

# **Final report on whether Spark's Resale Services should be omitted from Schedule 1 of the Telecommunications Act 2001**

Final report to the Minister for Communications on our recommendations under clause 1(5) of Part 1 of Schedule 3 of the Telecommunications Act 2001

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## Executive summary

### Purpose

- X1 This final report sets out and explains our recommendations to the Minister on whether Spark's three resale voice services (Resale Services) should be omitted from Schedule 1 of the Telecommunications Act 2001 (the Act) and whether the Minister's decision should be deferred.

### Our recommendations

- X2 We recommend that the Minister:
- X2.1 does not omit Resale Services from Schedule 1 of the Act at this time; and
  - X2.2 defers the decision for two years from the date of this report.
- X3 The deferral would allow us to revisit the possibility of omitting the service sooner than the next five yearly review.

### Why we have undertaken this investigation

- X4 This investigation follows our review under clause 1(3) of Part 1 of Schedule 3 as to whether there were reasonable grounds for commencing an investigation into whether any of the Resale Services should be omitted from Schedule 1 under section 66(b) (Schedule 1 Review).<sup>1</sup> In that review, we concluded that there were reasonable grounds.<sup>2</sup>

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<sup>1</sup> We are required to review each service in Schedule 1 at intervals of not more than five years under clause 1(3) of Schedule 3 of the Act.

<sup>2</sup> Commerce Commission "Commerce Commission's Final Decision on the Review of Designated and Specified Services under Schedule 1 of the Telecommunications Act 2001" 30 June 2016.

## Overview of the regulation of Resale Services

- X5 Resale Services provide retail service providers (RSPs) with the ability to rebrand and on-sell a complete voice service to end users. Schedule 1 of the Act contains the following Resale Services:
- X5.1 local access and calling services offered by means of a fixed telecommunications network;
  - X5.2 retail services offered by means of a fixed telecommunications network; and
  - X5.3 retail services offered by means of a fixed telecommunications network as part of a bundle.
- X6 RSPs currently buy Spark's wholesale voice services by commercial agreement but the inclusion of the services in Schedule 1 of the Act provides a regulatory backstop. We could compel Spark to supply these services--at a margin less than its own retail price--if commercial arrangements fail in a way that threatened competition.

## Reasons for our recommendations

- X7 We would recommend omitting the Resale Services now if there were fully effective competitive alternatives. Our investigation has provided evidence that Spark is facing increasingly effective competition to its Resale Services. There are a range of wholesale alternatives that allow RSPs to supply voice-only services as well as bundles of voice and broadband. However, our investigation has also concluded that the ability of RSPs to quickly switch to alternatives is constrained. This may allow Spark to exercise market power should the Resale Services be removed from Schedule 1 at this time. The use of such market power might also disrupt competition to provide ultrafast broadband (UFB) services as RSPs' attention is diverted to provisioning analogue voice services.
- X8 In balancing the relevant costs and benefits, our final view is that:
- X8.1 there is likely to be little or no benefit from immediate removal of the Resale Services from Schedule 1; and
  - X8.2 any benefit is likely to be outweighed by the potential costs associated with any exercise of market power by Spark especially while RSPs are migrating customers to alternatives including fibre.

- X9 We expect the constraint on switching to diminish as RSPs enhance their capability to utilise wholesale alternatives, and, in particular, as Chorus moves to greater automation in the provisioning process for the Baseband IP services (Baseband IP and Baseband IP Extended). At the same time we expect incentives on Spark to agree commercial commitments to better meet RSPs' requirements for security of supply will increase, reducing RSPs' reliance on the regulatory backstop.
- X10 In our draft report, our preliminary view was to recommend to the Minister that:
- X10.1 Resale Services should be omitted from Schedule 1; and
  - X10.2 Resale Services should be omitted one year after the date of the relevant Order in Council (a transition period).
- X11 Throughout our consultation process (which included submissions, cross-submissions, and a conference), parties have emphasised that switching from Resale Services to other wholesale inputs that can be used to provide voice services needs time and appropriate planning. This is because a sudden or forced migration could compromise customers' experience and competition.
- X12 Following consideration of issues raised during consultation, our view is that the presence of Resale Services in Schedule 1 gives RSPs certainty over their access terms. If Spark were to exercise market power (such as by withdrawing the services), a process could be initiated for a standard terms determination (STD) to compel continued provision of the services. This threat of regulation has ensured that Spark has supplied Resale Services and facilitated negotiation of supply on:
- X12.1 a commercial basis (using a retail-minus pricing approach); and
  - X12.2 terms that have avoided the need for regulatory intervention since the expiry of the initial resale determinations.

## Chapter 1 Introduction

1. This final report sets out and explains our recommendations to the Minister on whether Spark's three resale voice services (Resale Services) should be omitted from Schedule 1 of the Telecommunications Act 2001 (the Act) and whether the Minister's decision should be deferred.

### Why we have undertaken this investigation

2. This investigation follows our review under clause 1(3) of Part 1 of Schedule 3 as to whether there were reasonable grounds for commencing an investigation into whether any of the Resale Services should be omitted from Schedule 1 under section 66(b) (Schedule 1 Review).<sup>3</sup>
3. In that review, we concluded that there were reasonable grounds to commence an investigation under clause 1(5) of Part 1 of Schedule 3 into whether Spark's Resale Services should be omitted from Schedule 1.<sup>4</sup>
4. Section 66(b) empowers the Governor General, by way of Order in Council made on recommendation of the Minister, to amend Part 2 or Part 3 of Schedule 1 by omitting a telecommunication service from the Part. Section 68 requires that the Minister may not make a recommendation to the Governor General under section 66 unless the Minister accepts our recommendation that the proposed alteration be made. Our recommendation is required to be made in accordance with the procedure in Part 2 to Schedule 3.

### Statutory requirements for this investigation

5. Clause 1(5) of Schedule 3 requires that we must commence the investigation no later than 15 working days after making the reasonable grounds decision. The reasonable grounds decision was made on 30 June 2016. We gave public notice of that decision and started this investigation on 14 July 2016.<sup>5</sup>

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<sup>3</sup> We are required to review each service in Schedule 1 at intervals of not more than five years under clause 1(3) of Schedule 3 of the Act. The three Resale Services are designated services under Subpart 1 of Part 2 of Schedule 1.

<sup>4</sup> Commerce Commission "Commerce Commission's Final Decision on the Review of Designated and Specified Services under Schedule 1 of the Telecommunications Act 2001" 05 July 2016.

<sup>5</sup> Commerce Commission, "Notification of Commerce Commission's decision to commence investigation into potential omission of certain services of Spark New Zealand Limited from Schedule 1 to the Telecommunications Act 2001", 14 July 2016.

6. We issued the draft report required by clause 2 of Schedule 3 on 23 September 2016.<sup>6</sup> We invited submissions within 20 working days of the publication of the draft report. We received submissions and cross-submissions on that draft report during October 2016.
7. We held the conference required by clause 3 of Schedule 3 on 1 November 2016.<sup>7</sup>
8. Clause 4(3)(a) of Schedule 3 requires us to provide details of the "proposed alteration" in our final report. The proposed alteration that we have considered in this final report is to omit the Resale Services from Schedule 1.
9. Clause 4(3)(b) of Schedule 3 require us to make two recommendations in our final report:
  - 9.1 whether the proposed alteration should be made (ie, whether the Resale Services should be omitted from Schedule 1); and
  - 9.2 whether the Minister's decision on the proposed alteration should be deferred (ie, if the Minister's decision on whether to omit the Resale Services from Schedule 1 should be deferred).
10. We are required by section 19 to make recommendations that we consider best give, or are likely to best give, effect to the purpose set out in section 18. We considered all submissions, and information and opinions expressed at the conference (as required by clause 4(2) of Schedule 3). Our conclusions and the recommendations in this report are based on the information, opinions and evidence provided in submissions and at the conference, and the information and evidence we obtained under section 98 of the Commerce Act.
11. Clause 4(1) of Schedule 3 requires us to make reasonable efforts to prepare the final report no later than 120 working days after the date of giving public notice of the commencement of the investigation. Our report has been completed within this timeframe.
12. Following our recommendations, the Minister may request us to clarify any aspect of the final report and provide any additional information that is necessary to understand the nature and implications of our recommendations. The Minister may accept or reject any of our recommendations, or require us to revisit any of them.

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<sup>6</sup> Commerce Commission "Draft report on whether Spark's Resale Voice Services should be omitted from Schedule 1 of Telecommunications Act 2001 - Draft report under clause 2 of Part 1 of Schedule 3 of the Telecommunications Act 2001", 23 September 2016.

<sup>7</sup> The conference transcript is available on our website.

