TO: Sasha Daniels, Senior Counsel - Competition & Regulation, Telecom

FROM: Craig Shrive, Sally Fitzgerald and Emma Rae

DATE: 30 April 2014

SUBJECT: UCLL and UBA Final Pricing Reviews

Introduction

1. You have asked us to provide our views on the opinion provided by Chapman Tripp ("**CT**") to accompany Chorus' submission on the Commerce Commission's ("**Commission**") further consultation paper[1] dated 11 April 2014 ("**CT Opinion**"). The CT Opinion responds to advice provided by Dr James Every-Palmer to the Commission ("**JEP Opinions**")**.**[2]

2. Some of the propositions in the CT Opinion are not controversial, and we do not comment on them. The propositions which are prone to a higher degree of debate, and which we respond to in this advice, can be summarised as follows:

   (a) The Commission must carry out a separate TSLRIC process for each of the UCLL, SLU and UBA FPPs. The Commission cannot merge the UCLL and SLU STDs (Propositions (F), (G) and (H)).

   (b) The FPP exercise is about identifying an assumed more efficient price for the (already defined) "service", using TSLRIC. It does not involve the use of TSLRIC to redefine that service. The MEA must be capable of delivering the already defined facilities and functions of the current "service" (Propositions (I), (J), (K), (L) and paragraph 5.3).

   (c) The MEA for UBA must take Chorus' existing layer 1 copper local loop network as a given, and must utilise Chorus' copper network inputs (Proposition (M)).

   (d) Relativity, which incorporates build or buy incentives, is a mandatory relevant consideration (Proposition (O)).

   (e) Backdating of the FPP price is mandatory (Proposition (P)).

3. We also comment briefly on the claim that the avoidance of unnecessary and damaging constraints being imposed on an access provider's economic existence is a relevant consideration as a matter of general rule of law factors, and well as being indirectly reflected in the purpose of the Telecommunications Act 2001 ("**Act**") (Proposition (E)).

Executive Summary

4. Our views in this opinion are based on the following key points:

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[1] Commerce Commission *Further consultation on issues relating to determining a price for Chorus's UCLL and UBA services under the final pricing principle* 14 March 2014.

[2] Dr James Every-Palmer *FPP determination: Issues re service description and the modern equivalent asset* 12 March 2014; and Dr James Every-Palmer *UCLL pricing review determination and backdating the FPP price* 24 March 2014.

(a) The statutory definition of TSLRIC is important, given it provides the only specific legal direction on how to price the service. In our view, it does little more than set out a generic definition of TSLRIC as would be typically used in telecommunications regulation, and there is nothing in the legislative history or elsewhere in the Act that suggests anything other than that such an approach to TSLRIC should be taken.

(b) Not surprisingly, the definition of TSLRIC leaves many decisions to be made by the Commission, exercising its expert judgment in accordance with section 18 of the Act. Consistent with the purpose of TSLRIC (as we understand it) and section 18, the Commission's objective when exercising discretion under TSLRIC should be to set a price that could be expected in a competitive market.

(c) The concept of an MEA does not feature in the Act. We understand the Commission to be using it as a tool under the statutory definition of TSLRIC to assess forward-looking costs in the long run in a manner consistent with section 18. On this basis, the MEA need not (as a matter of law) replicate the full functionality and facilities of the current or existing service, nor is it required to do so. We do not interpret the definition of TSLRIC as placing constraints on the choice of MEA above and beyond what would typically apply under a TSLRIC exercise.

(d) Although it is correct that the Commission must set an FPP price for each service for which a pricing review application has been made, that does not prevent the Commission from using an MEA that is common to each service. Given that an important part of the Commission's task is to allocate common costs between services that share a common network, it may decide that a common model allows it to do that more effectively and avoid double counting risks (which may lead to over-recovery beyond efficient forward-looking costs in the long run).

(e) In particular, we do not interpret the Act as requiring a separate model to be used for UBA, or for that model to be predicated on an assumption that UBA will continue to be provided over the existing network. That is, it would be consistent with the scheme of the Act and the definition of TSLRIC to decide that UCLL and UBA are provided over the same MEA when considering the efficient forward-looking costs of each service.

(f) Although the Commission must consider relativity, it does not follow that this will have an observable effect on its pricing decision.

