

## Cross Submission

In response to the Commerce  
Commission's Consultation on  
setting prices for service  
transaction charges for UBA  
and UCLL services  
(25 September 2014)

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## **1. Introduction**

1. WIK-Consult has been appointed by Spark and Vodafone New Zealand (“Vodafone”) to support both companies in the course of the further cost modelling and FPP process of the Commission. Nevertheless, this cross submission is brought to the attention of the Commission as an independent expert report.
2. This cross submission statement should be read in connection with our submission from 8 October 2014 to the Commission’s Consultation paper on transaction charges. We do not repeat the analysis presented there in this paper.
3. We will address only selected questions which are raised in the submissions of market participants in New Zealand. We will mainly comment on methodological aspects of pricing and costing of transaction charges and will not comment on more legal aspects and aspects of particular transaction services.

## 2 The economic importance of transaction and ancillary service charges

4. Transaction charges are imposed to RSPs (and finally their customers) in addition to the recurring monthly UCLL and UBA charges. Transaction charges are “event-driven” in the sense that they are caused by events like connections, transfers, interference investigations or cease of service. Therefore, according to proper cost causation pricing principles they are generally non-recurring or one-off charges. Transaction charges are costs of using a wholesale service in the same way as and in addition to the recurring charges.
5. Insofar as wholesale transaction charges are not wholly or partially passed on by RSPs to their final customers they have to be recovered by recurring retail prices over the customer lifetime. This consideration allows to identify the economic burden of transaction charges to RSPs and their relevance and importance as part of the level of wholesale and retail prices.
6. Let us assume a customer lifetime of 30 month, a period which has currency in the New Zealand market, and, purely for the sake of illustration, a WACC of 10%. In the case of a new connection for UCLL where a site visit is required a transaction charge of \$155.10 is applied. In case no site visit is required a reduced transaction charge of \$70.46 becomes relevant. Distributing these transaction charges equally to the customer lifetime by means of an annuity formula leads to a monthly burden of \$5.86 (or \$2.66 in cases without site visit). This means transaction charges cause an uplift of 24.93% (11.33%) on top of the (geographically averaged) monthly UCLL recurring charge of \$23.52.
7. Using the UBA service also requires a connection service which amounts to \$15.85 in case of a remote connection. If an exchange or cabinet visit is required the connection charge increases to \$73.51. If an additional site visit (end-users premises) is necessary the transaction charge increases to \$169.73. If during the lifetime of a customer a transfer from one broadband service to another occurs an additional transaction charge of either \$15.85 or \$73.51 will be applied depending on the specific circumstances. In total the maximum transaction charges possible in these scenarios (which are of course only individual examples) amount to \$89.36, \$147.02 or \$243.24 respectively. Transposing these transaction charges to recurring costs on the basis of the same assumptions as in para 6 leads to a maximum monthly transaction charge burden of \$3.38, \$5.56 or \$9.20 respectively.
8. The tremendous impact which the change in transaction charges might have on the total wholesale cost of UBA can be demonstrated at the example of the proposed price change by Chorus for installing a splitter in the home. Chorus has proposed to increase this VDSL related transaction charge from \$145.05 to \$284.75. If this proposed price change of +96.3% would become reality the corresponding monthly

- burden for that transaction charge would increase from \$5.48 to \$10.77. This would imply an increase of the UBA total incremental service charge from \$16.40 (\$10.92 + \$5.48) to \$21.69 (\$10.92 + \$10.77). This is an increase of the total incremental charge by 32.2%.
9. This financial impact analysis clearly demonstrates that the Commission should give transaction charges and the costs of it (at least) the same attention as it intends to give to recurring service charges. Compared to the heated and complex debate and considerations on the UBA IPP price determination it becomes obvious that transaction charges (and potential changes of these charges as intended by Chorus) may more than off-set any efficiency considerations generated from bottom-up modelling of recurring services. The impact analysis also demonstrates that the Commission should clearly control the costs of all relevant transaction services. If the Commission leaves major transaction charges to the commercial considerations of Chorus, this may counterbalance efficiency gains of cost modelling. This holds in particular when erratic increases of (unreviewed or unregulated) transaction charges occur which seems to be the current pricing policy of Chorus.
  10. The financial burden analysis presented so far even underestimates the economic impact of transaction charges for four reasons:
    - (1) Customer lifetime is not a fixed number but a distribution of lifetimes over a variety of lifetimes. Therefore transaction charges increase the risk of RSPs.
    - (2) Transaction charges generate switching costs and therefore cause negative impacts on competition.
    - (3) RSPs cannot verify all transaction charges properly.
    - (4) Uncertainty due to the pricing of certain ancillary services on a POA basis.
  11. Different to the monthly recurring rental charges transaction charges have to be paid upfront by the RSP to Chorus. If they are not passed to the RSPs final customers directly transaction charges have to be earned over the customer lifetime. Economically they are therefore representing an investment into a customer. The profitability of this investment depends on the actual lifetime of a particular customer compared to the calculated lifetime which can deviate in one or the other direction. Insofar there is an economic risk involved which among others depends on the level of the transaction charge.
  12. Different to recurring wholesale charges one-off transaction charges cause switching cost. To keep its customer base the RSP has to win a new customer which causes additional transaction charges. Transaction charges incentivise RSPs to engage in retention measures and corresponding expenditure. This is not the most efficient way of price competition and competition in general.