## Overview of the regulation of Resale Services

13. Resale Services allow access seekers to purchase and resell a range of complete retail voice services from Spark. This provides access seekers with the ability to include fixed-line voice services as part of their overall package of services, enabling them to more effectively compete at the retail level.
14. The Resale Services were designed to lower barriers to entry at the retail level. Competitors can enter and supply retail end users with voice services without having to invest in their own infrastructure and voice equipment. Entry may occur on a standalone basis or as part of a bundle with other services (typically broadband services). All of the Resale Services are provided by Spark over Chorus' copper network.
15. The three Resale Services listed in Schedule 1 are:
  - 15.1 Local access and calling service offered by means of fixed telecommunications network (Local access and calling service);
  - 15.2 Retail services offered by means of a fixed telecommunications network (Retail Services); and
  - 15.3 Retail services offered by means of a fixed telecommunications network as part of a bundle of retail services (Part of Bundles).
16. The description of the Resale Services was amended in 2011 to include descriptions that applied from 1 December 2014. Since then, Telecom changed its name to Spark.

### Local access and calling service

17. This service is described in Schedule 1 as follows:<sup>8</sup>

A local access and calling service offered by Telecom to end-users by means of a fixed telecommunications network in the following markets: (a) all markets in which Telecom faces limited, or is likely to face lessened, competition for the service: (b) all, some, or no markets in which Telecom does not face limited, or is not likely to face lessened, competition for the service as determined by the Commission.

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<sup>8</sup> This service covers the line rental and local calls.

## Retail Services

18. This service is described in Schedule 1 as follows:<sup>9</sup>

A retail service that satisfies both of the following:

(a) either of the following: (i) a non-price-capped retail service (and its associated functions) supplying an access and calling service in a different form to a local access and calling service (and including, for the avoidance of doubt, a service supplying ISDN digital access, or Centrex-based access or facsimile); or (ii) a value-added non-price-capped retail service that is supplied in conjunction with a service described in subparagraph (i) above or a local access and calling service; and

(b) a retail service offered by Telecom to end-users by means of a fixed telecommunications network in the following markets: (i) all markets in which Telecom faces limited, or is likely to face lessened, competition for that service: (ii) all, some, or no markets in which Telecom does not face limited, or is not likely to face lessened, competition for that service as determined by the Commission.

## Part of Bundles

19. This service is described in Schedule 1 as follows:

A retail service that—

(a) is, or has previously been, offered separately by Telecom to end-users by means of a fixed telecommunications network; and

(b) is offered by Telecom to end-users as part of a bundle of retail services— (i) in markets in which Telecom faces limited, or is likely to face lessened, competition for that service; and (ii) if the effect of the bundled price is likely to significantly reduce the ability of an efficient rival to contest the market".

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<sup>9</sup> This service includes value added services like call waiting and call minder.

### **Focus of our analysis**

20. Our analysis is focused on the local access and calling service for the following reasons:
- 20.1 Retail Services offered by means of a fixed telecommunications network and Part of Bundles services do not exist in isolation from the local access and calling services offered by Spark to end users.
  - 20.2 Regulation of Retail Services may be required in case there is insufficient competition in the supply of the local access service, as other technologies may not be compatible with Spark's local access and calling services. Conversely, if there is competition (or regulated alternatives) in terms of local access, then there is unlikely to be a case for retaining regulation of this service, as similar retail services could be provided independently from Spark.
  - 20.3 The Part of Bundles is a service that allows access seekers to 'un-pick' and resell parts of a Spark bundle of retail services. Retail bundles typically include voice and broadband services. The need for a regulated service which provides access to part of bundles depends on whether the wholesale inputs required for providing competitive bundles of voice and broadband services are available on either competitive or regulated terms. The wholesale inputs required to offer the broadband part of a bundle can be purchased directly from Chorus. Therefore, if there is competition (or regulated alternatives) in terms of local access, then there is unlikely to be a case for retaining regulation of this service, as similar services could be provided independently from Spark. Conversely, if there is insufficient competition (or regulated alternatives) in terms of local access, there may be a case to retain the Part of Bundles service in Schedule 1.

### **'Backstop Regulation'**

21. The inclusion of a Resale Service as a designated service in Schedule 1 means that:
- 21.1 an access seeker can apply to us for a determination under section 27; or
  - 21.2 we can, as an alternative, make a standard terms determination (STD) in accordance with Subpart 2A of Part 2.
22. These processes mean that, provided the applicable conditions for a service are met, an access seeker can get access to a regulated alternative without undue delay, should the commercial negotiations fall down. The threat of regulation can often provide a sufficient incentive for parties to reach a commercial solution. We refer to this potential for regulated access terms as 'Backstop Regulation'.

23. There is no determination in place for any of the Resale Services that sets the price and non-price terms on which the service must be supplied.<sup>10</sup> Accordingly, there is no obligation to supply and there are no regulated access terms in place for Resale Services. Instead, Resale Services are currently supplied on a commercial basis (using a retail-minus pricing approach) with the terms of supply being subject to commercial negotiations between the parties.
24. If the local access and calling service were to be the subject of a determination or STD, an initial pricing principle would apply for price-capped residential local access and calling services. This would be Spark's standard price for its local residential calling service (as capped by the TSO deed for Local Residential Telephone Service) minus 2%.
25. An initial pricing principle for non-price-capped local access and calling services (such as supplied to business end users) would also apply under a determination or STD. This would be the retail price less a benchmarked discount that reflects the retail costs saved when supplying the service on a wholesale basis.

### **Structure of this report**

26. This report is structured as follows:
  - 26.1 Chapter 2 provides the framework we have used to evaluate whether the Resale Services should be omitted from Schedule 1 and whether the Minister's decision should be deferred;
  - 26.2 Chapter 3 details our assessment of the competitive constraints faced by Spark in the supply of Resale Services;
  - 26.3 Chapter 4 explains our assessment of the benefits and costs of omitting the Resale Services from Schedule 1; and
  - 26.4 Chapter 5 provides our final recommendations to the Minister.
27. Attachment A provides further detail about the process we followed and information we gathered in this investigation.

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<sup>10</sup> A determination is either a determination under Subpart 2 of Part 2 or a standard terms determination under Subpart 2A of the Act.

## Chapter 2 How we made our recommendations

28. This chapter explains the framework used for reaching our recommendations regarding whether the Resale Services should be omitted from Schedule 1, and whether the Minister's decision should be deferred.
29. In our draft report, we described our proposed framework.<sup>11</sup> Submissions broadly agreed with it.<sup>12</sup> The framework for this final report remains largely unchanged from our draft framework. In this report we also explain our task as specified in clause 4(3) of Schedule 3 and next steps should the Minister accept our deferral recommendation.

### Final report of recommendations

30. As explained in Chapter 1, the "proposed alteration" in this final report is to omit the Resale Services from Schedule 1. The two recommendations we need to make to the Minister are:
  - 30.1 whether the proposed alteration should be made (ie, whether the Resale Services should be omitted from Schedule 1); and
  - 30.2 whether the Minister's decision on the proposed alteration should be deferred (ie, if the Minister's decision on whether to omit the Resale Services from Schedule 1 should be deferred).
31. These required recommendations are explained in further detail below.

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<sup>11</sup> Commerce Commission "Draft report on whether Spark's Resale Voice Services should be omitted from Schedule 1 of Telecommunications Act 2001 - Draft report under clause 2 of Part 1 of Schedule 3 of the Telecommunications Act 2001", 23 September 2016, Chapter 2.

<sup>12</sup> For example, see Chorus "Submission in response to the Commerce Commission's Draft report on deregulating Spark's Resale Voice services", 17 October 2016, page 2; Vodafone "Draft report on deregulation of Spark's Resale Voice services", 17 October 2016, page 1; and Spark "Draft report on whether Spark's Resale Voice Services should be omitted from Schedule 1 of the Act", 17 October 2016, paragraph [7].

### **Recommendation on whether the Resale Services should be omitted**

32. We are required to make a recommendation to the Minister on whether the Resale Services should be omitted from Schedule 1, under clause 4(3)(b)(i) of Schedule 3.
33. This recommendation must logically follow from the conclusions reached in our final report. As explained in Chapter 1, these conclusions are based on the information, opinions and evidence we have obtained from the process we have followed leading up to the preparation of the final report.

### **Recommendation on whether the Minister's decision should be deferred**

34. In addition to our recommendation on whether to omit the Resale Services from Schedule 1, we must make a recommendation on whether the Minister should defer the decision for any period.
35. Clause 7(1)(a) of Schedule 3 sets out that if the Minister accepts our recommendation to defer the decision, the Minister must refer the recommendation back to us for a report at the end of the period on whether the recommendation should be amended.
36. Once the Minister has referred the recommendation back to us, clause 7(1)(b) of Schedule 3 sets out two options at the end of the deferral period:
  - 36.1 prepare a draft report setting out any proposed amendments to our recommendation; or
  - 36.2 prepare a final report that includes a recommendation that the Minister accepts an undertaking under Schedule 3A. This is not an option available to us in the present circumstances because we have not received any application under clause 13 of Schedule 3A.<sup>13</sup>

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<sup>13</sup> Clause 13 of Schedule 3A sets out that "(1) An access provider who wishes to make an undertaking must apply to the Commission in accordance with clause 14. (2) The Commission must deal with the application— (a) in accordance with clauses 15(2) and 16: (b) in the prescribed manner, if any". Clause 15 of Schedule 3A sets out that "(1) An application under clause 13— (a) may be made after the date on which public notice is given under clause 1(3) of Schedule 3; but (b) must be made not later than 40 working days after the date on which the Commission commences an investigation into the proposed regulatory change under clause 1 of Schedule 3."