(g) The Court of Appeal has provided guidance that should inform the Commission's decision on backdating, but backdating of an STD involves materially different circumstances that have not been considered by the courts. Accordingly, the Commission's primary task remains to ensure its decision is consistent with its statutory obligations (section 18 in particular).

Separate Process

5. We agree that the Commission must set a price for each service subject to FPP review, that the Commission cannot merge STDs under the FPP process, and that the service description cannot be amended under the FPP process.

6. However, we are unsure what the CT Opinion means when it states each FPP must follow its own process and cannot be dealt with jointly with another FPP for a separate service, or that although parallel work may be "sensible and efficient", the intellectual work must be done separately for each service.

7. If it means to say that the Commission cannot use the same model to determine a price for each service, then we disagree. Indeed, it seems that using a single model could be the type of sensible and efficient approach the CT Opinion refers to, as our understanding is that the TSLRIC process involves (among other things):

   (a) Identifying all services with shared/common costs;

   (b) Isolating the directly attributable costs for the service being priced; and

   (c) Allocating a share of common costs to that service.

8. In that context, it seems to be generally accepted by all parties that the full network should be modelled given the price of a number of services using that network is in issue.

9. As we discuss further below, this reasoning also applies to the issue of modelling UBA and UCLL - we see no reason why a common (or single) model cannot be used under the Act (if doing so is consistent with TSLRIC and section 18).

The service and MEA

10. We understand the JEP Opinions to say that:

   (a) The service(s) to be priced are the service(s) regulated under the Act and STDs;

   (b) There is nothing in the statutory definition of TSLRIC or the legislative history to contradict the position that TSLRIC should be applied as it would normally be applied by telecommunications regulators; and

   (c) Accordingly, the application of TSLRIC under the Act involves a significant degree of judgment, and may result in a MEA that abstracts from the "nuts and bolts" of the *in situ* service.

11. We agree. It also appears that CT largely agrees (see propositions (I) and (K)).

12. It therefore seems that the essential issue being debated is whether the Act places legal limits on the extent to which abstraction may occur under the TSLRIC exercise. The CT Opinion suggests the degree of abstraction is constrained by a legal requirement for the MEA to replicate the facilities and functions of the existing service (and, therefore, the existing network).

13. In our view the Act does not constrain the choice of MEA in this way. In summary, our reasons are that:

   (a) The FPP is TSLRIC as defined in the Act. We understand that the statutory definition of TSLRIC is consistent with the typical application of TSLRIC in telecommunications regulation;[3]

[3]See for example the application of TSLRIC by the Australian Competition and Consumer Council in the regulation of telecommunications access prior to 2012: ACCC *Domestic Mobile Terminating Access Service*

(b) The Act is silent on the concept of an MEA. However the definition of TSLRIC requires determination of "forward-looking costs over the long run". If the Commission is using the MEA to help determine efficient forward-looking costs over the long run (as seems to be accepted as the right approach in the CT Opinions at paragraph 5.3 and 20), then the long run nature of the forward-looking exercise suggests that ensuring the existing or current functionality is replicated is not the correct approach when determining an MEA, especially if that will result in the inclusion of costs that are not efficient forward-looking long run costs;[4]

(c) The Commission must exercise judgment and discretion to determine which MEA is likely to provide the best evidence of the efficient forward-looking costs of the services subject to the FPP process;

(d) So long as the MEA adopted is consistent with the definition of TSLRIC (eg it is capable of providing evidence of efficient forward-looking costs of the service), it is not possible to say that, as a matter of law, the MEA nevertheless cannot be adopted by the Commission; and

(e) When choosing between alternative MEAs that are consistent with the definition of TSLRIC, the Commission must make its decision in accordance with sections 18 and 19 of the Act.

14. We understand that, generally speaking, TSLRIC was developed as a methodology to determine the efficient forward-looking costs over the long run of providing a service, on the basis that it would produce a regulated price at the "competitive level".[5] Although economists may debate the efficacy of TSLRIC in meeting that objective, the fact that Parliament has directed that TSLRIC be used demonstrates its view that TSLRIC best meets the section 18 purpose. In making that deliberate and specific choice of methodology, it is reasonable to infer that Parliament knew that, among other things, TSLRIC is not designed to allow the recovery of the regulated supplier's actual costs, including those costs associated with the supplier's existing investments. Instead, it requires a significant degree of discretion and judgement to be exercised by the regulator to determine an estimate of costs that will translate into a price that would be charged in a competitive market (consistent with section 18).