13. Compared to the transparent structure of monthly recurring charges transaction charges are often hard to predict, to calculate and to verify for an RSP. The necessary information to check if the invoiced charges reflect the appropriate categories of work and service are usually only in the hand of the wholesale service provider. For example, the access seeker does not know whether a site visit is really necessary to connect a new customer. These factors contribute to unpredictability and intransparency of transaction charges.
14. For some ancillary services the relevant charges are unknown to an RSP because they are priced on a POA basis. The charges for such services are not only unknown, it is also not guaranteed that they reflect cost efficient service provision. There is no incentive for the access provider to produce an ancillary service cost effectively if it is priced on a POA basis. Even though Chorus has to use all reasonable efforts to provide an access seeker with two or more competitive quotes that does not solve the problems. Two quotes do not necessarily guarantee a competitive outcome. We would recommend to avoid charging on a POA basis as far as possible. Furthermore, access seekers should have the option for outsourcing the service and to produce it or manage the production of such services themselves. Also price corridors or input cost restrictions may be imposed.



### 3 Proper costing of transaction charges

15. Chorus favours a top-down approach to TSLRIC “*that starts with service company charges and overheads and enables the Commission to test for efficiency*”.<sup>1</sup> This top-down approach according to Chorus “*reflects the real-world costs of providing these services in New Zealand*”.<sup>2</sup> Prices of service companies were set by competitive tender. Chorus claims that such a pricing approach for transaction charges is consistent with TSLRIC.
16. We disagree with Chorus’ conclusion that its approach is consistent with TSLRIC. It is definitively not. Chorus is just requesting the compensation of its actually occurring costs. The TSLRIC approach is rather different. It requires from the Commission to identify the efficient cost of efficiently structured transaction processes. We have shown in our submission paper a variety of reasons why the current service charges will not be efficient and that the inherent incentive structures do not motivate Chorus sufficiently to keep such costs at an efficiently low level.<sup>3</sup> For the reasons we presented in our submission the Commission cannot simply regard the service companies’ charges as representatives of efficient costs. This has to be tested, checked and challenged by the Commission.
17. Chorus claims to be “*very transparent about third party charges*”.<sup>4</sup> Chorus also concedes that there is no one-to-one relationship between third party charges and transaction charges. In any case it needs a mapping of the service company charges to the transaction charges. Furthermore, in the Appendix 1 to its submission Chorus reveals that some transaction processes need simultaneous steps by Chorus and the service company. This means that a variety of allocation steps are necessary to transpose cost elements of the service company and of Chorus to achieve the relevant costs of the individual transaction services. These allocation procedures have to meet the proper TSLRIC allocation standards which the Commission has to check in detail. This step can only be conducted once the Commission has verified (or not verified) the efficiency of the individual transaction and ancillary service process as such.
18. Chorus seems to assume that all its transaction processes are efficient and the actual costs represent the efficient costs in a TSLRIC sense. Therefore Chorus proposes “*The Commission should adopt a top down methodology based on service company charges as an input to its cost model, with an allowance for overheads and a mechanism to adjust prices if the underlying cost inputs change or if there are changes in the relevant pricing index.*”<sup>5</sup>

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1 Chorus submission of 9 October 2014, para 6.

2 Chorus submission of 9 October 2014, para 7.1.

3 See WIK-Consult submission of 8 October 2014, para 19ff.

4 Chorus submission of 9 October 2014, para 6.

5 Chorus submission of 9 October 2014, para 35.

19. We agree with Chorus' general view of the price review process: "*This price review process should assure our customers that the transaction charges the Commission sets are efficient*".<sup>6</sup> At the same time Chorus is warning against price changes in saying that Chorus approach " ... *reflects the industry's current price structure mitigating the risks of shocks in the market ...*".<sup>7</sup> It is the nature of any regulatory costing and cost control approach that it usually leads to price changes compared to the previous ones. This is a rather probable outcome if the underlying charges have not been controlled before at all or have been controlled on the basis of a different methodology. The risk of shocks in the market may become relevant if the costing approach of the Commission may lead to significant price changes compared to the existing charges. Whether such risks are relevant can only follow from a thorough impact analysis the Commission has to conduct in such a situation. The need for price change as such is not a reason for a shock in the market.
20. Chorus is arguing that the Commission only has to review prices for core transaction charges set in the IPP determinations, because other charges are already priced at cost.<sup>8</sup> In Chorus words: "*Other sundry charges are priced on a cost basis, including in many cases taking the service company input with additional charges to cover administrative costs and common costs with a mechanism to reflect changes in the input costs.*" We disagree. It is the nature and the purpose of regulatory price setting to check and/or to set prices such that they reflect the relevant costs. That is today not guaranteed for sundry services for the same reason as it is for core transaction services. Charging for administrative and common costs on top of service company costs alone give reason enough at least to check for and to exclude double- or over-recovery of costs. We have questioned the simple use of service company charges already in the context of core transaction services.<sup>9</sup> The same critical arguments hold for sundry charges. In particular it is not appropriate to inflate charges over time "*to reflect changes in input costs*". Efficiency improvements over time are also relevant in the context of sundry charges and should be reflected in the price determination.
21. Chorus is claiming to receive an allowance for overheads on top of service company charges.<sup>10</sup> In its submission Chorus justifies its own overheads as cost for its own back-office function.<sup>11</sup> "*It includes, for example, the software licenses of our IT infrastructure, non-infrastructure net personnel costs, and a portion of our corporate property expenditure.*" It remains unclear from this description whether and to what extent these "overheads" are related to the transaction services. Unless there is not a separately identifiable service provision element of the transaction service provided by Chorus the Commission should not allow for a general compensation of