37. In preparing the draft report under clause 7 of Schedule 3, we must give public notice of its release and provide an opportunity for submissions on it. We must then prepare a final report “that contains the matters set out in the draft report and summarises, and makes recommendations on, the submissions received on the draft report”, as soon as reasonably practicable after the closing date for submissions.<sup>14</sup>
38. If the Minister accepts our recommendation to defer the decision, this mechanism in effect allows us to revisit the need for Backstop Regulation before the next five yearly review.

### **Our task must best give effect to section 18**

39. In reaching our final recommendations to the Minister, we must consider section 18, and make a recommendation that best gives effect to section 18.<sup>15</sup>
40. Section 18 sets out the purpose of Part 2 and Schedules 1-3, which is:
- ... to promote competition in telecommunications markets for the long-term benefit of end users of telecommunications services within New Zealand by regulating, and providing for the regulation of, the supply of certain telecommunications services between service providers.
41. Section 18(2) and (2A) identify particular matters that we are required to consider when determining what promotes competition in telecommunications markets for the long-term benefit of end users:

(2) In determining whether or not, or the extent to which, any act or omission will result, or will be likely to result, in competition in telecommunications markets for the long-term benefit of end users of telecommunications services within New Zealand, the efficiencies that will result, or will be likely to result, from that act or omission must be considered.

(2A) To avoid doubt, in determining whether or not, or the extent to which, competition in telecommunications markets for the long-term benefit of end users of telecommunications services within New Zealand is promoted, consideration must be given to the incentives to innovate that exist for, and the risks faced by, investors in new telecommunications services that involve significant capital investment and that offer capabilities not available from established services.

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<sup>14</sup> Clause 7(2)(a) and (b) of Schedule 3.

<sup>15</sup> Section 19.

42. As the High Court has observed, section 18(1) is the “dominant” provision in section 18, and subsections (2) and (2A) “are specified for the purpose of assisting analysis under section 18(1)”. In this sense, subsections (2) and (2A) are not isolated considerations on their own. Rather, they form part of the consideration of whether competition is promoted for the long-term benefit of end users.<sup>16</sup>
43. Put simply, we are required to make recommendations that promote competition in telecommunication markets for the long-term benefit of end users.

### **Applying section 18 to our recommendations**

44. We consider that we must apply section 18 to both of the recommendations we are required to make in this report. We consider the application of section 18 to both recommendations below.

### **Application of section 18 to our recommendation whether to omit**

45. We explain below how we apply section 18 in making a recommendation on whether the Resale Services should be omitted from Schedule 1.
46. Regulation involves costs and potentially distorts supply-side incentives. Telecommunications services should only be regulated where regulation best gives effect to the promotion of competition for the long-term benefit of end users of those services.
47. As explained earlier in Chapter 1, the Retail Services cannot be supplied in isolation from the access line. “Part of Bundles” is also likely to be linked to the local access and calling service. Therefore, we apply section 18 to the three Resale Services in conjunction.
48. The Resale Services should be omitted if competition is sufficiently effective and the benefits of regulation are outweighed by the direct and indirect costs of regulation, such as distortionary effects on price and non-price incentives. If, on the other hand, competition is not yet sufficiently effective and the benefits of retaining the services are likely to outweigh the costs of retaining the services, we consider the service should be retained in Schedule 1.

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<sup>16</sup> *Chorus Ltd v Commerce Commission* [2014] NZHC 690 at [34]. For a more detailed discussion see Commerce Commission, Determination for Chorus' unbundled copper local loop service [2015] NZCC 37 at paragraphs [148]–[155].

49. As a first step, in assessing whether regulation under Schedule 1 is required to best give effect to section 18, we identified the competitive constraints that might exist in respect of the Resale Services. These included direct constraints in the form of alternative services at the wholesale level, as well as indirect constraints that might operate via the retail level.
50. Once we had identified the potential constraints, we then assessed how effective these constraints on Spark were in the supply of Resale Services. Following this, we assessed the benefits and costs of omitting the Resale Services from Schedule 1.
51. We used the following indicators as a guide to whether Spark faced increasingly effective competition, and would continue to do so in the absence of Backstop Regulation of the Resale Services.
  - 51.1 We examined whether the competing suppliers provided an independent and effective constraint on the Resale Services (either directly through the wholesale level or indirectly through the retail level). We examined evidence such as movements in wholesale volume share, as well as pricing of Resale Services and the wholesale alternatives offered by competing providers. We focused on the ability of RSPs to self-supply the wholesale input and/or to source supply of the wholesale input independently of the Resale Services. In doing so, we took into account the availability of wholesale alternatives across New Zealand.
  - 51.2 We looked at whether RSPs have the ability to enter, invest and innovate in a sustainable manner using wholesale alternatives to supply retail voice services in the absence of Backstop Regulation of the Resale Services.
  - 51.3 We considered any additional constraints limiting Spark's ability to exercise market power in the absence of Backstop Regulation. Spark could exercise market power by either increasing prices or reducing the quality of the service for the Resale Services or by withdrawing them. We have also considered whether Spark could leverage this potential market power to other services.
52. We assessed the likely benefits of omitting the Resale Services. We did this by looking at the costs that could be avoided if these services were omitted from Schedule 1, such as avoiding any direct regulatory costs and potential distortions due to the price or non-price terms of the Resale Services. We also assessed the likely costs of omitting the Resale Services from Schedule 1 by considering the impact on RSPs.

**Application of section 18 to our recommendation on whether the Minister should defer the decision**

53. We consider that we must also apply section 18 when considering if we should recommend to the Minister to defer the decision on whether the Resale Services should be omitted from the Act.
54. If we conclude that the Resale Services should not be omitted from Schedule 1 at this time, but we are of the view that circumstances could evolve such that our recommendation may change at some point before the next five-year review period, we believe that section 18 is best given effect to if:
  - 54.1 the Resale Services continue to be listed in Schedule 1; and
  - 54.2 we recommend the Minister to defer the decision on whether to omit the Resale Services (as per clause 4(3)(b)(ii) of Schedule 3). As mentioned earlier in this chapter, the deferral would allow us to revisit the possibility of omitting the service sooner than the next five yearly review .

## Chapter 3 The competitive constraints on Spark

55. In this chapter, we first identify the potential competitive constraints faced by Spark's Resale Services and then assess how effective those competitive constraints are.

### Our view

56. Our view is that Spark is facing increasingly effective competition for its Resale Services. However, in our view, competition is not yet sufficient to fully constrain Spark's market power. Following consultation on our draft report, we are concerned that RSPs' ability to quickly switch to alternatives is currently constrained. This may allow Spark to exercise market power in the absence of Backstop Regulation. The use of such market power might also disrupt competition to provide UFB services as RSPs' attention is diverted to provisioning analogue voice services.
57. We expect the constraint on switching to diminish as RSPs enhance their capability to utilise wholesale alternatives, and, in particular, as Chorus moves to greater automation in the provisioning process for the Baseband IP services (Baseband IP and Baseband IP Extended). At the same time we expect incentives on Spark to agree commercial commitments to better meet RSPs' requirements for security of supply will increase, reducing RSPs' reliance on the regulatory backstop.

### Identifying the potential competitive constraints

#### What we said in the draft report

58. In our draft report, we noted that Spark may face a number of constraints when supplying the Resale Services. These constraints could be either direct constraints that reflect the wholesale options available to RSPs, or indirect constraints that occur as a result of choices made by end users at the retail level.<sup>17</sup>

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<sup>17</sup> Commerce Commission, "Draft report on whether Spark's Resale Voice Services should be omitted from Schedule 1 of the Telecommunications Act 2001", 23 September 2016, paragraphs [B4], [B5].

*Direct constraints*

59. In assessing direct constraints at the wholesale level, we considered what wholesale services are available as alternatives for RSPs to use to supply retail voice services to end users. These wholesale services include wholesale voice services offered by Chorus that can be used as an input into the supply of traditional voice services from a fixed location (PSTN analogue voice services) over copper to end users (Baseband Copper, Baseband IP, and Baseband IP Extended). In addition, RSPs can use wholesale broadband services offered by Chorus and other operators to offer bundles that include managed voice over internet protocol (VoIP) services together with broadband.
60. In terms of wholesale services Chorus offers that can be used as an input to provide retail voice services, our view was that the Baseband Copper service was likely to be a close substitute for Spark's Resale Services. This is because Baseband Copper is the same access input used to provide Resale Services. We also found that the Baseband IP and IP Extended services represented potential substitutes for the Resale Services, noting that these access services were currently available from Chorus in respect of 60% of copper connections, and that this level of coverage could be extended further.<sup>18</sup>
61. A number of RSPs had raised concerns over the compatibility of Chorus' Baseband IP services with devices such as medical and security alarms and Electronic funds transfer at point of sale (EFTPOS) terminals. We concluded that this was unlikely to be a significant limitation as these devices are increasingly supported by the Baseband IP services.
62. We also noted in our draft report that Spark had been migrating end users that have EFTPOS terminals and medical alarms to Chorus' Baseband IP services, and that Spark had informed us that it had not encountered any difficulties in the trials that it had conducted.
63. We further noted in our draft report that a number of wholesale access services also used to provide broadband provided an increasingly effective competitive constraint and were available from operators such as Chorus and the LFCs. These services can be used to supply VoIP services to end users. They include the UCLL service, the UBA service, UFB-based services, and cable and FWA-based services.