15. Against that background, key aspects of the definition of TSLRIC to note are:

(a) It requires a determination of the forward-looking costs of the total facilities and functions that are directly attributable to, or reasonably incremental to, the service, taking into account provision of other services; and

(b) It must include a reasonable allocation of forward-looking common costs, which is defined to mean costs that are efficiently incurred in providing the service but

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Pricing Principles Determination and indicative prices for the period 1 January 2009 to 31 December 2011 March 2009.

4 We note that the Commission has not clearly set out in its consultation papers what it believes the purpose of the MEA to be. It has simply stated that TSLRIC requires it to determine an MEA. We also note that Vodafone's most recent submission points out that the Commission has yet to set out a clear approach or framework for selection of the MEA: Vodafone New Zealand *Comments on further consultation papers on issues relating to determining a price for Chorus' UCLL and UBA services under the Final Pricing Principle* 11 April 2014 at paragraph C1.

5 See for example: Brian Williamson *Access Pricing in Telecommunications – Time to Revisit LRIC?* January 2004 at page 1.

which are not directly attributable, and specifically excludes any costs in relation to TSO instruments.

16. Based on our understanding of how TSLRIC is typically applied by regulators, the Act does little more than define TSLRIC (plus) as is commonly understood (eg TSLRIC plus an allocation of common costs). That is, it is simply a generic definition of TSLRIC.

17. Accordingly, the TSLRIC definition leaves much to the expert judgement of the Commission. For example:

    (a) How are forward-looking costs to be determined? What type of costs are to be included?

    (b) What are directly attributable or reasonably incremental facilities and functions?

    (c) How must other services be taken into account?

    (d) How should common costs be reasonably allocated?

18. We do not think it is possible to reasonably infer that Parliament intended a particular answer to such questions, or that it intended to place implied legal constraints on how TSLRIC would normally be applied by regulators. In our view, these are the types of matters on which Parliament intended the Commission to exercise its judgement, in accordance with sections 18 and 19 and how TSLRIC is typically applied by regulators.

19. In that context, we note that sections 49 and 52 provide that the draft and final determinations must include a price which, **in the opinion of the Commission**, is determined in accordance with the FPP. This wording demonstrates Parliament's understanding that the application of the FPP is not an exact science, by expressly providing that the Commission may exercise discretion when deciding whether a price has been determined in accordance with the FPP.

20. We expect that when applying TSLRIC the Commission will have to make a diverse range of choices to determine efficient forward-looking costs over the long run, including determining cost of capital, operating costs, depreciation, and an allocation of common costs. MEA appears to have been developed as a tool under TSLRIC that assists regulators to apply TSLRIC to determine an efficient estimate of forward-looking capital costs.[6] Conceptually, it would be a strange outcome if the definition of TSLRIC directed the Commission to apply one element of a TSLRIC methodology in a very specific way, but was silent on any of the other key elements typically determined when a regulator is applying TSLRIC.

21. The CT Opinion nevertheless argues that the MEA adopted under the application of TSLRIC must be capable of delivering the facilities and functions of the service as defined by Schedule 1 and the STD. This seems to be based on the proposition that applying TSLRIC cannot be used to redefine the service subject to the FPP.

22. The latter proposition is correct, but in our view it still does not follow that the MEA must replicate the existing functionality of the network, as a matter of law. However the scope of the service to be priced is legally defined, the specific choices made by the Commission to obtain the TSLRIC based price for that service are not legally defined, as discussed above.

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[6] We understand MEA originated as a generic asset valuation technique rather than being specific to TSLRIC (see for example: OfCom *Alternative methodologies for the valuation of BT's duct assets* 2 March 2010).

23. Accordingly, when the CT Opinion says that "it cannot have been a legislative intent that the service to be the subject of the PRD exercise would be one which (in the relevant hypothesis) was inconsistent with, or assumed away, such functionality", it appears not to consider that developing an MEA ***is part of*** the PRD exercise, and not the PRD exercise in itself. Even if it was the case that the MEA did not have the full functionality of the service being priced (or was capable of greater functionality), it does not mean that the MEA is incapable of providing evidence to feed into the broader TSLRIC calculation. Indeed, we think it is open to the Commission to decide that an MEA that does not replicate all of the functionality of the existing network and / or service provides the best evidence of forward-looking costs over the long run (that is, evidence of a price that could be expected in a competitive market).