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<sup>6</sup> Chorus submission of 9 October 2014, para 7.3.

<sup>7</sup> Chorus submission of 9 October 2014, para 7.3.

<sup>8</sup> Chorus submission of 9 October 2014, para 15.

<sup>9</sup> See WIK-Consult submission of 8 October 2014, para 19ff.

<sup>10</sup> Chorus submission of 9 October 2014, para 35.

<sup>11</sup> Chorus submission of 9 October 2014, para 39.

- overheads because that might imply a double- or over-recovery of the same service element costs.
22. Additionally Chorus states in relation to its outsourcing of overhead services, that “*If we insourced the service that the service companies perform the result would be that, although we would not be incurring any service company overhead, our own internal overhead would simply increase (i.e. this would just shift cost)*”.<sup>12</sup> This statement in connection with Chorus statement, that processes have been outsourced in tendering processes to several service partners generally reflects Chorus assumption, that the outsourced processes are not subject to economies of scale and scope. For processes which require driving to different locations it may be true, that distance efficiency gains maybe overcompensated by losses of economies of scale and scope if several service companies are involved. For overhead processes on the other hand these distance efficiency gains do not occur and we do not agree with Chorus’ assumption, that these outsourced processes are not subject to economies of scale and scope. In other words: Before checking the efficiency of outsourced processes it has to be checked if it is efficient to outsource processes at all.
23. Chorus is rejecting the bottom-up costing approach because of its complexity and time requirements. Chorus then is arguing that “*the act of measurement may itself distort the performance*”.<sup>13</sup> We disagree. All the points and criteria mentioned in this context (by Chorus) have to be taken care of when conducting a proper bottom-up costing. When that is done properly the performance of the costing approach is by no means distorted but just a proper application of bottom-up costing. The other way around is essential. If Chorus is unable to provide the relevant data it is referring to in para 42 of its submission, the Commission would be unable to check the efficiency of Chorus’ cost in a top-down approach. Thus, Chorus has to generate the information and data it is referring to in para 42 of its submission and has to provide these data to the Commission so that the Commission can do its regulatory costing job properly.
24. Chorus is arguing in para 60ff. that bulk rates are not justified for UBA transaction charges. This may hold insofar as fully automated remote processes are concerned. Connections which require exchange or cabinet visits and port changes at the DSLAM, however, face the same economies of scale and scope as the corresponding UCLL transaction services. This should be reflected in the pricing structure by appropriate bulk rates.

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<sup>12</sup> Chorus submission of 9 October 2014, para 40.1.

<sup>13</sup> Chorus submission of 9 October 2014, para 41ff.

## 4 Cost efficiency adjustments

25. WIK presented in its submission of 8 October 2014 cost efficiency adjustments regarding transaction services as practiced by some NRAs in Europe. We would like to add a few more details in order to inspire the further charge review process by the Commission in New Zealand.
26. In a competitive market a firm operates at efficient costs. Furthermore, competition forces a firm to realise productivity gains, and to pass those gains on to its customers by lower prices after accounting for unavoidable changes in input prices and compensation for input price volatility risk. Due to its market position Chorus is not under pressure to operate at efficient cost and to pass over productivity gains to access seekers. Regulation has to take care for both aspects of efficiency improvements. In a pragmatic approach the Commission may set an efficiency improvement factor X which should take care of the need to bring down transactions charges to their efficient level and to pass over future productivity gains to access seekers.
27. In the UK charges are calculated on the basis of a price cap methodology including an X-factor, which considers efficiency gains to be achieved by the access provider. This approach can be introduced to New Zealand in a simplified way by starting from Chorus current transaction charges and applying an efficiency gain factor requiring price decreases in real terms.
28. In a pragmatic approach the Commission may use international benchmarking to find a relevant value for the efficiency improvement factor regarding transaction charges in the following sense: On the basis of a transaction charge price benchmark over time the Commission can identify the transaction charge development in a variety of benchmark countries. The price path in real terms, e.g. identified by nominal transaction charges corrected by a consumer price index, is an appropriate indicator of the implied efficiency improvements in other jurisdictions.
29. The approach suggested in para 26ff. can only be an interim solution until the Commission has developed its own bottom-up approach for calculating efficient transaction charges which would be definitively the first best approach and which we strongly recommend to introduce in New Zealand.