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<sup>18</sup> *ibid*, paragraph [B41.2].

64. Our preliminary view in the draft report was that those wholesale services were likely to provide an increasingly effective competitive constraint on Spark in the supply of the Resale Services.

*Indirect constraints*

65. We assessed whether there might be indirect constraints on the Resale Services. These operate through the retail level and depend on the extent to which end users are prepared to switch between retail services that use alternative wholesale inputs.
66. For example, suppose that Spark was considering an increase in the price of one of the Resale Services supplied to an RSP. The RSP may pass the price increase through into the retail price of the voice service supplied using the Resale Service. If the increase in the retail price were to induce end users to switch to other retail services that do not rely on Resale Services, Spark would lose the entire resale revenue stream. Such switching of demand away from resale may deter Spark from increasing resale prices in the first place.
67. Therefore, even if there were no close substitutes for the Resale Services at the wholesale level, Spark could still be constrained from imposing a price increase for Resale Services as long as there is competition at the retail level from firms using self-supplied wholesale inputs.
68. To assess indirect constraints, we looked at the alternatives that are available for end users who want to purchase a voice service. We considered whether VoIP services, which are provided over a broadband connection, were likely to constrain traditional fixed-line voice services. We also considered whether mobile voice services were likely to constrain fixed voice services.<sup>19</sup>
69. We concluded that a managed VoIP service is likely to be a close substitute for a traditional analogue voice service. A managed VoIP service provides end users with similar functionality and quality, at the same or lower price. We noted that according to Spark, the majority of residential end users who have migrated to UFB-based services no longer retained a copper connection.<sup>20</sup> We also found that although mobile services are becoming increasingly close substitutes for fixed voice services, mobile services do not yet appear to be sufficiently close substitutes to constrain Spark.<sup>21</sup>

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<sup>19</sup> *ibid*, paragraph [B8].

<sup>20</sup> *ibid*, paragraphs [B15], [B42.3].

<sup>21</sup> *ibid*, paragraph [B29].

## Analysis of submissions

70. In their submissions on the draft report, Spark and Vodafone agreed with our preliminary view that there are a range of competing wholesale alternatives that can be used to supply voice services.<sup>22</sup> Spark submitted that its Resale Services face effective competition from wholesale services offered by Chorus, the LFCs, and wireless operators.
71. At the conference, Spark expressed the view that although other local access wholesale services will not be perfect substitutes for the Resale Services, they are effective competitive constraints. Spark also stated that increasing competition from those wholesale alternatives had led to reductions in the margins Spark earned on its Resale Services since separation.<sup>23</sup>
72. Chorus said that it generally supports the approach taken in the draft report. Chorus noted that its Baseband IP services are an important alternative wholesale input given its availability to almost all New Zealanders. Chorus submitted that:<sup>24</sup>
- if resold POTS is deregulated, and RSPs are not happy with the service provided by Spark, they have the option to migrate to our Baseband IP service. If this were to occur, we would want any transition to be smooth.
73. Vocus and Trustpower disagreed with the preliminary view in the draft report. In its submission, Vocus said that Baseband IP has the potential to be a substitute input for voice services, although it is not yet a competitive constraint to Spark's Resale Services.<sup>25</sup> At the conference, Vocus explained that it had started to reduce its reliance on the Resale Services by increasing its uptake of Chorus' wholesale services. Vocus noted that this had been a resource-intensive process, and that the main issue it faces with Baseband IP relates to the coverage of the service.<sup>26</sup>
74. Vocus submitted that the migration of customers onto VoIP services using naked UBA is even more challenging, and that such services will only appeal to a segment of the retail market.<sup>27</sup>

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<sup>22</sup> Spark submission, 17 October 2016, paragraph [4]; Vodafone submission, 17 October 2017 [sic], page 1.

<sup>23</sup> Conference transcript, page 10.

<sup>24</sup> Chorus submission, 17 October 2016, page 3.

<sup>25</sup> Vocus submission, 17 October 2016, paragraph [9].

<sup>26</sup> Conference transcript, page 12.

<sup>27</sup> Conference transcript, pages 9, 10.

75. Vocus also referred to the opportunity cost to RSPs who are currently focused on UFB migrations. If RSPs had to undertake an additional migration of end users from Resale Services to other wholesale inputs such as Baseband IP, this would increase contention for RSP resources at a time when UFB uptake is starting to accelerate. Vocus was also concerned about the capacity of Chorus to undertake additional migration to Baseband at a time when UFB migrations are increasing. Vocus estimated that it could lose 20% of its customers during such a migration, with 5-8% of customers likely to face issues relating to customer equipment.<sup>28</sup>
76. Trustpower agreed that emerging technologies and alternative wholesale inputs are becoming available, although "the strength of these alternative services is not yet sufficient to constrain Spark's market power."<sup>29</sup> Trustpower emphasised the risks of fast-tracking the switching of customers from the Resale Services to alternative wholesale inputs used to provide voice services such as Chorus' Baseband services:<sup>30</sup>
- Time is required to ensure adequate testing of the new systems and staff training. The risk of errors, and therefore the likelihood of poor customer experience, increases if there is inadequate time.
77. In its cross-submission, Trustpower referred to the time and effort necessary to utilise such alternatives:<sup>31</sup>
- Investing and testing systems to enable the provision of Baseband alternatives to PSTN services is costly and takes considerable time to ensure the continuity of service for the customer.
78. Although Trustpower did not indicate a timeframe within which it would be ready to utilise these alternatives, Trustpower submitted that if a transition period is to be used, it should be two to three years.<sup>32</sup>
79. At the conference, Trustpower said that it was not at the same stage as other RSPs in the migration away from Spark's Resale Services, and that although it is embarking in that direction, it remained reliant on resale.<sup>33</sup> Trustpower referred to the investment required and challenges faced by an RSP migrating customers to Chorus' Baseband service. In particular, it would be important to carefully manage the migration process to avoid disruption for customers.

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<sup>28</sup> Vocus submission, 17 October 2016, paragraphs [10], [19]. See also Vocus "Review of Designated & Specified Services under Schedule 1 of the Telecommunications Act", 23 May 2016, paragraph [5].

<sup>29</sup> Trustpower submission, 17 October 2015 [sic], paragraph [1.3.2].

<sup>30</sup> *ibid*, paragraphs [1.4.7].

<sup>31</sup> Trustpower cross-submission, 26 October 2016, paragraph [3.1.4].

<sup>32</sup> *ibid*, paragraph [4.1.6].

<sup>33</sup> Conference transcript, page 13.

80. According to Trustpower, once the migration capability (of both RSPs and Chorus) has been developed, any migration would have to be undertaken quickly and on a large scale in order to offset the loss of volume rebates in the commercial resale agreements. Trustpower reiterated its view that it does not currently have any alternatives to the Resale Services.<sup>34</sup>
81. Following the conference, Trustpower provided further details on the steps that it is taking to develop its capability to move customers away from resale voice services.<sup>35</sup> These steps include  
[  
].
82. Having reviewed submissions and the discussion at the conference, we still consider that a number of wholesale services are emerging as alternatives to Spark's Resale Services. The extent to which these wholesale services are seen as a constraint on Spark's Resale Services is likely to vary depending on how easily demand can be switched away from the Resale Services.
83. Chorus' Baseband IP services appear to be the closest substitutes for Spark's Resale Services. The Baseband IP services are wholesale voice services which typically do not require the end user to switch to a different retail service or to change customer premises equipment. Chorus, as well as RSPs, have acknowledged that the Baseband IP services are a good potential alternative to Spark's Resale Services. Baseband Copper can also be used to provide voice services but requires additional investment by RSPs and therefore represents a less close substitute.
84. Other wholesale services, such as UBA and UFB, can be used to offer managed VoIP services to end users. These wholesale services are also likely to constrain Spark's Resale Services to some extent, although the strength of the constraint from these services may be less than that from the Baseband IP services. For example, during the conference, Vocus submitted that the migration of end users onto VoIP services using naked UBA is more challenging than migrating end users onto Baseband services.<sup>36</sup> We also note that for an RSP to switch from the Resale Services to UFB services, the decision to switch is ultimately made by the end user, although the RSP can promote this transition.

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<sup>34</sup> Conference transcript, page 40.

<sup>35</sup> Trustpower "Trustpower submission: Draft Report on whether Sparks' Resale Voice Services should be omitted from Schedule 1", 10 November 2016. This was a submission in response to the Commission's request for comments on information obtained from Spark under a s 98 Notice.

<sup>36</sup> Conference transcript, pages 9, 10.