24. In conclusion, it is important to be clear regarding the distinction between legal requirements under the Act, and the economic tools engaged to fulfil those legal requirements. The latter involve abstraction and hypothesising, the very purpose of which is to develop an MEA that represents a modern efficient network, which is very likely to be different to (and typically more efficient than) Chorus's existing network. We do not read the Act as imposing any constraints on that process in addition to what would typically apply under a TSLRIC exercise.

25. We understand that a range of potential MEAs may be available. Again, in our view, the Act does not dictate the choice of MEA. Rather, the key question for the Commission is whether its choice of MEA in consistent with applying the statutory definition of TSLRIC to the service for which a price is being determined, such that it will contribute to establishing the best estimate of the efficient forward-looking costs over the long run of the service.

The service question

26. The CT Opinion also seeks to establish the scope of the facilities and functions provided by the service(s) subject to the FPP. We note that:

    (a) The legal descriptions of the UCLL and UBA services do not, on their face, require the level of functionality argued by Chorus (and in the CT Opinion). Nothing in the Act or STDs goes into the level of detail regarding the nature of functions that are currently being debated. Accordingly, even if it was correct that the MEA must replicate the functionality of the existing service as defined in the Act and/or STD (which we do not consider to be the case), the level and extent of functionality being sought by Chorus does not appear to be required by the Act or STDs;

    (b) This may be why, when discussing the legal requirements for service functionality, CT relies on a "legislative intent or expectation" and/or the context that access seekers will be using the existing service, and have reflected and relied on aspects of the functionality in their own services. However:

        (i) No basis or authority is provided for inferring that legislative intent or expectation;

        (ii) As the CT Opinion states, the FPP process should not be used to redefine the nature of the service regulated under the Act;

        (iii) It is not relevant to the debate regarding the choice of MEA (as discussed above).

27. In particular, the CT Opinion states that the MEA must be capable of providing TSO functionality. However, even if it was assumed that meeting TSO requirements required continued use of copper (we understand that it does not), we do not see how that is a valid basis for informing the choice of MEA. Costs incurred to meet TSO obligations are clearly to be excluded from the TSLRIC exercise, as they are expressly excluded from the statutory definition of forward-looking common costs.[7]

28. If providing TSO functionality is not a relevant cost when ascertaining the TSLRIC of a service, then we do not see how providing TSO functionality can inform the choice of MEA.

29. In that context, we think it is appropriate for the Commission to consider whether any claimed functionality of the existing service is relevant to assessing Chorus' efficient forward-looking costs over the long run of providing the UBA or UCLL services, which it could expect to recover in a competitive market. If not, then there appears to be no reason for such functionality to inform the choice of MEA. For example, does providing a UCLL service which supports low-speed data services impose additional cost on an access provider in comparison to a UCLL service that did not include that functionality?

MEA for UBA

30. The FPP for UBA refers to the same statutory definition of TSLRIC as used for UCLL.

31. Accordingly, following the analysis above, in our view there is no basis for the proposition that the Act directs the choice of MEA for UBA (and specifically, that it must be modelled on the existing copper network).

32. As for UCLL, the determination of the MEA for the UBA service is a matter subject to the Commission's expert judgment. The fact that the Act requires TSLRIC to be applied to the "additional costs" of UBA does not legally direct the choice of model. The Commission's task remains to establish a price based on the efficient forward-looking costs of the UBA service.

33. Those costs include the efficient costs of the unbundled local loop over which UBA is provided. Accordingly, the Commission may decide that an efficient UBA service would be provided over a new MEA layer 1 network, to ensure that inefficiencies in the existing layer 1 network do not create an inefficient UBA price.

34. Put another way, we think it is wrong under the Act to conceptualise UBA as being provided over the unbundled local loop in a manner that is different to UCLL. Both the UBA and UCLL services are provided over the same unbundled local loop network (with UBA having additional functionality). Accordingly, if it is correct to abstract from the existing network to determine TSLRIC for UCLL, it must be correct to do the same for UBA.

35. This would be the case even if the UBA service was subject to an FPP in isolation (ie there was no parallel UCLL process). However, given that the UCLL and UBA FPP processes are occurring in parallel, in our view, the Commission has an opportunity to use the same model to, among other things, ensure the most efficient allocation of "additional costs" to UBA and to avoid double recovery of costs between the UCLL and UBA services.

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[7] Telecommunications Act 2001, schedule 1, section 1.

