and requires evidence to be presented to the Commission to support any claim that some element of the existing functionality warrants such serious weight. While we have not reviewed the entire factual background to this matter, our initial view is that the prevailing market context, where a transition from copper to fibre-based services is anticipated in the medium term, raises the evidential burden on those parties seeking to have significant weight placed on existing copper functionality to a level that may be very difficult to satisfy in practice.

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7 Chapman Tripp "Unbundled Copper Local Loop (UCLL) and Unbundled Bitstream (UBA) Access Services – Pricing Review Determination (PRDs) – Legal Framework" (11 April 2014) at paragraph [5.4].