85. Much of the discussion throughout the consultation on the draft report was on the emerging competitive threat of Chorus' Baseband IP services and on whether there are limitations in terms of the existing coverage and functionality of the Baseband IP services.
86. We remain of the view that neither coverage nor functionality in terms of customer premises equipment (CPE) compatibility will be significant limitations of Chorus' Baseband IP services. This is because of the following:
- 86.1 the current coverage (60% of copper connections) could be extended further in line with the footprint of Chorus' Ethernet-based UBA service, by installing line cards into existing new-generation Ethernet DSLAMs. At the conference, Chorus said it would extend Baseband IP coverage on an "on demand" basis. Vocus responded that it would be willing to use Baseband IP as long as Chorus is prepared to expand coverage;<sup>37</sup>
- 86.2 the Baseband IP services increasingly support the types of services which are currently available using the Resale Services.
87. As RSPs increase their capability to use the Baseband IP services we expect that the coverage of Baseband IP services will continue to increase in the near future. This is consistent with Chorus' intentions to expand coverage in response to demand.
88. However, the extent to which the Baseband IP services are a close substitute for Resale Services is likely to be limited by:
- 88.1 the costs and time to Chorus of physically migrating end users' lines over to the Baseband IP services; and
- 88.2 the upfront costs and time to RSPs to utilise the service.

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<sup>37</sup> *ibid*, pages 27-28, 31.

89. During the conference, Chorus noted that it plans to automate the ordering process for the Baseband IP services.<sup>38</sup> However, Chorus also emphasised the challenges of physically migrating end users over to its Baseband IP services. Chorus explained that although expanding the coverage of the Baseband IP services is complex and involves installing the physical equipment, such as line cards that are necessary to support the service, the more challenging issue for Chorus relates to the actual line migration process itself. Chorus noted that even if the line cards were universally available, the physical switching of end users onto the Baseband IP services is labour-intensive. The switching of end users involves technician visits to the cabinet in order to cut the line over to Baseband IP and to ensure that the service is working.<sup>39</sup>
90. We recognise that a number of RSPs are not yet in a position to quickly switch to wholesale alternatives such as Chorus' Baseband IP services. We note that these RSPs may require time to bring forward the investment required in order to utilise other wholesale services and to migrate customers between wholesale inputs.
91. While services such as Chorus' Baseband IP services are emerging as good potential alternatives to resale, there is a legitimate concern from RSPs over the timeframe within which the service could act as an effective competitive constraint on Spark.

## **Assessing the effectiveness of the competitive constraints**

### **What we said in the draft report**

92. In our draft report, we noted that the increasing availability of, and demand for, wholesale alternatives that can be used to provide retail voice services had resulted in a reduction in the number of Resale Services supplied by Spark.
93. From a peak of 440,000 resold lines in 2012, the number of resold lines had dropped to 319,000 lines by 2016.<sup>40</sup> As of June 2016, the number of resold lines represented 36% of retail fixed connections supplied by non-Spark RSPs, down from 51% in 2014.

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<sup>38</sup> *ibid*, page 31.

<sup>39</sup> *ibid*, pages 24, 25.

<sup>40</sup> Commerce Commission, "Draft report on whether Spark's Resale Voice Services should be omitted from Schedule 1 of the Telecommunications Act 2001", 23 September 2016, paragraph [69].

94. We noted that the reliance on Spark's Resale Services varied for each RSP. For example, approximately [ ]% of the retail voice services supplied by Trustpower in 2016 were based on Resale Services, whereas for Vocus and 2degrees, the importance of the Resale Services was less. In 2016 Vocus relied on resale to supply [ ]% of its retail voice services, and 2degrees used resale to supply [ ]% of its retail voice services.<sup>41</sup>
95. We noted that some of the wholesale alternatives are not available in respect of all end users. However, we found that the number of end users beyond the reach of other wholesale alternatives was small, and that in those areas, resale-based services represented less than 1% of the customer base of RSPs.<sup>42</sup>
96. Our preliminary view in the draft report was that the pricing evidence before us supported the view that Spark faced increasing competition in the supply of the Resale Services. The margins that Spark earns on the Resale Services (ie, the margin between the price Spark charges for resale and the price Spark pays to Chorus for the Unbundled Copper Low Frequency (UCLF) input has been declining in recent years. We also referred to evidence provided by Chorus, which indicated that Chorus had developed and expanded its Baseband IP services as a competitive alternative to resale.
97. Our preliminary view in the draft report was that Spark's Resale Services are facing increasingly effective competitive constraints.<sup>43</sup>

### Analysis of submissions

98. In its submission on the draft report, Spark supported our reasons in the draft for the proposed withdrawal of the Resale Services from Schedule 1. According to Spark, there is clear evidence that the Resale Services face effective competition from wholesale inputs and services supplied by Chorus, the LFCs and wireless operators.
99. In particular, Spark agreed with the observation in the draft report that:<sup>44</sup>
- ...customers are migrating off the PSTN and on to alternative platforms and services. ...  
Voice services can be readily provided over Chorus wholesale accesses [sic] or competing platforms and customers are already to migrate to alternative services
100. Spark said that such trends were expected to accelerate with the roll-out of the UFB programme and fixed wireless services.<sup>45</sup>

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<sup>41</sup> *ibid*, paragraph [68].

<sup>42</sup> *ibid*, paragraph [92].

<sup>43</sup> *ibid*, paragraph [56].

<sup>44</sup> Spark submission, 17 October 2016, paragraphs [16].

101. Vodafone agreed with the draft report that there are sufficient competitive alternatives to the Resale Services. These alternatives provide a range of options for access seekers and the right incentives for Spark to continue offering competitive wholesale services on a commercial basis.
102. Vodafone expects competition in the market to only increase further as the deployment of new fibre and wireless networks continue to displace copper-based services. Vodafone also supported the use of a transition period to allow RSPs time to prepare for the use of new wholesale services.<sup>46</sup>
103. Trustpower disagreed with the preliminary conclusion in the draft report that competition had developed sufficiently to support omitting the Resale Services from Schedule 1.<sup>47</sup> Trustpower argued that the competitive constraints faced by Spark are not yet effective. Trustpower said that it cannot readily avoid using the Resale Services and will have little choice until it is in a position to switch customers away from Resale Services.
104. Vocus submitted that the draft report had identified the correct trends but it would be premature to withdraw Resale Services from Schedule 1.<sup>48</sup> According to Vocus, RSPs may require a longer period to migrate customers to alternative services such as Baseband IP. Vocus suggested that any decision to withdraw Resale Services from Schedule 1 could be conditional on Chorus' Baseband IP services reaching a coverage threshold.<sup>49</sup>
105. In our view, the trends that we identified in the draft report, and with which most parties agreed, clearly indicate that Spark is facing increasingly effective competition.
106. The Resale Services account for a declining, although still important, proportion of competitors' retail fixed line services. While other wholesale services such as UFB services and naked UBA services represent an increasing share of competitors' retail fixed line services. This is summarised in Figure 3.1 below.

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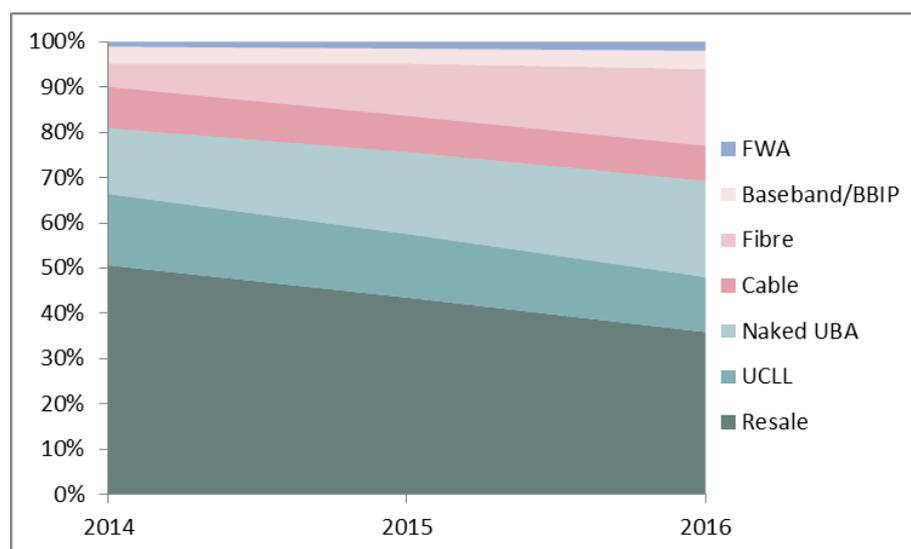
<sup>45</sup> *ibid*, paragraphs [16], [17].

<sup>46</sup> Vodafone submission, 17 October 2017 [sic], page 1.

<sup>47</sup> Trustpower submission, 17 October 2015 [sic], paragraph [1.5.1].

<sup>48</sup> Vocus submission, 17 October 2016, paragraph [11].

<sup>49</sup> *ibid*, paragraph [15].