Relativity

36. It is clearly the case that relativity between UCLL (as defined in the Act) and UBA is a mandatory relevant consideration. However, we note that:

(a) If the prices for UCLL, SLU and UBA are set using TSLRIC, it is difficult to see what further adjustment may be required to give effect to the relativity consideration;

(b) The High Court recently decided that, in the context of section 18, it will not always be the case that a mandatory relevant consideration will have an observable impact on every decision made by the Commission.[8] In that case, the decision in issue was essentially evidence-based, which meant it was not susceptible to adjustment on section 18 grounds. Similarly, the Commission could decide that prices determined under TSLRIC are not susceptible to further adjustment on relativity grounds (compared to, for example, prices set under the IPP where further adjustment may be warranted); and

(c) It may therefore be difficult for the Commission to find evidence that further adjustments to TSLRIC prices are justified for the purpose of ensuring relativity.

Backdating

37. The CT Opinion does not cite any authority for Proposition (C),[9] as elaborated on in paragraph 9 of the opinion. As we understand it, the proposition is that the distinction between "ratio" and "obiter" is irrelevant, and the Commission must adhere to any "judicial exposition" of a superior court - namely a reasoned judgment analysing aspects of a statute and stating their purpose and effect.

38. In our view, Proposition C can do no more than explain the normal position that:

(a) The Commission must apply relevant statutory provisions and act consistently with its statutory powers; and

(b) When considering how to apply or interpret its statutory powers, the Commission must consider whether there is court guidance on how to properly do so. That will require careful consideration of the scope and extent of a court's decision.

39. In the case of backdating, our view is that the Commission will need to balance the following considerations:

(a) the Act is silent on backdating;

(b) the Court of Appeal has clearly stated that an FPP price should be treated as being more efficient than the IPP price it replaces (as stated in Proposition (F) of the CT Opinion);

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[8] *Chorus Ltd v Commerce Commission* [2104] NZHC 690 at [135].

[9] Proposition (C): Insofar as the courts have analysed and opined on the purposes and provisions of the Act, including in deciding various issues that go to making a PRD, that discretion is not unfettered but must be exercised lawfully, rationally, having regard to the section 18 purpose, the Act as a whole, and other relevant considerations.

(c) The Courts have not considered how backdating should be applied in the materially different circumstances of an FPP for an STD (as elaborated on in the JEP Opinions); and

(d) Backdating will amount to giving the FPP determination retrospective effect. In that context, we are surprised that Proposition (P) of the CT Opinion states that the FPP determination should be presumed to operate retrospectively "in the absence of some truly extraordinary countervailing considerations". The normal legal presumption is against retrospectivity, which can only be rebutted by clear statutory intent.

40. Ultimately, the Commission will need to decide whether backdating is consistent with section 18 in all the circumstances (as set out in the JEP Opinions).

Unnecessary constraints on economic existence

41. Proposition (E)[10] is raised as a foundational non-controversial proposition. In that context, it is not clear how it is intended to impact on the Commission's task under the FPP processes. Although it is fair to assert that unnecessary and damaging constraints on an access provider's economic existence should be avoided where possible, we note that:

(a) The Act gives the Commission power to set prices for monopoly services - it is an invasive form of regulation and by its very nature will result in constraints on the access provider's economic interests. It should be expected to result in prices that are different (lower) than what would be charged in the absence of regulation;

(b) So long as the Commission acts in accordance with its statutory mandate, the constraints will not be "unnecessary" (we understand the CT opinion to accept this point); and

(c) If this proposition is intended to amount to an assertion that there is a proportionality standard to be applied under section 18 (such that the greater the extent of regulatory intervention, the higher standard of justification required), then this was recently doubted by the High Court.[11] We do recognise that a proportionality argument could be more relevant when considering whether to remove regulation where competitive market forces have emerged to place an alternative constraint on the regulated firm. By contrast, where the regulated firm has no competitive constraint on its access pricing, it is incumbent on the regulator to set a price that would prevail in a competitive market, consistently with section 18.

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[10] Proposition (E): While the purpose of the Act is to provide for regulation of certain designated telecommunication services, and the provisions of the Act are paramount, the avoidance of unnecessary and damaging constraints being imposed on an access provider's economic existence is a relevant consideration as a matter of general rule of law factors, and well as being indirectly reflected in the purpose of the Act.

[11] *Chorus Ltd v Commerce Commission* [2104] NZHC 690, at [165] - [170].