**Figure 3.1 Breakdown of competitor fixed connections (2014-2016)**

Source: Commerce Commission data

107. As can be seen from Figure 3.1 above, the proportion of retail lines supplied by Spark's competitors using the Resale Services has been dropping, from 51% in 2014 to 36% in 2016. This reflects the following:
- 107.1 the declining number of Resale Services (from 409,000 services supplied in 2014, to 319,000 services in 2016);
  - 107.2 the increasing use of other wholesale services supplied by Chorus and the LFCs (from 315,000 services in 2014, to 482,000 services in 2016); and
  - 107.3 the self-supply of voice services, such as using cable or FWA ([ ] services in 2014, and [ ] services in 2016).
108. Figure 3.1 above also shows the expansion in demand for UFB services over the last couple of years (accounting for 17% of non-Spark retail connections in 2016, up from 5% in 2014). We expect that the growth in UFB services will continue to be driven by end user choices to migrate to the greater functionality and higher speeds offered over fibre. However, although the decision on whether to switch from Resale Services to UFB services is ultimately made by end users, RSPs can promote the transition from copper to fibre.

109. Therefore, we still consider that UFB services, where available, provide RSPs with an alternative to supply retail voice services. In the event that Spark were to attempt to increase the price of its Resale Services in areas where the UFB had been deployed, an RSP using resale would be incentivised to more aggressively promote UFB services to its end users. To the extent that higher resale prices flowed through into higher retail prices for services supplied using resale, end users would have an added incentive to switch to fibre-based services.
110. Although the importance of Resale Services has been diminishing in recent years, we consider that the ability of RSPs to switch demand from Resale Services to wholesale alternatives may be constrained in the short term. This view is based on the submissions received on the draft report and the concerns that were further articulated and discussed at the conference. In particular, a number of RSPs have yet to make the investment in their systems and transmission networks that would enable them to utilise alternatives such as Baseband IP to supply retail voice services.
111. In its cross-submission, Spark acknowledged the practical migration difficulties raised by RSPs, although Spark argued that these difficulties are not material for the competitive process.<sup>50</sup> In our view, such difficulties increase the costs of switching away from Spark's Resale Services. This in turn will limit the ability of RSPs to respond in a timely manner should Spark attempt to exercise market power for Resale Services.
112. The evidence that we have gathered during the course of the current investigation indicates that the margin earned by Spark on its Resale Services has been declining in recent years. In particular, this was confirmed by the information Spark provided in response to a notice we issued under section 98 of the Commerce Act.<sup>51</sup>
113. For example, according to Spark's billing data for the three months to August 2016, Spark's Resale margin (the margin between Spark's resale price and the UCLF cost paid to Chorus) was \$[ ] per resold line. This compares to a margin between Spark's resale price and Chorus' UCLF cost of \$[ ] in the first quarter of 2012,<sup>52</sup> a reduction of [ ]%. This is consistent with the view that Spark is facing increasing competition in the supply of Resale Services.

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<sup>50</sup> Spark cross-submission, 17 October 2016 [sic], paragraph [4].

<sup>51</sup> Spark letter, 19 October 2016.

<sup>52</sup> Spark letter, 20 June 2016.

114. However, we note the following.
- 114.1 While Spark's Resale margin has been declining, the reductions offered by Spark appear to have been greater for those RSPs who have more wholesale options and more bargaining power. For example, Spark's margin (June 2016) on Resale Services supplied to Vodafone was \$[ ] per line, while the margin Spark earned on Resale Services supplied to Vocus was \$[ ] per line, and on Resale Services supplied to Trustpower was \$[ ] per line.
- 114.2 Trustpower has claimed that Spark has only lowered its wholesale margins in those cases where RSPs have started switching to alternatives and that such alternatives are not yet available for smaller RSPs.
- 114.3 The above suggests that Spark may be able to exercise market power at least in respect of the RSPs with less bargaining power, when such RSPs are unable to take advantage of wholesale alternatives. Therefore, the omission of the Resale Services from Schedule 1 would leave RSPs vulnerable to Spark disrupting their ability to supply voice services either on a standalone basis or in a bundle with other services. A number of RSPs have expressed the view that the current Backstop Regulation has been an effective threat which is likely to have influenced Spark's behaviour.<sup>53</sup>
115. In our view, if Spark were to cease supplying Resale Services to those RSPs who are unable to take advantage of wholesale alternatives, the RSPs would face the prospect of losing their retail end users to Spark. RSPs may also face considerable disruption from having to undertake an additional migration at a time when demand for fibre-based services is increasing. This could harm competition in the provision of UFB at the retail level.
116. We are not satisfied that the current commercial contracts would provide sufficient protection to RSPs, given the notice periods in the termination clauses of the contracts. Given the concerns raised in submissions and discussed at the conference, the wholesale alternatives to the Resale Services may not be practically available to RSPs within such a timeframe.
117. In such circumstances, we consider that retaining Backstop Regulation of the Resale Services at this stage will limit Spark's ability to take advantage of RSPs during a period in which RSPs are developing their capability to make greater use of other wholesale inputs.

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<sup>53</sup> See for example, Conference transcript, page 12.

## **Chapter 4      Costs and benefits of omitting the Resale Services**

118. In this chapter we analyse the costs and benefits associated with omitting the Resale Services from Schedule 1.

### **Our view**

119. Our view is that the benefits from immediate removal of the Resale Services from Schedule 1 are likely to be outweighed by the potential costs.

120. We consider that the benefits from removing the Resale Services from Schedule 1 include any avoided regulatory costs. Our view is that these avoided costs are low both for Spark and for us. Backstop Regulation will not impose additional costs on Spark (costs associated with having this offer available) to the extent that Spark would otherwise continue to provide wholesale services on a commercial basis. Direct regulatory costs for us, Spark and RSPs are also unlikely to be significant as they are only related to the five yearly review required by clause 1(3) of Schedule 3.

121. The potential costs that could arise from omitting Resale Services from Schedule 1 are higher than we initially considered in our draft report. Such potential costs would arise in the event that Spark exercised market power, for those RSPs who currently face practical difficulties in switching their existing customers away from Spark's Resale Services. The consultation process has emphasised the challenges of additional migration of end users to alternative wholesale services, particularly when a significant number of customers are already being migrated to UFB. Submissions from Chorus and from RSPs using the Resale Services stated that migration to other wholesale alternatives requires time and appropriate planning, so that the process runs smoothly and negative impacts on competition and on end users are avoided.

### **What we said in our draft report**

122. In assessing whether the Resale Services should be omitted from Schedule 1, our preliminary view in the draft report was that the net benefits of omitting the Resale Services from Schedule 1 would be small but still best give effect to section 18.

## Benefits

123. In the draft report we said that the benefits that would arise from omitting the Resale Services from Schedule 1 were:<sup>54</sup>
- 123.1 avoiding any direct regulatory costs; and
  - 123.2 avoiding any distortions due to the price or non-price terms of the Resale Services.
124. Our preliminary view was that the direct regulatory costs that could be avoided if the Resale Services were omitted from Schedule 1 would be relatively low. The only direct regulatory costs would be those costs incurred by us and the parties in the five-yearly review process. We also noted in our draft report that we expected Spark to continue supplying Resale Services.
125. In terms of the potential distortionary effects of retaining the Resale Services in Schedule 1, we analysed whether Resale Services were delivering competitive retail pricing or innovation in voice services. We observed in the draft report that the price for a voice-only service plan in New Zealand ranked among the highest in comparison to other OECD countries. This is a sharp contrast to prices for mobile voice services. However, when the voice service was bundled with a broadband plan, and RSPs were using other wholesale inputs, we were starting to see some differentiation in terms of price and service features.<sup>55</sup>

## Costs

126. In the draft report we said that the costs that could arise from omitting the Resale Services from Schedule 1 were:<sup>56</sup>
- 126.1 any costs to RSPs of bringing forward the development of the business systems needed to use other wholesale inputs; and
  - 126.2 any costs to the small number of customers whose choice of telecommunications suppliers may be reduced.

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<sup>54</sup> Commerce Commission, "Draft report on whether Spark's Resale Voice Services should be omitted from Schedule 1 of the Telecommunications Act 2001", 23 September 2016, paragraph [128].

<sup>55</sup> *ibid*, paragraph [133].

<sup>56</sup> *ibid*, paragraph [134].

127. Our view in the draft report was that the costs for RSPs of bringing forward the investment to develop the systems needed to use other wholesale inputs would only need to be incurred if negotiations with Spark failed. We also said that RSPs are already migrating from Resale Services to other wholesale inputs because of their greater potential in terms of functionality, so these costs were likely to be incurred by RSPs anyway.
128. Also, our view was that the risk of leaving some customers with a reduced choice in terms of telecommunications supplier is low. Only a small number of end users will have Spark as the only possible fixed voice provider and Spark's Telecommunications Service Obligation will continue to cap the retail price for voice service.
129. However, we also said in the draft report that Backstop Regulation of the Resale Services provided for regulated retail-minus pricing to be put in place in an STD. In our view, this gives RSPs the confidence that they would always be able to compete with Spark at the retail level.<sup>57</sup>

### **Analysis of submissions**

130. Spark and Vodafone agreed with our preliminary view that Resale Services should be omitted from Schedule 1. In contrast, Trustpower and Vocus said that they were not convinced of the net benefits of an early withdrawal of the Resale Services from Schedule 1.
131. Spark said the PSTN is a legacy technology that is increasingly costly to maintain and that they expected to migrate customers to alternative platforms over time.<sup>58</sup> They argued that continued Backstop Regulation in the face of competition from alternative technologies could only add cost and distort incentives for market conduct and future investment. They further said that, under these circumstances, continued regulation through a Backstop Regime was unlikely to promote outcomes consistent with the section 18 objectives.<sup>59</sup>

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<sup>57</sup> *ibid*, paragraph [131].

<sup>58</sup> Spark submission, 17 October 2016, paragraphs [17].

<sup>59</sup> *ibid*, paragraph, [5].

132. Spark also reiterated that they have incentives to continue to provide the wholesale service:<sup>60</sup>

(...) we have got a major customer that is transitioning off our services and we know that all of our customers at retail are shifting on to different technologies. That has not resulted in us increasing our price for any of them, including that major customer that we know has made a choice, a conscious choice to shift away from us. Instead we have done what you would expect in a competitive market, we have sat down with them and figured out what we can do to keep them with us for longer, and that usually means a lower price.

133. The Act does not provide for a specific technology as a platform to provide Resale Services. Therefore, we do not think that current Backstop Regulation is imposing additional costs on Spark (other than costs associated with the 5-year review of Schedule 1 services), particularly if Spark continues to provide commercial Resale Services.
134. Trustpower said that "the benefits of deregulation do not appear to outweigh associated costs".<sup>61</sup> Trustpower disagreed that the current framework is discouraging RSPs from investing in voice capability. Trustpower also emphasised that "investing and testing systems to enable the provision of baseband alternatives to PSTN services is costly and takes considerable time to ensure the continuity of service for the customer".<sup>62</sup>
135. Trustpower further said that they have "the resources available to invest in the systems required to transition from PSTN to Baseband IP", but that it needs the time to execute this transition.<sup>63</sup> Trustpower went on to say that smaller RSPs may not be able to make this transition, and will likely be faced with higher input costs from Spark as a result, which will impact their ability to make competitive offers to consumers.
136. We acknowledge that Trustpower and smaller players have yet to develop the capability to use Baseband IP as an input instead of Resale Services. We also note that small players also rely on wholesale carriers to manage portability, so they would also need to develop portability systems if they wanted to move away from the Resale Services.

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<sup>60</sup> Conference transcript, page 16.

<sup>61</sup> Trustpower submission, 17 October 2015 [sic], paragraph, [1.1.3].

<sup>62</sup> Trustpower cross-submission, 26 October 2016, paragraph [3.1.4].

<sup>63</sup> Trustpower letter, 10 November 2016, paragraph [9].

137. We understand that developing such capability may take time. Resale Services offered by Spark will continue to be an important option for those providers who do not wish to invest in their own capability to offer voice services.
138. Vocus agreed that we had identified the correct trends although Vocus was not convinced of the benefits of an early withdrawal of the Resale Services from Schedule 1. Vocus also said that it was not "seeking to prolong the existence of the legacy PSTN or encourage inefficient investment by Spark in legacy technology".<sup>64</sup>
139. In the conference Vocus reiterated that it had started the "journey" of migrating customers to Baseband IP, but that to further enhance migration they need coverage and more time.<sup>65</sup>
140. Vocus also expressed concerns that Spark would have the ability to exploit its competitive advantage over a transition period.<sup>66</sup>
141. Vodafone submitted that where there are net benefits of deregulation, even if small, deregulation will best give effect to section 18. However, Vodafone also said in its submission and at the conference, that a transition period will diminish the risk of disruption.<sup>67</sup>
142. We understand the concerns expressed by Vocus, Vodafone and Trustpower about being exposed to Spark during the period in which they are preparing to be able to utilise other wholesale options. We understand that current Backstop Regulation gives RSPs the confidence that Spark will not exercise market power including while they are migrating their customers to other wholesale alternatives. If Spark did exercise market power, we could intervene with a determination or an STD. The use of such market power might also disrupt competition for the supply of UFB services.

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<sup>64</sup> Vocus submission, 17 October 2016, paragraph [8].

<sup>65</sup> Conference transcript, page 12.

<sup>66</sup> *ibid*, page 8.

<sup>67</sup> Vodafone submission, 17 October 2016. Conference transcript, page 14.

## Chapter 5 Our recommendations to the Minister

143. This chapter explains our recommendations to the Minister that would best give effect to section 18.

### Our recommendations

144. We recommend that the Minister:

144.1 does not omit the Resale Services from Schedule 1 at this time; and

144.2 defers the decision on whether to omit the Resale Services from Schedule 1 for two years from the date of this final report.

145. We make these recommendations for the following reasons:

145.1 As explained in Chapter 3 above, Spark is facing increasingly effective competition for its Resale Services. However, we are concerned that RSPs' ability to switch to those alternatives is currently constrained. This may allow Spark to exercise market power in the absence of Backstop Regulation. The use of such market power might also disrupt competition for the supply of UFB services.

145.2 We expect the constraint on switching to diminish as RSPs enhance their capability to utilise wholesale alternatives, and, in particular, as Chorus moves to greater automation in the provisioning process for the Baseband IP services. At the same time we expect incentives on Spark to agree commercial commitments to better meet RSPs' requirements for security of supply will increase, reducing RSPs' reliance on the regulatory backstop.

145.3 We also anticipate that the effectiveness of competition may evolve sufficiently in two years' time to justify revisiting whether the Resale Services should be omitted from Schedule 1.

145.4 There are likely to be little or no benefits from the immediate omission of the Resale Services from Schedule 1. The avoided regulatory costs of omitting Resale Services from Schedule 1 are low both for Spark and for us. This was balanced against the potential costs that may arise should Spark exercise market power in the absence of Backstop Regulation.

146. We consider that the two year deferral period is appropriate for the following reasons:
- 146.1 A two year deferral period signals to the market that the Resale Services are likely to be omitted from Schedule 1 in two years' time if the trends in competition that we have observed continue;
  - 146.2 A two year deferral period discourages Spark from exercising market power in respect of those RSPs who currently face practical difficulties in switching their existing customers away from Spark's Resale Services; and
  - 146.3 Most RSPs currently using the Resale Services argued for a transitional period longer than 12 months. Trustpower, in particular, argued for two to three years.
147. We note that we are recommending that the Minister defers the decision for two years from the date of this final report, instead of the initially proposed 12 month transition period. In our view, a transition period applying after the Minister's decision to omit a service from Schedule 1 would not be appropriate. This is because once the Minister's decision to omit is made, the Regulatory Backstop effect of retaining the service in Schedule 1 during the transition period would cease.
148. If the Minister accepts our recommendations, the Regulatory Backstop will be retained and we will revisit our recommendations in two years. Meanwhile, RSPs will have the opportunity either to agree on appropriate commitments from Spark (with suitable end-of-life transitions) to meet their continuity of supply requirements in the event the Regulatory Backstop were to be no longer available, or to enhance their capability to utilise alternative wholesale services such as Baseband IP.
149. If the Minister accepts our deferral recommendation we will follow the process explained in Chapter 2 under the heading "recommendation on whether the Minister's decision should be deferred".

## What we said in our draft report

150. Our preliminary view was to recommend to the Minister that the Resale Services should be omitted from Schedule 1 but that the date on which the Resale Services are omitted should be 12 months after the date of the relevant Order in Council.
151. We said that our draft recommendation to omit the Resale Services from Schedule 1 was based on the following evidence:
  - 151.1 Retail competition was established, increasingly effective and no longer dependent on access to the local access and calling service. Chorus, the LFCs and fixed wireless operators all had the infrastructure to offer alternative wholesale voice services to RSPs; and
  - 151.2 The net benefits from omitting the Resale Services from Schedule 1 were likely to be small, but removal of Backstop Regulation would still best give effect to section 18.
152. Our draft report recommended a transition period of 12 months before the omission of the Resale Services took effect.
153. We noted that Chorus faced some short term constraints in terms of the provisioning process for managing new Baseband IP services orders and that Chorus was taking steps to alleviate these constraints by automating the provisioning process. According to Chorus, the provisioning process will be automated by the end of September 2017. Our preliminary view was that this supported the use of a transition period.
154. We said that the transition period would allow RSPs time for:
  - 154.1 bringing forward the investment in the business systems needed to use other wholesale inputs;
  - 154.2 adapting to the use of new wholesale inputs;
  - 154.3 migrating customers; and
  - 154.4 renegotiating new commercial contracts with Spark for the provision of Resale Services.

## Analysis of submissions

155. Submissions on the draft decision indicated the following points:
- 155.1 Only Trustpower disagreed with our overall draft decision;
  - 155.2 All parties, apart from Spark, agreed that a transition period of at least 12 months was necessary;
  - 155.3 Chorus said that any transition should be smooth. It also said that it has a number of initiatives in place to support migration, including pre-provisioning of Baseband IP cards and automation of ordering processes (from the end of September 2017);<sup>68</sup> and
  - 155.4 Chorus highlighted that most migrations currently require a technician visit to a cabinet, so any significant migration would need to be well planned. Chorus also emphasised that it is willing to work with RSPs on this.<sup>69</sup>
156. When questioned about the ideal length of a transition period, Chorus said it could not estimate a time for the transition period, but that they were able to adjust to demand.<sup>70</sup>
157. Trustpower said the proposed 12 month transition period was not long enough. Trustpower emphasised the risk of compromising customers' experience if the process was rushed. Trustpower also stressed that the length of the process is due to the need to negotiate contracts with other providers of wholesale inputs. For these reasons, Trustpower proposed a transition period of two to three years.<sup>71</sup>
158. At the conference Trustpower characterised this as an almost emergency situation, in which they would need to focus all their efforts and resources, but still risked compromising customers' experience.<sup>72</sup>
159. Vocus supported a transition period. However, Vocus recommended more than 12 months, as based on its experience, the process of migrating customers is not trivial.<sup>73</sup>

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<sup>68</sup> Chorus submission, 17 October 2016, page 3.

<sup>69</sup> Conference transcript, page 24.

<sup>70</sup> *ibid*, page 33.

<sup>71</sup> Trustpower submission, 17 October 2015 [sic], paragraph [1.6].

<sup>72</sup> Conference transcript, page 14.

<sup>73</sup> Vocus submission, 17 October 2016, paragraph [12].

160. Vocus also said that there is a large gap between current coverage of Baseband IP (60%) and the possible footprint (97%), and that we could make the end of the transition period conditional on:<sup>74</sup>
- achieving a trigger for actual coverage in combination with some form of commitment to extend the coverage further, in a timely manner, up to the 97% coverage, as required by an RSP.
161. During the conference Vocus said it had embarked on the journey to migrate customers from the Resale Services some years ago. The main issue for Vocus had been the lack of ubiquitous coverage of the alternatives, and the time it takes for coverage to be extended. Vocus also said that, because they have already started they know that the process can be hard at times but most of all time consuming.<sup>75</sup>
162. Vodafone strongly supported a transition period (minimum 12 months) to allow RSPs to migrate, invest in new business support systems required to use new wholesale alternatives, and (re)negotiate commercial arrangements.<sup>76</sup>
163. At the conference, Vodafone said it would not characterise this as an emergency situation because the risk of not reaching a satisfactory commercial agreement with Spark has always been there. Vodafone said that competition has been developing and will continue and that was the reason why it considered that a deferral would be useful.<sup>77</sup>
164. At the conference Vodafone also mentioned that it would be worth confirming whether the omission from the Act could trigger the regulatory event clause in the resale contracts.<sup>78</sup>
165. Spark said that a 12 month deferral was unlikely to add much in terms of certainty, bargaining power, or stability to the industry, as resale has not been subject to a regulatory determination for nearly 10 years. Spark said it would have no commercial incentive to terminate wholesale agreements. Spark said that because there is no real prospect of regulation within the one year window, there is no real benefit from imposing such a lengthy notice period.<sup>79</sup>

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<sup>74</sup> *ibid*, paragraph [15].

<sup>75</sup> Conference transcript, page 12.

<sup>76</sup> Vodafone submission, 17 October 2016, page 1.

<sup>77</sup> Conference transcript, page 14.

<sup>78</sup> *ibid*, page 17.

<sup>79</sup> Spark submission, 17 October 2016, paragraphs [22], [23].

166. At the conference, Spark re-emphasised that there has not been effective regulation for the past 10 years and that they could not see why it would be important now.<sup>80</sup>
167. Regarding the impact of the regulatory event clause in the contracts, Spark said at the conference that it had not thought about its implications in this context.
168. On 4 November 2016, Spark responded in writing to Vodafone's question raised at the conference on whether removing local access and calling services from Schedule 1 (what Vodafone referred to as deregulation) might be considered a "regulatory event" in the context of relevant resale agreements. After obtaining legal advice on the relevant provisions, Spark concluded that:<sup>81</sup>

deregulation would not constitute a regulatory event for the purposes of the relevant arrangements and would not provide Spark with substantive rights to cancel the services or the discounts it provides to RSPs.

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<sup>80</sup> Conference transcript, page 16.

<sup>81</sup> Spark letter to Telecommunications Commissioner "Conference question: local access and calling investigation", 4 November 2016.

## Attachment A Process followed and information gathered

- A1 In Chapter 1 we explained the process we must follow for this investigation.
- A2 The table below provides further detail about the process we followed and the detailed quantitative and qualitative information we gathered from industry participants.

14 July 2016	We commenced this investigation.
20 July 2016	We issued questionnaires to Spark, RSPs who purchase the Resale Services, and FWA providers.
12 August 2016	We received responses to our questionnaires.
July / August 2016	We obtained additional information from industry on substitutes for the Resale Services, and information on competitive constraints that Spark faces in the provision of the Resale Services.
23 September 2016	We published our draft report, in which we set out our proposed recommendation and reasons, and invited submissions and cross-submissions from interested parties.
6 October 2016	We issued a notice to Spark under section 98 of the Commerce Act. <sup>82</sup>
13, 19 October 2016	We received responses from Spark to our section 98 notice.
17 October 2016	We received submissions on our draft report from Spark, Vodafone, Chorus, Vocus, and Trustpower.  Public versions of submissions were published on our website.

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<sup>82</sup> Commerce Commission letter to Spark New Zealand Limited, "Notice to supply information and documents to the Commerce Commission under section 98(a) and (b) of the Commerce Act 1986 (Notice)", 6 October 2016.

26 October 2016	<p>We received cross-submissions from Spark and Trustpower.</p> <p>Public versions of cross-submissions were published on our website.</p>
1 November 2016	<p>We held a conference. The transcript of the conference is available on our website.</p>
3 November 2016	<p>We provided parties with the opportunity to comment on the findings that we had drawn from the information we had received from Spark in response to the section 98 notice.<sup>83</sup></p>
4 November 2016	<p>We received a letter from Spark in response to a question raised by Vodafone and the Commission during the conference on whether removal of the local access and calling services from Schedule 1 might be considered a "Regulatory Event" in the context of resale agreements between Spark and RSPs.</p> <p>A public version of Spark's letter was published on our website.</p>
10 November 2016	<p>We received a response from Trustpower, commenting on the findings that we had drawn from the information we had received from Spark in response to the section 98 notice.</p> <p>A public version of Trustpower's response was published on our website.</p>

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<sup>83</sup> Commerce Commission email, "Commerce Commission - Information provided by Spark New Zealand Limited under section 98 of the Commerce Act", 3 November 2016.

## Glossary

Baseband services	Commercial services supplied by Chorus that allow the delivery of voice services to end users.  The different variants of Baseband services, such as Baseband Copper, Baseband IP and Baseband IP Extended, and their relationship with Chorus' Unbundled Copper Low Frequency (UCLF) are detailed in Attachment A of our draft report.
BBIP	Baseband internet protocol.
CPE	Customer premises equipment.
Designated service	A service described in Part 2 of Schedule 1. Includes both price and non-price terms for access.
DSLAM	Digital Subscriber Line Access Multiplexer
EFTPOS	Electronic funds transfer at point of sale.
FWA	Fixed wireless access.
IP	Internet protocol.
ISDN	Integrated services digital network.
LFC	Local fibre company.
Naked broadband	Retail broadband services that are provided on their own, without being bundled with a voice service.
OECD	Organisation for Economic Co-operation and Development
OSS	Operational Support Systems
POTS	Plain old telephone service is a term used to describe a basic voice service provided over a copper network.
PSTN	Public Switched Telephone Network, as defined in section 5 of the Act.
RSP	Retail service provider.
Specified service	A service described in Part 3 of Schedule 1, which excludes the price payable for access to a specified service.

STD	Standard terms determinations are the Commerce Commission's primary mechanism for regulating telecommunications services under the Telecommunications Act 2001.
TSO	Telecommunication service obligations.
UBA	Unbundled Bitstream Access service is a regulated wholesale service provided by Chorus that connects a customer's premises to the first data switch, and can be accessed by retail telecommunications providers to provide broadband service over the copper line.
UCLF	Unbundled Copper Low Frequency service is a regulated wholesale service provided by Chorus that enables access to and interconnection with, the low frequency band of the copper line (being the frequency between 300 and 3400 Hz) and can be accessed by retail telecommunications providers to provide voice services. The UCLF service is available from an exchange including on cabinetised lines.
UCLL	Unbundled Copper Local Loop service is a regulated wholesale service provided by Chorus that connects a customer's premise to the local exchange and can be accessed by retail telecommunications providers to provide a voice and broadband service over the copper line.
UFB	Ultrafast Broadband is the name given to the Government's initiative to roll-out a fibre access network in New Zealand. The network connects the customer's premises to the retail telecommunications' providers network so they can provide high-speed broadband services and voice over internet protocol (VoIP).
VoIP	Voice over internet protocol is a way to send voice calls over a data connection such as a broadband connection.
Managed VoIP	Managed VoIP service is a publicly available telephone service, using internet protocol, provided through fixed wireless, DSL, cable, and other fixed internet platforms whereby the RSP controls the quality of service provided.
Unmanaged VoIP services	Software-based VoIP applications, offered exclusively as content-based services on a best-effort basis by providers that are not electronic communications providers (for example, VoIP using Skype, Hotmail, or Yahoo Mail). Some allow calls to mobile numbers and landline numbers.